The University of the Witwatersrand

LEGAL ASPECTS OF THE CURRENT FRAMEWORK REGULATING DIRECTORS’ AND SENIOR MANAGERS’ INDEMNIFICATION AND DIRECTORS' AND OFFICERS' LIABILITY INSURANCE IN SOUTH AFRICA

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DECLARATION

The author, Siphephelo L Mbuli, declares that this thesis is his unaided work and represents his ideas and opinions. This thesis has not been previously submitted for academic examination for any qualification.

Signature: ____ *SL MBULI* Electronic Signature _________

Date: ________14 May 2025___________

Johannesburg.

DEDICATION

To Him: ‘It matters not how straight the gate,

How charged with punishments the scroll,

You shall remain the Master of my fate, and

You are the Captain* of my soul!’

To aMalindisa amahle: oMakhunga – slima saka noNtekeni – Ndlolothi – May the Lord bless and keep thee, the Lord make His face to shine upon all thee, and be gracious unto Thee – The Lord lift His countenance upon Thee all, and grant Thee peace!

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ABSTRACT

There is a measure of controversy and tension as to the conflicting imperative to shield directors and officers from personal liability for damages in the event of bona fide negligent breaches of their duties and the ever-increasing need to hold those in effective management of corporations accountable, especially considering recent local and global corporate failures. In regulating this position, the legislature in section 78(2) of the Companies Act 71 of 2008 has retained a framework introduced by the Companies Act 23 of 1939. The effect of these provisions, which have survived the recent reform of corporate laws, is that they further entrenched the prohibition against exemption clauses in articles of a company or any agreement which purports to exempt directors and senior managers against liability which, in the absence of such provision, would by law attach to the director or officer in respect of any negligence, default, breach of duty or breach of trust. The research is interested in the convergence or interplay between ethical principles, such as good faith and the law. While the law is clear on the standard of care expected of directors and senior managers and the liability consequences that follow for violations of this duty the question remains whether it also provides adequate protection to directors and senior managers that are prepared to take aggressive good faith risks aimed at maximising value for all relevant stakeholders including the company. The current enforcement framework permits indemnification through liability insurance and the business judgment rule as the main protection available to directors and senior managers for certain permissible faults or breaches of applicable standards. The rationale for the continued prohibition of exemption clauses is unclear. The findings reveal that the current framework does not provide adequate protection to directors and senior managers when they are compared with their counterparts in jurisdictions that make provision for both the inclusion of exemption clauses and indemnification through liability insurance. It is recommended that it is an opportune moment for policy makers to revisit the continued blanket prohibition against exculpatory clauses and to develop methods further that protect directors and senior managers from catastrophic personal financial liability for honest errors of judgment. Re-envisioning the response and model to the director or insurance crisis that may ensue if fiduciaries are held liable and insurance and the business judgment rule are found to be insufficient. These methods will be central to the objectives of transforming and expanding the pool of talented individuals willing to serve in corporate positions on the boards of South African companies.

UKUFINYEZWA (ISIZULU)

Kukhona ukudideka nobu nzima ngenhloso obuvela uma sizama ukuvikela abaqondisi na ba phathi ezindlekweni lapho uma benze amaphutha amsulwa noma nezibopho zabo kanye nesidingo esibalulekile soku qiniseka ukuthi baphathe izinkampani ngokomthetho kakhulu uma kubekwa ukuwa kwezinkampani aNingizumu Afrika nangaphandle. Ukugwema lokhu, isishayamthetho ku-section 78(2) weCompanies Act 71 of 2008 sigcine uhlaka olwethulwa yi-Companies Act of 1939. Imithelo yalemibandela, esamile nokushintsha kwemithetho yezinkampani, ukuthi iyaqhubeka igcizelela ukuvimbela ukuvunwa ezivumelwaneni zenkampani ezivuna abaqondisi nabaphathi benkampani ukuthwala izindleko ngokomthetho uma kwenzeke ubudedengu, noma ukuphulwa ukwethembeka. Loluphenyo lubheke ka khululu ukuhlobanaba noma ukwenzeka phakathi kwezimo zokuziphatha ezifana nokwethembeka kanye nokwenza izintho ngokusemthethweni. Umthetho ubeka obala okulindelekile kubaqondisi kanye nabaphathi kanye nemiphumela yezindleko ezilandelayo njegemiphumela yokuphula imigomo, umbuzo omile ukuthi loluhlaka liyakhona yini ukuvikela abaqondisi nabaphathi uma bethatha izinqumo ezihlose ukunyusa inzuzo kuzozonke iziphathamandla kanye nenkampani uqobolwayo. Ukufakwa kwaloluhlaka muva nje kuvumela ukukhululwa ngokomshwalense wezindleko kanti futhi izimiso zezinqumo zebhizinisi yizo zodwa njenge zindlela ezikhona ukuvikela abaqondisi nabaphathi emaphutheni avumelekile noma ukuphula imigomo ebekiwe. Umqondo oqhuba ukugwema kokuvunwa kwabaqondisi nabapathi awucacile. Imphumela yocwaningo ngohlaka iveza ukuthi alunikezi ngokuvikwelwa kwa bapathi neziphathamandla uma beqhathwaniswa nonozwakabo abasezindaweni ezivumela kokubili ukuvunwa nomshwalense. Iseluleko esiqhamukayo sithi yisikhathi esifanele ukuthi abapathi mthetho baphine bavakashele umthetho onqabela ukuvunwa kwabaqondisi nabaphathi nano kuthi baqhamuka nezindlela ezintsha zokuvikela abaqondisi nabaphathi ezindlekweni ezibucayi ezivela njengemiphumela yamaphutha amsulwa ezinqumo abazithathayo. Ukubeka kabusha ezwini lokuphendula kanye nokwakha icebo logwema inhlekelele engehlela abaqondisi nabaphathi lapho betholakala benecala lobudedengu kanti futhi lapho umshwalense unganelanga ukubavikela ezindlekwni. Lama cebo abalulekile ukufeza izinhloso zokuguqula nokuvikela abaqondisi nabaphathi abaqavile futhi abazimisele ukuthatha izikhundla sokuzinikela ukusebenza emabhodini ezinkampani zaseNinguzimi Afrika.

KEY TERMS

Business commercial decision, Business judgment rule, Company, Directors, Duty of care, Exculpatory Clauses, Liability, Liability Insurance, Indemnification, Senior Managers, Delaware, United Kingdom.

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CHAPTER 1

INTRODUCTION AND RESEARCH METHODOLOGY

1.1 Introduction

A complex question that remains for jurists concerned with corporate law (both locally and internationally) is the interaction between the imperative to enforce rules and proprietary standards on directors and senior managers necessary for the promotion of corporate governance and the need, in certain limited instances, to shield directors and senior managers[1]

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[1] The words 'prescribed officer' and 'senior manager' are both used, and the same meaning should be denoted to these terms. The title refers to 'directors' and 'senior managers'. The title also refers to 'indemnification of and directors' and officers' liability insurance. The Companies Act 71, as amended ("the Act"), which came into operation on 1 May 2011, defines the terms 'director' and 'prescribed officer'. The Act introduced the concept of 'prescribed officer' into South African company law. Throughout this thesis, the link and/or relationship between the terms, their meanings, import and implications are sought to be explained in simple language, and more critically, why the classifications are unique and important in understanding the thrust of this research paper and its arguments. For example, even though directors are also technically company officers. However, not every company officer is necessarily a 'director'. The distinction can be muddied in semantics and language. However, the definitions are important for company law and the question of accountability, there are subtle nuances that have to be appreciated. See sections 1 and 66(10) read together with Regulation 38 of the Act. See also Botha M 'Are senior managerial employees prescribed officers in terms of the Companies Act 71 of 2008, and are they treated the same as executive directors? (2012) 4 TSAR 786 at 787, wherein the extent to which the term 'prescribed officer' includes senior managerial employees is discussed. See also Idensohn K 'The Meaning of 'Prescribed Officer' Under the Companies Act 71 of 2008' (2012) (4) *SALJ* 717 – 735 at 718. However, not all 'senior managers' are 'prescribed officers' and Idensohn points out that the question of whether the definition

from liability for monetary damages for breaches of fiduciary duties, especially the duty of care, skill and diligence. Recent reforms to South African corporate law have not provided a clear resolution to this problem nor, has the balance been appropriately struck between the conflicting policy imperatives relating to enforcement and the protection of directors and senior managers.[2]

The interpretation of the provisions in the Companies Act 71 of 2008 ("the Act") relating to directors' and senior managers' duties and standards should not only be consistently evolving towards greater accountability but also a purposive approach ought to be adopted to maintain a nuanced balance that is flexible enough to support and protect directors and senior managers who aggressively pursue the interests and objects of the company, in good faith, for the benefit of all relevant stakeholders.

In light of recent corporate failures that have shocked the world and caused harm to many, the argument and approach in response to those failures has been to focus on accountability and, in particular, the behaviour of directors and senior managers in the management of corporations.[3] This object is, in the main, being pursued through legislative reform and other contemporary means to encourage directors and senior managers to aspire to increased standards of care in the discharge of their duties and roles. As such, directors and senior managers are subject to greater scrutiny and liability for errors and omissions committed in service of the company.[4] However noble and admirable these measures and objects may be to prevent corporate failures, they should be counterbalanced with the basic consideration that

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applies to a person depends on 'the nature, degree, consistency or reach of the participation or control' that he or she exercises within a company. See also Chapter 3 paragraphs 3.2.1 to 3.2.6 below, where the point is made that the broadness of the designation furthers the objects of increased liability introduced by the current legal enforcement framework. See also Idensohn K 'The Regulation of Shadow Directors' 2010 SA Merc LJ 326 – 345 at 343.

[2] See Havenga M 'Directors fiduciary duties under our future company-law regime' (1997) 9 SA Merc LJ 310 – 324 at 310, who acknowledges that "…Company management can only be effective if those who manage are allowed a certain measure of freedom and discretion in the exercise of their function. Contrarily, effective control of management is vital in the interest of the company itself and its various stakeholders…. a proper balance needs to be established between freedom to manage, accountability and the interests of different stakeholders.' See also the first King Report on Corporate Governance in South Africa (1994) at para 1.2, 1.3 and 1.16 ("the King Code I"); the Report of the Committee on the Financial Aspects of Corporate Governance (1992) at para 7.1 and 7.2 ("the Cadbury Report").

[3] Some recent high-profile corporate scandals in South Africa include Steinhoff, African Bank Investments Limited, Masterbond and Fidentia, and in the United States of America, these include Enron and Worldcom. See also Bekink M 'A Historical Overview of the Director's Duty of Care and Skill: From the Nineteenth Century to the Companies Bill 2007' (2008) 20 SA Merc LJ 95 - 116 at 95, where she enumerates some corporate failures in recent history both nationally and internationally.

[4] See section 76(3)(c) of the Act, which contains elements of both objective and subjective elements that set the standards directors and senior managers are required to meet. See also Esser I & Delport P 'The duty of care, skill and diligence: The *King Report* and the 2008 Companies Act' (2011) 74 *THRHR* 449-455 at 453.

directors and senior managers should be granted leeway to take calculated risks and, in certain instances, to aggressively pursue profit, sustainability, and, ultimately, bring value for all concerned stakeholders without fear of liability if decisions taken in good faith later prove unsuccessful.

To encourage entrepreneurship, which invariably includes taking reasonable risks, directors and senior managers can rely on the protection permitted in subsections 78(4) to (7) of the Act that makes provisions for indemnification and the procurement of liability insurance to indemnify directors and senior managers. The enforcement framework concerning the definitions of directors and senior managers (who have now been designated under the term 'prescribed officer') under the Act has been extended to include persons who previously were not subject to regulation.[5] The continued prohibition against exculpatory clauses in section 78(2) of the Act has the effect that directors and officers have less than adequate protection in the current enforcement framework.

Furthermore, the Act has now codified in part directors' common law fiduciary duties, and these are by implication extended to apply to senior managers, with the apparent object of codification being to make the duties easily accessible to directors and senior managers. The increased focus on accountability in the current legal framework provides the basis for this study of a general and material question, namely: whether such increased enforcement is sufficiently tempered with adequate protection for directors and senior managers under section 78 of the Act and, conversely, what the influence of the enforcement framework is on the protection of directors and officers.

Despite the fact that subsections 78(4) to (7) of the Act permit the provision of protection of directors and senior managers through indemnification and by means of a company advancing funds for the purchase of liability insurance, for adverse costs, expenses and money damages that may be awarded against a director or senior manager in legal proceeding that emanate from their service to the company, the availability of this protection is not guaranteed or secured right for directors and senior managers as the ultimate decision to extend indemnification or the purchase of liability insurance remains at the sole discretion of the

[5] See on section 1 of the Companies Act 61 of 1973 ("the 1973 Act"). Traditionally the word 'officer' included directors and any persons in a managing position such as Chief Executive Officer, or a managing director. However, the current framework now includes senior managerial employees into the category of officer irrespective of whether they are formally designated as such by the company. See JT Pretorius et al *Hahlo's South African Company Law through the Cases* 6 ed (1991) at 264. Also see Regulation 38 read together with sections 1 and 66(10) of the Act, wherein the Minister designated certain functions within the company as prescribed functions, irrespective of designation or the lack thereof by the company.

company. Directors and senior managers have no effectual means to insist on the inclusion of such provisions in their service agreements with the company.[6] Booysens and Minaar,[7] for example, strongly warn against, the catastrophic personal financial risk posed to directors and senior managers should a company opt against the purchase of directors' and officers' liability insurance. According to Booysens and Minnar it is an imperative for a company now more than ever to understand the multitude of applicable laws, regulations and relevant nuances within which it operates that impose tangible obligations and potential liability on directors and senior managers and to take necessary to ameliorate the risks by taking appropriate measures to shield directors and senior managers for permissible mistakes and errors in their service to the company. Since these laws and regulations are stringent and subject to change the risk posed to directors and senior managers and if left unchecked, can pose an existential problem where the company loses or is unable to attract or retain talented individuals to its board for corporate service.[8] They counsel that directors and senior managers must be assured by the company that their directors' and officers' liability insurance is in place to protect them by funding their legal or defence costs and that cover will be available to pay for an award for monetary damages should they could be held liable for in connection with their honest breaches

[6] Bekink M 'Indemnification and aspects of directors' and officers' liability insurance in terms of section 78 of the Companies Act 71 of 2008' (2011) 23 *SA Merc LJ* 88 - 105, at 102. Bekink remarks that the absence of a statutory right to insist on the inclusion of payments towards the purchase of directors' liability insurance as part of a remuneration package holds grave disadvantages for directors (at 101 and 102). For example, the Canada Business Corporation Act 1985 in section 124(5) imposes a statutory obligation on a company to indemnify its directors for costs, charges and expenses reasonably incurred in the defence of any legal proceedings. The position is also similar under section 8.52 of the US Model Business Corporation Act which also requires a corporation to indemnify a director in respect of reasonable expenses incurred by him in connection to any proceedings in which he was wholly successful on the merits or otherwise in the defence of any proceedings.

[7] T Booysens & T Minnaar 'When the D&O Cover is not Enough' https://www.cgfresearch.co.za/LinkClick.aspx?fileticket=e8FuaZoH00o%3D&tabid=112&portalid=0&mid=47, accessed on 17 May 2021. CGF Research Institute (Pty) Ltd is a private company that specialises in professional services related to Corporate Governance, Risk and Compliance (GRC) related matters, catering for all industry sectors, no matter the size of the organisation. AON South Africa (Pty) Ltd is a licensed short-term Financial Services Provider that provides intermediary services in respect of insurance policies provided by licences underwriting firms and other related and additional services which are generally set out in their regulatory licence with the Financial Sector Conduct Authority and in accordance with the provisions of the Financial Advisory and Intermediary Services Act 37 of 2002. Furthermore, it has to be noted that given the discretionary language used in subsections 78(4) to (6) of the Act regulating the purchase of liability insurance many companies may elect to operate without such cover, at all because it is not a compulsory requirement in terms of section 78 of the Act. No law or requirement makes the purchase of directors' and officers' liability insurance compulsory. This position is unsustainable given the potential risk to the personal assets of directors and senior managers in the fulfilment of their duties in the event of them being sued for monetary damages. See Anderson S, Mostert F and Mostert F 'The Underwriting Process of Liability Insurance in South Africa' (2014) 4 *Risk Governance & Control Financial Markets and Institutions* 46 -54 at 46.

[8] See Booysen & Minnaar op cit note 7.

of their duty of care, skill and diligence in their capacity as director or senior manager of the company.[9]

Mongalo[10] puts forward a compelling argument for the inclusion of exemption clauses as a further form to shield directors and senior managers and according to him it is regrettable that the South African policy makers opted to exclude including statutory provisions in the Act that permit a company to include provisions in the company's Memorandum of Incorporation or any other contract allowing for the exemption or exculpation of directors or senior managers for liability for negligence and breach of the duty of care. He states that the prohibition places South African directors and senior managers in an adverse position when compared to their counterparts in other jurisdictions where such clauses are permitted. He makes the point that it was recommended by the American Bar Association ("the ABA") that lawmakers consider amending section 247(1) of the Companies Act 61 of 1973 (" the 1973 Act")[11] by allowing a company in its memorandum or articles to include provisions exculpating the directors and officers from liability for money damages in derivative actions brought by the company, save for wilful breaches.[12] However, this recommendation was overlooked by policy makers, and section 78(2) of the Act contains the same prohibition that was contained in section 247(1) of

[9] See Booysen & Minnaar op cit note 7.

[10] T Mongalo 'Exculpation of Directors' Liability for Money Damages: Is South African Corporate Law Providing Sufficient Protection from Personal Liability for Directors?' (2021) 10 IJEBL 141 at 141, 148 and 149. The benefit of exemption clauses cannot be discounted. Their possible inclusion in the current framework could have enhanced the protection available to directors of senior officers if policy makers had seen fit to include this protection in section 78(2) of the Act. It is apparent from the interpretation of section 78(2) that the Legislature has opted for indemnification as opposed to clauses that exculpate directors and senior managers from liability. This research work will seek to find the reasons for this option and give a view on whether this is a sound approach considering the context of the current regulatory framework with due regard to the model used in select and relevant foreign jurisdictions. In this exercise, the statutory provisions in such jurisdictions will be quoted and analysed together with examples of the actual provisions (and how they have been applied and interpreted in practice and by the courts). It will be argued that it was imperative for the protection of directors and officers to permit the inclusion of exemption clauses as an additional means to provide protection. The option elected by the Legislature to provide protection mainly through indemnification and liability insurance in terms of section 78(4) to (6) of the Act is not flexible or wide enough to provide a sufficient measure of protection to directors and senior managers. There some glaring difficulties with the scope of protection permitted in subsections 78(4) to (6) of the Act which need attention, and this will be highlighted in Chapter 6 of this thesis. The operation of directors' and officers' liability insurance policies is designed to prospectively assist directors and senior managers (through education and training) to mitigate the potential of liability and to expertly handle claims involving directors and senior managers with the object of maintaining the reputation and good standing of the individual director or senior manager where the fact so indicate.

[11] Section 247(1) of the 1973 Act effectively voided any provision or provisions in the articles of a company or any contract that purported to exempt a director or officer from liability for negligence and a breach of his or her fiduciary duties. Initially this section also prohibited indemnification of directors and officers for negligence. However, the section was amended in 1998 by the inclusion of a proviso that allowed for a company take out insurance to benefit directors and officers (see Dario Milo 'New Companies Act Clears Some Long-Standing Muddy Waters' Business Day 13 July 2009).

[12] The recommendation was made by Members of the Corporation Law Committee of the American Bar Association - Committee on Corporate Laws 'Report on South African Companies Act No. 61 of 1973 and Related Legislation (2001) at 21.

the 1973 Act. Section 78(2) of the Act, in the narrow sense, does not permit the inclusion of exemption clauses or the so-called 'hold harmless' clause, save for indemnification for legal costs and damages in terms of subsections 78(4) and (7) of the Act through liability insurance. The contention is that the inclusion of exculpatory clauses together with liability insurance is a preferred approach to protecting directors and senior managers against liability for monetary damages, as there are certain potentially unique instances which are not covered by the so-called built-in protection measures in the Act, which include the business judgment rule and liability insurance.

Writing within the context of directorial duties under the Act, Horne poignantly raises the question of whether South African directors' liability under the Act does not potentially constitute 'a dangerous trap' when their position is compared to their counterparts in other jurisdictions.[13] In his assessment of the available directorial protective instruments, he concludes that the Act does not sufficiently protect directors to promote entrepreneurship and risk taking while holding accountable those who are guilty of extensive or egregious breaches of directorial duties.[14]

In addition to Mongalo's contentions and Horne's concerns, it is argued in this thesis that the policymakers' refusal to revisit the blanket prohibition against exemption clauses as further protection for directors and senior managers will have far-reaching implications for the diversity and quality of the pool of individuals willing to serve in the role of director and senior manager in South African, and a willingness by directors and senior managers to take necessary and rational risks. The considerations used to justify the continued prohibition are outdated and out of sync with the present realities in which directors and senior managers operate.[15] Liability insurance as the main means of protection in the current framework is, in itself, inadequate to provide the necessary protection given the increased liability under the current legal enforcement framework together with other economic factors that companies operate under. The protection of directors and senior managers would have been greatly enhanced by

[13] Horney J 'Is directors' liability under the Companies Act of 2008 a potentially dangerous trap in comparison to other jurisdictions?' (2022) 8 *JCCL&P* 50 – 66 at 50.
[14] Ibid at 66.
[15] In the Department of Trade and Industry Policy Paper South African Company Law for the 21st Century Guidelines for Corporate Law Reform (2004) 'the Policy Paper' at 40 it was declared as fact that because South Africa was not a litigious society, it was not necessary to include exculpatory clauses or to indemnify directors from liabilities incurred in the discharge of their functions, However, the correctness of this assertion was questioned in light of the contradictory statements made in the Policy Paper which raised as a key issue the current law and rules applicable to directors were deficient and lacking in that they did not provide effective means for the enforcement of directors' duties. See Kennedy-Good S & Coetzee L 'The Business Judgment Rule (Part 2)' (2006) 27 *Obiter* 277 -292 at 290.

permitting the inclusion of exemption clauses in the Memorandum of Incorporation of the company or agreements of service between a director or senior manager and the company. The protection provided by exemption clauses fits in well with the other protection measures available to a director or senior manager. Some examples of statutory protection available to directors and senior managers include the business judgment rule (section 76(4) of the Act), relief by the court (section 77(9) of the Act), and an anticipatory application by a director or senior manager to the court for relief (section 77(10) of the Act). These listed protection measures invariably require a director or senior manager to incur legal costs in raising a defence which could potentially expose a directors' or senior managers' personal assets to attachment should there be no sufficient indemnity or liability insurance in place as permitted in subsections 78(4) to (7) of the Act. Essentially, directors' and officers' liability insurance policies are a necessity for directors and senior managers to defend any proceedings where they are sought to be held liable for negligence, errors, and breach of fiduciary duties especially the duty of care, skill and diligence.

One consideration that may be of some help in this regard is to determine whether a complementary approach would have been more appropriate for South Africa that is capable of providing extensive protection through exculpatory provisions, indemnification and liability insurance.[16] The proposed complementary approach is not contradictory, and it will be argued that a complementary model can achieve a delicate balance between accountability and protection. The proposed model, that permits the inclusion of exculpatory clauses and indemnification through liability insurance. has been adopted in other jurisdictions such as Delaware in the United States other states in the US have followed suit, these include amongst others North Carolina, Arizona, Washington and Massachusetts.[17] It will be argued through this research that this model is more flexible and that ought to be followed in South Africa. The current South African approach, which is informed by United Kingdom's approach to regulation and enforcement of directors and senior managers duties, is outdated and exposes South African directors and senior managers to serious personal liability and financial risks that are not faced by directors and senior managers in jurisdictions where the protection

[16] Carmiciumaru commented that the indemnification of directors in South Africa has always been problematic and controversial due to the apparent wording used which contributed to poor interpretation and understanding of the provisions in the relevant legislation (Lucian Mihai Carmiciumaru *An Assessment of the Impact of Corporate Governance Codes on Directors and Officers Liability Insurance* (unpublished LLM dissertation, University of Witwatersrand, 2010) at 169).

[17] In the US state of Delaware, the approach adopted by law makers is that there are statutory provisions that allow for the inclusion of exculpatory provisions and indemnification of directors and officers through liability insurance. The provisions in this jurisdiction are discussed in greater detail in this proposal.

available to directors and senior managers includes both exculpatory clauses and indemnification through liability insurance for honest errors of judgment and breaches of the duty of care, skill and diligence.

1.2 Thesis and Objectives

The research paper is concerned with the question of whether the formulation of the current framework - which expressly prohibits exemption clauses - regulating directors' and senior managers' indemnification and liability insurance provides clear and sustainable provisions to encourage and protect those in effective management of companies to take necessary risks in pursuing value for all concerned. I will argue there is a possible link between the continued prohibition of exclusion clauses and the potential result that could eventuate those suitably qualified individuals may be deterred from taking up positions as company directors or senior managers due to the exposure to personal liability for monetary damages and legal costs.[18] Equally, the need to fairly balance the requirement for accountability needs to be considered and how this may be done appropriately. The current framework is an imperfect system that has serious gaps that deserve consideration. The research work will test whether the current framework is sufficiently flexible to uphold the imperative of accountability on the one hand and provide protection to directors and senior managers, on the other, in circumstances where it is appropriate and fair to do so.

In 2004, the then Minister of Trade and Industry, Mandisa Mpahlwa, published a Policy Paper titled The *South African Company Law for the 21st Century - Guidelines for Corporate Law Reform* ('the Policy Paper').[19] The Policy Paper set out the basic approach the government intended to take with company law reform so that company law should promote the

[18] As was the case in the US state of Delaware following a shock decision which held directors personally for damages for negligence. It was found that the directors conduct was not covered by the protection of the business judgement rule. The impact of the *Smith v van Gorkom* 488 A2d 858 (1985) case, which prompted law makers in the state of Delaware to enact statutory provisions enabling the inclusion of exemption clauses, after directors in reaction to the *Smith v van Gorkom* decision, decided to resign or make themselves unavailable for further terms and the resultant increased premiums for indemnity insurance, is discussed more fully in paragraph V(e) of this research proposal.
[19] GG 26493 of 23 June 2004.

competitiveness and development of the South African economy.[20] It provided reasons and certain specific considerations for the reform.[21] The guidelines in the Policy Paper shaped and influenced the Companies Bill of 2007[22] ('the 2007 Bill') and, thus, the current Companies Act, of 2008 (Act No. 71 of 2008). The Policy Paper confirms that it sets the framework and guidelines for the foundation upon which the new Companies Act ought to be based. This foundation is relevant and necessary to understand the Act and the context of its provisions, which form part of my interpretation of the provisions of the Act and the scope of this study.

One of the reasons given for the reform was stated to be 'a series of spectacular corporate failures' that necessitated an improved corporate governance framework for the regulation of companies.[23] The review of corporate law was set to be undertaken with the view to '...understanding the role of company law in the 21st Century and its role in the economy as a whole...' Accordingly, the object of the review was recorded as being aimed at ensuring that the new act would be appropriate to the 'legal, economic and societal context of South Africa as a constitutional democracy and an open economy'.[24] It was thus envisioned that the prospective regulation should, amongst other things, promote –

‘(a) the efficiency of companies and their management;

(b) encourage transparency and high standards of corporate governance,

recognising the broader social role of enterprises.[25]

It is clear in the Policy Paper that efficiency and accountability were regarded as paramount considerations for a properly functioning economy.[26] The Legislature sought to develop clear rules for corporate governance that addressed the duties and liabilities of directors.

More importantly, the Policy Paper correctly alludes to the appropriateness of considerations that need to be taken in creating provisions that permit the exculpation, indemnification or insurance of directors against liability in certain defined instances. In the

[20] Department of Trade and Industry Policy Paper South African Company Law for the 21st Century Guidelines for Corporate Law Reform (2004) ‘the Policy Paper’ at 5.
[21] Ibid at 8.
[22] GN 677 GG31104 of 30 May 2008. The Bill [B 61D—2008].

[23] The Policy Paper supra op cit note 15 at 8.
[24] The Policy Paper supra op cit note 15 at 8.
[25] The Policy Paper supra op cit note 15 at 10.
[26] The Policy Paper supra op cit note 15 at 9,15, and 17.

Policy Paper, it was conceded that there was a common debate in various jurisdictions on whether it should be permissible to exculpate, indemnify or insure directors and senior officers against liability. However, it was stated that South Africa was not a litigious jurisdiction at the time, and thus it was 'not necessary or desirable to exculpate or indemnify directors against liability'.[27] Nonetheless, the concession was correctly made that, to enable companies to both attract and retain competent directors in instances where there is a sharp focus on directors' conduct, it may, for purposes of the review, be necessary to enable a company to indemnify a director against the expense of successfully defending an action for damages against him or her.[28] The crucial point to note is that the Department of Trade and Industry essentially gave a mandate to the drafters of the new act to research, postulate and advise on the appropriate framework allowing for the exculpation or indemnification of directors and managers, taking into consideration the 'legal, economic and social context of South Africa as a constitutional democracy and an open economy'.[29] This study will consider and reflect on how this mandate was carried out by questioning the evolutionary process undertaken in this regard from the extensive review, of the Companies Bill to the applicable provisions of the Act; being subsections 78(2) and 78(4) to (5).[30] The effectiveness of the regulatory framework and the protection afforded to directors and senior managers in subsections 78(4), (5) and (7) of the Act will be examined.

The specific objectives of this thesis are to:

(i) To identify whether the current enforcement framework which excludes exemption clauses adequality provides directors and senior managers protection from liability for personal damages.

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[27] The Policy Paper supra op cit note 15 at 40. The proposition contained in the Policy Paper suggested that the indemnification of directors for legal expenses incurred in successfully defending litigation against them would be sufficient protection for directors in South Africa (and not exculpation or liability insurance) because there was a perception that South Africa did not have a litigious culture.

[28] The Policy Paper at 38 and 39. It was stated in the Policy Paper that 'A common debate in all jurisdictions is whether it should be permissible to exculpate, indemnify or insure directors against liability. As South Africa does not have a litigious culture, it is not necessary or desirable to exculpate directors against liability. However, to enable companies to attract and retain highly qualified directors in circumstances where the actions of directors are increasingly under scrutiny, it may be necessary for a company to be able to indemnify a director against the expense of successfully defending an action against him or her.'

[29] The Policy Paper supra op cit note 15 at 7.

[30] This will be dealt with more specifically in the methodology section. However, this study is desktop based and no information will be collected and considered empirically, such as statistics and data regarding litigation involving directors and senior managers in South Africa, and some consideration in the future and the parameters for qualitative and quantitative liability insurance together with its availability in the South African market for directors and senior manager fall outside the scope of this study.

(ii) Investigate and suggest better approaches to balance the object of accountability and protection of directors.

(iii) Identify the ideal reforms that should be incorporated into the South African enforcement framework; and

(iv) Propose means to protect directors and senior managers that could be adopted from identified reforms.

1.3 Research Questions

The main question to be answered is whether South African directors and senior managers are at a greater risk of being unable to protect their assets against liability claims for monetary damages (in the case of a breach of the duty of care), and thus in a less favourable position, when compared with their counterparts in jurisdictions which make provision for both exculpatory clauses and indemnification through liability insurance? Secondly, whether the interpretation of the provisions of the current framework, which prohibits the inclusion of exculpatory clauses in subsection 78(2) of the Act, is capable of being flexible enough to balance the objects of accountability on the one hand and the protection of directors and senior managers from personal liability for damages for risks taken in good faith for the benefit of all relevant stakeholders? Lastly, a related sub-question is whether the current enforcement framework regarding the indemnification of directors and senior managers through liability insurance is sufficiently tempered with adequate protection for directors and senior managers under subsections 78(4) to (7) of the Act.

My thesis will highlight three issues in analysing the research question. First, I will consider the objective of increased accountability for persons involved in the effective management of a company. I will examine how this objective is expressed and give insight into the factors that the court will likely consider when interpreting the definitions applicable to directors and senior managers of a company.

Secondly, in the light of increased accountability for directors and senior managers, it is important to understand whether, and how, the Act makes directors and senior managers accountable for the exercise of their powers. This question is relevant to the topic of the proposed thesis as it relates to the applicable standard of care and liability for loss and the breach of the duty of care.

Thirdly, I will consider the formulation of the current legal framework which has been extended to include a large class of persons such as senior managers of a company and whether it is sufficiently complemented by appropriate mechanisms to protect directors and senior managers from damages claims that may be brought against them for errors and or omissions in the execution of their roles, in good faith, of their service to their company. I will examine whether subsections 78(4) to (7) of the Act provides meaningful access to directors and senior managers to protection and whether directors and senior managers face greater risk because of the prohibition of exculpatory clauses in subsection 78(2) of the Act.

1.4 Main areas of Analysis

The legal framework regulating directors' and senior managers' duties and liabilities is mainly made up of provisions contained in legislation, the Memorandum of Incorporation ("the MOI") of companies, the common law, and voluntary principles on best practice. The Act lists as one of its objects in section 7(b)(i) of the Act the promotion of 'the development of the South African economy' by encouraging entrepreneurship and enterprise efficiency. Closely related to this objective is the aim 'to encourage the efficient and responsible management of companies'.[31] To give effect to these objects, the Act has introduced reforms in the definitions of 'director' and 'prescribed officer'.

The thesis will analyse the adequacy of the protection provided to directors and senior managers through indemnification for personal liability for negligent acts in executing their service to the company. The most important provisions, especially those dealing with directors' and senior managers' liability and duties, are contained in the Act. Furthermore, the provisions of the Act relating to exculpation and indemnification of directors and senior managers will be considered as contained in subsections 78(2) to 78(4), (5) and (7) of the Act.

[31] Section 7(b)(j) of the Act.

Sections 78(2), together with 78(4) and (5) of the Act, will be analysed to evaluate the adequacy of directors' and senior managers' protection in the event of a damages claim for negligence and the breach of the duty of care.

1.4.1 Definitions: Director and Prescribed Officer

It is of fundamental importance to understand the definition of 'director' and 'prescribed officer' as set out in the Act, as directors and prescribed officers represent a special key to understanding how the current legal framework is structured.[32]

According to section 1, a 'director' is a member of the board of a company, as contemplated in section 66 of the Act, or an alternate director and includes any person 'occupying the position of director or alternate director, by whatsoever name designated'.[33]

The definition of 'director' has been extended in respect of certain sections of the Act to include various persons, which includes but is not limited to, 'prescribed officers' and 'alternate directors'. These 'directors' are therefore subject to the same onerous duties, standards, and liabilities as directors who have been formally designated as such.

It will be argued that the aim of the extended definition of 'director' is to make a greater number of persons who are in effective control of the business subject to the same duties, standards and liabilities as directors who have been formally appointed.

One example of the extension of the definition of a director is found in section 76(1) of the Act, which deals with the standards of directors' conduct. It provides that: -

'In this section, 'director' includes an alternate director, and -

(a) a prescribed officer; or

[32] Farouk HI Cassim (ed), Maleka F Cassim, Rehana Cassim et al *Contemporary Company Law* 3 ed (2021), at 540.

[33] The Act basically recognises different types of directors namely, alternate directors, which are specifically included in the definition of 'director' in section 1, ex officio director in terms of section 1 and 66(40(ii), an MOI appointed director as per section 66(4)(a)(i), an elected director as contemplated in sections 66(4)(b) and 68, and a temporary director appointed to fill a vacancy as envisioned in section 68(3) of the Act.

(b) a person who is a member of a committee of a board of a company, or of the audit committee of a company, irrespective of whether or not the person is also a member of the company's board.'

The definition of director has also been extended to include prescribed officers for purposes of section 20 (validity of company actions), section 69 (ineligibility and disqualification of persons to be the director or prescribed officer), section 75 (director's self-financial interests, section 77 (liability of directors and prescribed officers), section 78 (indemnification and directors' insurance). This was not the case under the 1973 Act, which clearly distinguished between directors and officers. It was acknowledged in *R v Kritzinger*[34] that a company, being an artificial legal entity, functions through its board of directors. The board of directors of a company represents its 'directing mind and will'.[35]

A counterview that deserves consideration is whether the focus, in the current framework, on increased accountability of directors and senior management is justifiable in the context of recent corporate failures and misdeeds.[36] Increased accountability and the enforcement thereof promote the protection of a broader base of interested stakeholders overall.[37] However, it is humbly submitted that insistence on an approach that prioritises one group, such as shareholders' interests above those of directors and senior managers, is unsustainable and should be rejected in favour of an approach that delicately balances the interests of various groups.

1.4.2 Provisions Dealing with Directors' and Prescribed Officers' Duties and Liabilities

The interpretation of the Act concerning directors' and senior managers' duties and liabilities is the imperative base from which the main thrust of the framework can be sourced. Other acts

[34] 1971 (2) SA 57 (A), at par 59.
[35]*Mostert NO v Old Mutual Life Assurance Co (SA) Ltd* (083/2001) [ZASCA] 104 (unreported) *at 41*.
[36] See Stout L & Blair M 'Director Accountability and the Mediating Role of the Corporate Board' (2001) 79 *Cornell Law Faculty Publications* 403 – 407 at 403.
[37] An argument has been made for an integrated stakeholder-inclusive approach that recognises that companies should in their operations 'act with economic, social and environmental responsibility' (see Cassim et al supra op cit note 32, at 672). Cassim et al state that stakeholders are any persons or groups that may affect the company's operation and vice versa, which may include, inter alia, shareholders, lenders, suppliers, creditors, employees, unions, analysts, society at large, communities, etc.

of parliament may in certain specific instances list duties for directors and senior managers.[38] The latter also has a bearing on the applicable framework and enforcement.

The point has been correctly made that the Act does not expressly exclude the common law, and where appropriate it does not conflict with the statutory provisions of the Act, it still applies.[39] Section 76(3)(c) of the Act, constitutes a statutory codification and restatement of the common law duty of care, skill and diligence. It relates to directors' and senior managers' duty to exercise reasonable care, skill and diligence provided as follows: -

> "Subject to subsections (4) and (5), a director of a company, when acting in that capacity, must exercise the powers and perform the functions of director-
>
> (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 concerning the company as those carried out by that director; and
>
> (ii) having the general knowledge, skill and experience of that director."

This is a non-fiduciary duty and the courts have confirmed that it is owed to the company with the effect that the protection of the company is, ultimately, in the interest and indirectly protection of shareholders of a company.[40] The test used is both objective - subsection 76(3)(c)(i)) and subjective -subsection 76(3)(c)(ii) of the Act.

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[38] For example, the National Environmental Management Act 107 of 1998 in section 34(7) imposes liability on directors and senior managers for environmental damage caused by the company and its operations. Similarly, the Occupational Health and Safety Act 85 of 1993 in section 16(2) imposes certain duties on a Chief Executive Officer of a company to discharge failing which a breach could result in liability.

[39] The Act does not exclude or replace the common law, and it has been argued that to the extent that the common law is not in conflict with a statutory provision, it will apply. Therefore, the common law duties remain applicable and relevant. The question is whether the common law duties of directors will apply to prescribed officers and whether we can turn to the common law in determining which persons are included in the definition of 'prescribed officer'. See P Delport *The New Companies Act Manual* 2 ed (2011) at 90.

[40] See *Hlumisa Investment Holdings (RF) Ltd and Another v Kirkinis and Others* (Case no 1423/2018) [2020] and *De Bruyn v Steinhoff International Holdings N.V. and Others* (29290/2018) [2020] ZAGPJHC 145 (26 June 2020). The principles relating to the director's duty of care and skill were largely developed by the English courts in cases such as *In re City Equitable Fire Insurance Co Ltd* [1925] 1 Ch 407, *In re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425 and *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392.

The King Codes, although a voluntary collection of best practices on good corporate governance, carries weight and has a unique influence on the regulatory framework. The courts have in the past looked to the King Codes (and other best practice(s) standards) as guidelines to gauge the ethos of what is intended by the framework.[41]

In certain instances, the Memorandum of Incorporation of a company may detail certain company rules and practices tailored for the entity and the directors and senior managers of that company are under an obligation to observe and serve under such rules or practices.[42]

Section 77(2)(b)(i) of the Act specifically deals with the liability of directors and senior managers for breach of the duty of care and skill as provided for in section 76(3)(c) of the Act and the common law. Therefore, a director or senior manager who breaches their statutory duty of care and skill (i.e., is negligent) in the discharge of their functions or duties will be held liable per the common law principles relating to breach of duty for any loss, damages or costs sustained by the company because of the directors' or senior managers' default.

Lastly, in addition to the potential risk of liability for personal damages directors and senior managers face reputational risks in the event of being found guilty of breaching their duty of care and provisions of the Act. [43]

1.4.3 History of Exculpatory Clauses in South Africa

Subsection 78(2) of the Act contains the prohibition against exculpatory clauses in any agreement, Memorandum of Incorporation or resolution adopted by a company. Subsection 78(2) of the Act provides that: -

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[41] In the matter of *South African Broadcast Incorporation Limited v Mpofu and Another* [2009] 4 All SA 169 (GSJ) a full bench approved certain basic principles of corporate governance relying, *inter alia,* on the King Report on Corporate Governance for South Africa.

[42] An example of a typical rule that could be inserted in an MOI is as follows:

'1. Powers of the Directors

1.1 The Board of Directors has the power to-

1.1.1 To appoint or co-opt any person or individual, in accordance to the law, to fill any vacancy on the Board of Directors on a temporary basis, or as an additional director provided that such appointment must be duly ratified by the shareholders, at the next AGM.'

[43] In the matter of *Organisation Undoing Tax Abuse and Another v Myeni and Others* (15996/2017) [2020] ZAGPPHC 169 the director concerned was declared a delinquent director in terms of section 162(5) of the Act. The court considered the duties imposed on a director under the Act, as amplified by the Public Finance Management Act 1 of 1999. It found that terms of section 50 of the PFMA Act, all directors of SAA were subject to heightened fiduciary duties.

> 'Subject to subsections (4) to (6), any provision of an agreement, the Memorandum of Incorporation or rules of a company, or a resolution adopted by a company, whether express or implied, is void to the extent that it directly or indirectly purports to— (a) relieve a director of— (i) a duty contemplated in section 75 or 76; or (ii) liability contemplated in section 77; or (b) negate, limit or restrict any legal consequences arising from an act or omission that constitutes wilful misconduct or wilful breach of trust on the part of the director.'

Subsection 78(2) largely preserves and restates the position on exculpatory clauses and indemnification which prevailed under the 1973 Act, as it generally prohibits exemption and indemnification of directors and senior managers from liability that would otherwise attach to them arising from negligence, default or breach of fiduciary duties.[44] The indemnification of directors and senior managers is allowed under certain specified instances, subject to subsections 78(4) to (6) of the Act.

Section 247(1) of the 1973 Act, stated that 'Subject to the provisions of subsection (2), any provision, whether contained in the articles of a company or any other contract with a company, and whether express or implied, which purports to exempt any director or officer or the auditor of the company from any liability which by law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty to the company or to indemnify him against any such liability, shall be void'.

The formulation of the general prohibition on exemptions and indemnities under section 247(1) of 1973 was criticised as being unclear and controversial in that it was not understood what the effect of the provisions was.[45]The crux of the complaint was whether section 247(1) prohibited exemption from liability only, or if it also invalidated provisions in the articles which reduced or abrogated the duty of a director or officer.

The prohibition against exemption and indemnification in sections 247(1) of the 1973 Act and 78(2) of the Act owes its roots in English Law. The English Legislature accepted the recommendations made by the Greene Committee[46], in their 1925 report, that the common article or provision that exempted directors from liability for loss except when it is due to their 'wilful neglect or default' gave unjustifiable protection to directors. The view was that under

[44] Cassim et al supra op cit note 32 at 773.
[45] P Delport *Henochsberg on the Companies Act 61 of 1973* 5 ed (2011) at page 384.
[46] The Greene Committee (UK) Company Law Amendment Committee (mnd) 2657 (1925 – 26) paragraphs 46 – 47.

this exemption directors had the impunity to be guilty of the grossest negligence provided that the director concerned did not consciously do anything which he recognised as being improper. The report called for an alteration of the law.

Furthermore, the report rejected the notion that without the mechanisms of exculpatory clauses and indemnification, it would be difficult for companies to find suitable persons willing to serve as directors.[47] The reason for the committee rejecting these assertions according to them was that there was no basis for it. Cassim submits[48] that there is a justification for these mechanisms and that notwithstanding the committee's rejection of the assertion, there is a need to carefully balance the two conflicting underpinning policies. The first is, the objective to encourage persons to accept office as directors and on the other hand, secondly the necessary imperative policy to protect companies and shareholders from the consequences of wrongful acts of directors of a company.

I will argue that the continued reliance on the Greene Report or the reluctance to re-examine the position is not appropriate given the fact that the report is outdated. The landscape has since then changed considerably. The continued prohibition means that directors and senior managers have limited protection in the face of increased accountability. The limited protection could result in directors and senior managers leaving South Africa for jurisdictions where the protection offered to their counterparts includes exemption clauses and indemnification.

It has been suggested that the availability of exemption clauses and indemnification serves as a disincentive for directors and senior managers to maintain high management standards.[49] Alternatively, it is argued that exemption and indemnification constitute a dilution to the effectiveness of shareholder lawsuits as a managerial control device.[50] The counter-arguments must be placed within the proper context of the regulatory framework and its aims. Bekink correctly notes[51] that corporate law makes provision for the indemnification of directors

[47] Ibid at paragraph 47.
[48] Cassim et al supra op cit note 32 at 772.
[49] Finch V 'Personal Accountability and Corporate Control: The Role of Directors' and Officers' Liability Insurance' (1994) 57 *MLR* 880 – 915 at 881 is of the view that the one of the purposes of the rules of corporate law is to 'encourage wealth creation yet discourage corporate wrong doing'. See also Weiss J 'The Effect of Director Liability Statutes on Corporate Law and Policy' (1989) 14 *Journal of Corporation Law* 637 – 660 at 638.
[50] Weiss J Ibid at 639.
[51] Bekink M supra op cit note 6 at 91, who argues that a central part of corporate law is concerned with striking a balance between 'constraining potential abuses by directors of their powers and granting them enough freedom from a strong centralised management'. Directors' and officers' liability insurance operates to remove the fear and risk of personal financial ruin, which in turn, will have a positive impact on corporate performance. Thus, Directors' and officers' liability insurance is not only a tool or instrument to encourage talented individuals to

and senior managers from liability in certain instances. Liability insurance for directors and officers is seen as a tool that companies have adopted in some cases to exempt their directors and officers from liability or to limit the extent of the directors' and officers' liability for breach of their fiduciary duties or the duty of care and skill.[52]

It should be borne in mind that policy makers received a recommendation from the American Bar Association to consider amendments to the provisions relating to the prohibition of exemption clauses.[53] Section 247(1) was criticised as being unnecessarily restrictive.[54] A warning was issued to policy makers concerning the *Smith v Gorkom*[55] decision. The ABA proposed that the provisions should be altered to make it possible for companies to include provisions in articles of association or an agreement to protect directors from liability for monetary damages in instances where the director has merely acted negligently and in good faith. Exculpation provisions, according to the ABA have operated well to encourage suitably qualified individuals to serve as directors and to provide adequate protection to directors in the exercise of their duties.[56] It was the ABA's view that shareholders should be able to decide for themselves, through the inclusion of exculpation provisions in a company's charter (MOI), whether to forego a claim against a director for a failure to perform their duties. However, the caveat is that as long as the exculpation does not extend to include egregious misconduct such as bad faith, reckless or wilful misconduct.[57]

1.4.4 Background on Indemnification and Liability Insurance

Subsection 78(4) to (7) of the Act creates the legislative framework, and parameters, within which a director or senior manager can be indemnified by a company or within which a company may make provision for liability insurance for its directors or senior managers against the personal legal liability that may attach to them for wrongful acts committed in their capacity

serve as directors, but to do so, without being overly conservative or cautious in their approach to managing the affairs of the company, because of the threat of personal liability.

[52] Cassim et al supra op cit note 32 at 772.
[53] The ABA Report supra op cit note 12 at 21
[54] Ibid at 21.
[55] *Smith v van Gorkom* 488 A2d 858 (1985).
[56] ABA Report supra op cit note 12 at 22.
[57] Ibid at 22.

as a director or senior manager of the company. Subsections 78(4) to (5) and (7) of the Act provides that: -

'(4) Except to the extent that a company’s Memorandum of Incorporation provides otherwise, the company—

(a) may advance expenses to a director to defend litigation in any proceedings arising out of the director’s service to the company; and

(b) may directly or indirectly indemnify a director for expenses contemplated in paragraph (a), irrespective of whether it has advanced those expenses, if the proceedings—

(i) are abandoned or exculpate the director; or

(ii) arise in respect of any liability for which the company may indemnify the director, in terms of subsections (5) and (6).

(5) Except to the extent that the Memorandum of Incorporation of a company provides otherwise, a company may indemnify a director in respect of any liability arising other than as contemplated in subsection (6)…..

(7) Except to the extent that the Memorandum of Incorporation of a company provides otherwise, a company may purchase insurance to protect –

(a) a director against any liability or expenses for which the company is permitted to indemnify a director in accordance with subsection (5); or

(b) the company against any contingency including, but not limited to –

(i) any expenses –

(aa) that the company is permitted to advance in accordance with subsection (4)(a); or (bb) for which the company is permitted to indemnify a director in accordance with subsection (5).'

The area of greatest concern lies in the discretionary language used in subsections 78(4) to (5) and (7) of the Act which states that a company 'may' advance expenses or directly or indirectly indemnify a director or senior manager or that a company 'may' purchase insurance to protect a director or senior manager. Subsections 78(4) and (5) of the Act confer a rather wide discretion on the company to decide on whether or not to indemnify or take out liability insurance. In the absence of a provision in the company's Memorandum of Incorporation or other agreement making provision for indemnification and purchase of insurance by the company a director or senior manager does not have a statutory basis to insist on such indemnification or insurance. This renders the question open whether or not an entity has a positive duty, and from where such a positive duty could arise, if any, to provide its directors or senior managers with indemnity and or liability insurance.

A further complicating factor relevant to the interpretation of the provisions of the Act relating to the indemnification of directors and senior managers is the right of reimbursement a company retains in subsection 78(8) of the Act.[58] Section 78(8) of the Act provides that even though a company has taken out the necessary directors' or officers' liability insurance for its directors and senior managers and the insurance policy has responded to the entity or the insurer that advanced defence costs in terms of sections 78(8) of the Act the company reserves the right to pursue reimbursement of the defence cost or monies advanced in the indemnification of the director or senior manager if the defence is not upheld by the court or arbitrator, as the case may be. This means that up until the point that a court has made a pronouncement on the merits and liability (and depending on what the court finds) the cover can be said to be contingent. Similarly, at times the insurer in handling a claim may find themselves in a position where it cannot from the onset pronounce on policy response as the question of whether the claim will be covered, and the extent that it will be covered, can be inextricably linked with the interpretation of a peculiar provision of the insurance contract and the facts of a particular matter. In such a case, the insurer would often allow the matter to run its full course, whilst advancing the defence costs until the court hands down its verdict and reasons, therefore. If the

[58] Section 78(8) of the Act provides that 'A company is entitled to claim restitution from a director of the company or of a related company for any money paid directly or indirectly by the company to or on behalf of that director in any manner inconsistent with this section.'

court or arbitrator does not uphold the defence advanced on behalf of a director or senior manager in such a situation could potentially trigger the reimbursement obligation created by section 78(8) of the Act which can be enforced by a company or insurer that has advanced legal defence cost or monies in connection with litigation proceedings. Given the fact that there is always risk attached to any litigation the likelihood of a director or senior manager being required to reimburse the company or insurer if the decision goes against them becomes a reality as opposed to being a distant obscurity. The cost of litigation can be substantial and potentially crippling for directors and senior managers whose personal assets could potentially be at risk if the defence is not upheld.

Unfortunately, the current framework fails to protect directors and senior managers through the inclusion of exculpation clauses and under the discretionary language regarding the decision to procure directors' and officers' indemnity liability insurance. This leaves directors and senior managers vulnerable and potentially personally liable for costs and damages even though they acted in good faith, and in cases where a decision taken later proved 'wrong'. The level of protection undoubtedly has a limiting effect on directors' and senior managers' freedom and abilities to take risks (in pursuance of the stated objectives for all relevant stakeholders). It is important to understand if there are non-statutory options, within the current framework, available to directors and senior managers through which they could protect their reputation and personal assets.

1.4.5 International Comparison: Identifying the Gaps and Deficiencies

Foreign law has in certain instances, some persuasive value on components of the current framework; this is both historically and on a contemporaneous basis.[59] It is important to consider the extent to which the South African enforcement framework compares with the framework in place in comparative jurisdictions on select issues under discussion in this thesis. There are valuable lessons from foreign jurisdictions that may answer the question of how best a balance should be struck between accountability and giving protection to directors and senior managers. Foreign law will only be considered in the context of the framework relating to

[59] Mongalo T 'South Africanizing Company Law for Modern Competitive Global Economy' (2004) 121 *SALJ* 93 - 116, at 93 and 96. It is noted that a great portion of South African company law has its origin in the United Kingdom and the framework was built on the foundations of English law.

directors' and senior managers' standards of conduct and liability and approaches to exculpation and indemnification. Therefore, this thesis does not only seek to contribute to the general body of knowledge on accountability and protections of directors and senior managers in South Africa but, it is also aimed at pointing out some weaknesses in the current framework as ushered by the Act and to make recommendations on how the protection available under section 78 of the Act could be improved so that some of the objectives of the Act and the corporate law reform process may be fully realised.

The South African model, which prohibits the inclusion of exemption clauses in any article of association or any contract, was inherited from English law. The UK Legislators' approach was informed by the Greene Report's findings on what was then considered to be adequate protection for directors. A great deal of time has elapsed since the report was first released in 1925. The subject, of whether to revisit the prohibition of exemption clauses, has not received any further attention since then. In South Africa, the ABA in the lead-up to the drafting of the Act pertinently raised this issue and it was recommended that the Legislature ought to adopt provisions which remove the prohibition against exculpation clauses to give better protection to directors and officers in instances where the normal protection means such as the business judgement rule does not adequately deal with a particular situation. This deficiency was highlighted with reference to the Delaware Supreme Court case of *Smith v Van Gorkom*[60] where the effect of the court's decision was such that even though directors had

[60] *Smith v van Gorkom* 488 A2d 858 (1985). The facts briefly were that shareholders of Trans Union Corporation ('TU') sought a rescission of a cash-out merger of TU to another entity. In the alternative, the shareholders claimed damages against members of the board of directors. A critical question was whether the board of directors had acted in an informed manner and thus entitled to the protection of the business judgment rule in approving the cash-out merger. A related question was whether the shareholders vote approving the cash-out merger ought to be set aside on grounds that the shareholders had not been properly informed. A central figure in the transaction was Mr van Gorkom, who was the time was TU's chairman and chief executive officer. It would appear that TU had been having problems with generating sufficient taxable income to offset large investment credits. One of the options that was considered, as a possible solution, was a leveraged buy-out of TU by another entity. The chief financial officer of TU had done a limited study and assessment of the value of the company's stock and what would be necessary to service the debt. Van Gorkom without the knowledge of the board or senior management found a buyer. Van Gorkom called a special meeting of TU's board. Prior to the meeting only a few board members were advised of the purpose of the meeting. This meeting included senior management. In the meeting van Gorkom revealed the terms of the offer, reference was made to a further study, but it was not produced in the form of a report for the board to consider. Senior management were not in favour of the proposal, and they were concerned with the timing of the transaction. The transaction was approved by the board after a twenty (20) minute oral presentation by van Gorkom. The motivation by van Gorkom was devoid of the methodology used to arriving at the price of the stock of TU. After TU entered into the transaction senior management revolted against the decision. The board of directors went on to present the transaction for approval to the shareholder of TU. The court found that the board of directors had not made an informed decision on the transaction, pertinent questions regarding the transactions were not raised. The court also stated that the information disclosed to the shareholders

diligently informed themselves of details of the transaction and decision, they were still held personally for the loss in the difference between the share prices in a cash-out merger. The impact of the decision was that it sent shockwaves and the state of Delaware saw a rise in directors declining reappointment and a shirking of qualified persons unwilling to take up new positions as directors due to the potential of personal risk. Consequently, the premiums and costs associated with indemnification insurance policies increased significantly. The Legislature had to step in to correct the situation and they did so through enacting provisions which allowed exculpation clauses for directors and officers in certain instances. However, the ABA's recommendations were ignored, and this raises the question of whether South African directors and officers are adequately protected when compared to their counterparts in jurisdictions which allow for both exemption and indemnification.

The United States approach is of particular interest to the South African position and more specifically the example in the Delaware General Corporation Law and the Model Business Corporation Act. The Delaware approach makes provision for the inclusion of exculpatory clauses in directors' service contracts in terms of section 2.02(b)(4) of the Model Act and section 102 (b)(7) of the Delaware General Corporation Law.[61] Sections 8.51 of the Model Business Corporations Act in addition makes provision for the indemnification of directors and officers under certain instances. The justification of the comparison between the South African and Delaware positions is that although there appear to be certain commonalities in the framework protection of directors and senior managers, the South African model is lacking because the policy makers decided to prohibit the inclusion of exculpation clauses. The protection of directors and senior managers under the Delaware model is more comprehensive as it includes the inclusion of exculpatory and indemnification clauses. The latter is more desirable and would give directors and senior managers in South Africa greater freedom to aggressively pursue profits to the benefit of all relevant stakeholders.[62]

The Delaware experience and model will be contrasted to the South African position. There is a reasonable basis for its consideration and comparison to the South African position. In South Africa, policy makers attempt to strike a balance between self-regulation and state

by the board on the transaction was insufficient for them to make an informed decision, and therefore set aside the shareholders' approval.

[61] See also the ABA Report supra op cit note 12 at 21 and Mongalo T supra op cit note 10 at 145.
[62] See also the ABA Report supra op cit note 12 at 21 and Mongalo T supra op cit note 10 at 141.

regulation.[63] However, given the limited protection available to directors and senior managers in sections 78(4) and (5) of the Act, it is a grave concern for directors and senior managers that there is a lack of adequate protection which could have been possible through the lifting of the prohibition against exculpatory clauses in section 78(2) of the Act and requiring the purchase of director and senior managers indemnity insurance to be compulsory.[64]

The Delaware position highlights the importance of a nuanced approach to the requirement that skilled and suitably qualified persons take up positions as directors and senior managers and the protection of the company and relevant stakeholders from the potentially harmful conduct of directors and senior managers.[65] The *Smith v Van Gorkom* [66] judgement represents anecdotal evidence for the South African position that potential liability might affect the recruitment of directors and senior managers of suitably qualified abilities to act in such positions. The crux of the impact of the *Smith v Van Gorkom* [67] case was that following the Delaware Supreme Court's decision to hold directors personally liable for a breach of care, directors refused to take up new positions or to stand up for re-election. The applicable provisions were appropriately amended for the inclusion of the option by a company to procure the necessary indemnity insurance for directors (and officers) in certain instances.[68] It has been

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[63] Mongalo T supra op cit note 55 at 97. See also Delport P supra op cit note 33 at 156 wherein he remarks on 'the basic principle of corporate law (and associations in general) being that by assenting to be a shareholder in a company a person undertakes by his contract to be bound by the decisions of the majority of shareholders, if those decisions on the affairs of the company are arrived in accordance with the law, even if they adversely affect his own rights'. The argument that will be made is that directors' decisions are a corollary to the majority rule for at least two reasons. The first, the appointment of directors is more instances done with the approval of shareholders and reflects the wishes of the majority. Secondly, the decisions and actions taken by directors and managers are made with due regard to the wishes of shareholders. Shareholders are able to ratify, or reverse decisions taken by directors and senior managers (section 20(2) of the Act. Legally speaking shareholders also for part of the enforcement framework. A further point relates to the concept of delegation that may have a bearing on the nature and role of directors. An ongoing discussion relates to the nature and classification of directors and senior managers towards the company. There have been many attempts to consider directors as trustee, agents, managing partners or sui generis.

[64] The Legislature has in a related field insisted that there be a minimum amount of insurance in place to protect beneficiaries in the event of negligence or misdeeds. In regulation 30(2)(u) of the Pension Funds Act 24 of 1956 it is stipulated that a fund must have a policy of insurance to indemnify the fund against losses due to dishonesty or fraud by any of its officials. The fund's auditors are required to ascertain on an annual basis that such a policy is in place.

[65] Cassim et al op cit note 32 at 772.

[66] *Smith v van Gorkom* 488 A2d 858 (1985).

[67] *Smith v van Gorkom* 488 A2d 858 (1985).

[68] Following the *Smith v van Gorkom* 488 A2d 858 (1985) decision most states in the U.S. adopted and incorporated provisions permitting the exculpation and indemnification of directors and officers, in certain instances. In this regard, see section 2.02(b)(4) and (5) of the Model Business Corporation Act 2000/01/02 which provides that a company's articles of incorporation may include ' (4) a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which he is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of section 8.33; or (D) an intentional violation of criminal law; and (5) a provision permitting or making obligatory

argued that the policy considerations advocating for the provision of protection to directors and officers have had certain desirable effects such as limiting resignations of directors and officers because of the insulation from liability. Furthermore, the protection can be a catalyst for directors and senior managers to have the comfort in taking good-faith risks.[69] However, in contrast, the South African position is lacking in both.

According to Slaughter,[70] corporations rely mainly on two methods to mitigate the financial disincentive to corporate service indemnification and insurance. However, a crisis arose following the *Smith v Van Gorkom* decision where directors' and officers' liability insurance may have been inadequate or unavailable. The availability of insurance became ever-increasingly more difficult to find and expensive. The resultant shrinking coverage and increasing liability exposure caused a directors' and officers' liability crisis which posed a threat to incumbent directors and officers. This also led to directors resigning and refusing to stand for further terms. She concludes that the desirable policy interest in providing protection is the expansion of indemnity rights. There is yet to be a definitive judgment dealing with the application of the standards of directors in South Africa but a decision along the lines of *Smith v Van Gorkom*[71] could potentially send shockwaves and lead to restrictive directors' and officers' liability insurance in South Africa. The fact that the decision to purchase directors' and officers' liability insurance in terms of section 78(4) of the Act is left at the discretion of the company further represents the potential limited protection available to directors and officers especially in the light of the continued prohibition of exculpatory clauses in section 78(2) of the Act. She advocates for adequate protection of directors to prevent resignation or hesitancy to serve as directors because of the lack of insulation from personal liability (the potential of significant litigation costs and adverse judgements serve as a disincentive that outweighs the benefits of directorship). Lastly, she is of the view that the availability of adequate protection could catalyse desired corporate behaviour which encourages good faith risk-taking necessary for corporate success and profitability.[72]

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indemnification of a director for liability (as defined in section 8.50(5)) to any person for any action taken, or any failure to take any action, as a director, except liability for (A) receipt of a financial benefit to which he is not entitled, (B) an intentional infliction of harm on the corporation or its shareholders, (C) a violation of section 8.33, or (D) an intentional violation of criminal law'.

[69] Slaughter S 'Statutory and Non-Statutory Responses to the Director and Officer Liability Crisis' (1987) Vol. 63: *Iss.1 Indiana Law Journal* 181 - 200, at 185.

[70] Ibid at 184.

[71] 488 A2d 858 (1985).

[72] Slaughter S op cit note 57 at 185.

However, Slaughter[73] cautions that the protection of directors should be nuanced and balanced by not providing protection that is too generous. She cites two conflicting considerations regarding the adoption of exculpatory clauses 102(b)(7) of the Delaware Code which is compensation and deterrence. Shareholders may not be compensated for losses caused by a breach of the duty of care, skill and diligence. This may also cause a diminution of the efficacy that is imposed on directors by the potential of liability. In the South African position, a delicate balance needs to be struck between providing a protective environment and liability. The current framework which prohibits exclusion clauses and provides for discretionary indemnification means that the South African approach lacks the appropriate balance and directors and officers serving in South African incorporated companies are in a less favourable position than their counterparts in jurisdictions where both exculpation clauses and indemnification is permitted. It is important to state that wilful and gross misconduct is specifically excluded from being indemnified in terms of section 78(4)(a) -(b) – (5) and (7) of the Act. The operation of exemption clauses would not mean that directors and senior would be relieved from liability for intentional acts or conduct which would constitute overprotection that goes against public policy.

In the US state of North Carolina,[74] there was an outcry following a United States Court of Appeals for the Fourth Circuit of the Eastern District of North Carolina in a matter of *F.D.I.C. ex rel. Cooperative Bank v Rippy*[75] held that the officers of the corporation were not covered by exculpatory clauses (which the court deemed applied only to directors) because they were shielded against liability by the business judgment rule. This meant that the officers could be held personally liable for simple negligence. According to Jordan,[76] the decision highlighted a 'gap' in liability coverage between directors and officers in duty of care cases. In the South African position, there is a serious 'gap' in liability coverage for both directors and officers due to the continued prohibition of exculpation clauses, and directors could be potentially held liable for simple or mere negligence arising from a breach of a duty of care. The application of the business judgment rule in subsection 76(4)(a)(i) to (iii) of the Act has not been tested yet by a South African court. The formulation of the statutory duty of care and

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73 Slaughter S op cit note 57 at 188 and 189.
74 The State of North Carolina in response to the *Smith v Van Gorkom* decision and the Model Business Corporations Act inclusion of exculpation provisions adopted provisions that follow Section 102(b)(7) that allows for exculpation of directors but not officers.
75 799 F.3d 301 (4th Cir. 2015).
76 Jordaan H, 'Overcoming the Rippy Effect: Why the North Carolina Business Corporations Act Should Allow Permissive Officer Exculpation' (2016) 94 *N.L. Rev*. 2155 – 2175 at 2156.

skill in subsection 76(3)(c) of the Act has been criticised as being unclear concerning the subjective and objective requirements that a director or officer is required to be judged by in discharging the duty of care and skill.[77] The application of the business judgment rule is for example, is only applicable to a situation where directors have taken a decision. It will not assist directors and senior managers where the allegation relates to an alleged failure or an omission to exercise their duty of care, skill and diligence to properly supervise the affairs of the company. The liability gap may even be greater for a company that has elected not to purchase directors' and officers' liability insurance policies for its directors and senior managers. In such a case, a director or senior manager will have to fund the litigation costs and potential award for monetary damages from their means and assets.

1.5 Methodology

The research questions will be answered through applying two basic approaches: an analytical review of the relevant sections of the Act and a comparative law analysis. The two approaches will be applied to the research questions. The research is prepared on a desk-top approach.

A critical assessment of the relevant provisions of the Act dealing with the current enforcement framework relating to the protection and liability of directors and senior officers will be conducted.

This assessment will include a review of the applicable common law, statutory law, case law, textbooks, articles, and other relevant sources. In appropriate instances, comparisons will be drawn between the position that prevailed before the commencement of the Act and the current dispensation. This comparison will be used to highlight the shift and potential pitfalls created as a result of the failure to appreciate the potentially problematic implications that may befall South African directors as a result of the continued prohibition of exculpation clauses and discretionary indemnification.

77 Mongalo op cit note 5 at 151 to 152. However, the use of the phrase "the general knowledge, skill and experience of that director" in the formulation of the standards by the legislature faced criticism because it resulted in the objective standard being overshadowed by subjective considerations. Bekink argued that the courts might be confused in interpreting and applying the test (see Bekink M supra op cit note 3 at 114).

A comparison of the South African position and other legal systems will make it possible to gain insight and best practices applied globally to achieve the objectives of protection of directors and the object of enforcing accountability at appropriate levels.

1.6 Delimitations of the Research Study

The focal point of the research is to understand and unpack the current enforcement framework relating to directors and senior managers duty of care, skill and diligence and how the increased liability is counterbalanced with measures meant to protect directors and senior managers for honest errors of judgement and breaches in the discharge of the duty of care. The current framework ushered in by the Act represents a shift in the approach to enforcement and accountability in that there is heightened accountability which exposes directors and senior managers to serious personal financial risk which may be a disincentive for corporate service to South African boards without looking deeply into methods that may be adopted to insulate directors and senior managers for inevitable errors of judgement.

The research will show that conceptually the application of the focus of the framework has changed to include more persons to whom it previously did not apply to. The actual duties and sources of liability and how they are likely to affect the position regulated by the new definitions of directors and 'prescribed officer' or ‘senior managers’ are questions that are yet to be considered within the current framework. For purposes of this research the term ‘senior manager’ is used to indicate the broadness of the extended definition of director under the current enforcement framework. It will be demonstrated that the new definition of ‘prescribed officer’ is broad enough to include senior managers who factually or legally exercise general material control or participate in the making of material decisions affecting the company or its major divisions.

An interrogation of the broader philosophical underpinnings for the extension of the enforcement framework will be conducted, regarding directors and senior managers, considered as prescribed officers. The definitions of other 'officers' such as the company secretary, the auditor, etc. will not be analysed extensively, save in the context of a general reference to directors and senior managers. The focus will be narrowed to the potential liability that directors and senior managers face in the event of a breach of their duty of care and the adequacy of the protection provided through liability insurance in the absence of exemption clauses. The substantive and granular details of the duties and potential liability of directors, in general, will not be dealt with extensively and will only be reserved for further focus on a more in-depth analysis of the current enforcement framework relating to directors and senior managers.

Furthermore, the interplay between the statutory duties applicable to directors and senior managers and those imposed by the common law will not be explored in any great detail. The statutory statement of directors and prescribed officers' duties in section 76 does not expressly exclude the operation of the relevant common law principles and, as such, the actual assessment of the common law duties and how they apply to prescribed officers represents the next step and will be left for further research.

1.7 Chapter outline

What follows is the structure for the research work.

1.7.1 Chapter 1: Introduction

In the introduction, various aspects raised in this research proposal will be expanded upon. An overview and objectives of the research will be set out together with background context setting out the research problem. This chapter sets out the importance of the undertaken research and the research methodology used in analysing the research objectives.

1.7.2 Chapter 2: Theoretical Foundation

This chapter will map out the definitions of 'director' and 'prescribed officer' within the broader context of the current enforcement framework. I will unpack the objectives of accountability and transparency imposed by corporate governance on directors and senior managers. Chapter 2 examines the provisions of the Act designed to make directors and senior managers accountable in the exercise of their powers. The duties and liability imposed on directors and senior managers will be discussed in this chapter. Models of enforcement will be considered and how they fit in seeking a balance between punishing faithless directors and senior managers while protecting directors and senior managers willing to take aggressive good faith risk-taking.

1.7.3 Chapter 3: The Duties and Liability of Directors and Senior Managers

In this chapter, the duty of care and skill and civil liabilities of directors are discussed. It is demonstrated that the current legal framework has increased the liability of directors and senior managers while not providing adequate protection for good-faith errors. It importance of understanding the essence of the framework and the purposes of corporate governance for the management of a company will be discussed. This will be limited to its application to the role and designation of directors and senior managers of a company.

1.7.4 Chapter 4: The Nature and Evolution of the Prohibition Against Exempting Directors and Senior Managers From Liability: The Current Position

I analyse the history of the prohibition of exemption clauses regarding United Kingdom law. The development and outline of the difficulties that surround the prohibition will be traced and explained. I intend to argue that the effect of the prohibition as contained in section 310 of the English Companies Act 1985 (which was comparable to section 247(1) of the 1973 Act) failed to make a distinction between the forms of liability that can be excluded. The provisions merely made all forms of exclusion of liability void. The prohibition did not distinguish between a breach of a duty of care (which relates to negligence) and a breach of trust. The two duties are conceptually different and ought to receive different considerations. The blanket prohibition meant the scope of the duty concerned and the consequences of such a breach were incapable of being excluded in a company's articles of association or any agreement. Since the duties placed on directors and officers of companies are very onerous, the rise in litigation involving directors,[78] the prohibition which negates exculpation clauses, should be revisited.

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[78] Some recent cases involving directors include *Hlumisa Investment Holdings (RF) Ltd and Another v Kirkinis and Others* (Case no 1423/2018) [2020], *De Bruyn v Steinhoff International Holdings N.V. and Others*

1.7.5 Chapter 5: International Benchmarks and Trends in the Evolution of the Standard of Care, The Business Judgment Rule and the Exemption of Directors and Senior Managers

The Delaware model represents a more advanced approach to the protection of directors and officers in that it makes provision for both the exculpation and indemnification of directors and senior managers. A qualitative comparison of the framework applicable in Delaware and South Africa will be undertaken with the view to determining the strength of protection of directors and senior managers against monetary damages for alleged negligence and breach of fiduciary duties.

The United Kingdom approach is analysed and contrasted with the South African position. Legal developments of the United States, especially the state of Delaware, which are arguably of utmost importance to this study and the issue of solving the director and senior manager liability. It will be discussed extensively in this chapter.

1.7.6 Chapter 6: The Scope of Indemnification and Liability Insurance for Directors and Senior Managers Under Subsections 78(4) – (7) of the Act

In this chapter, I will consider the wording of subsection 78(2) in the context of the entire section. I will unpack the considerations the policy makers took into account in persisting with the prohibition that was present in section 247(1) of the 1973 Act to the current Act (section 78(2)). The potential impact and benefits of the inclusion of exculpatory provisions on directors and senior managers will be outlined. Lastly, the concept of exculpation will be contrasted with the indemnification of directors and senior managers.

The application of the extended definitions of insurance law and the protection of directors and senior managers under subsections 78(4), (5) and (7) of the Act will be discussed in great detail in this section. The wording (and interpretation) of subsections 78(4) and (5) of the Act will be analysed. The practical application of the subsections will be explained. I will

(29290/2018) [2020] ZAGPJHC 145 (26 June 2020), and *Organisation Undoing Tax Abuse and Another v Myeni and Others* (15996/2017) [2020] ZAGPPHC 169.

also consider specific policy wordings and trends with a view to highlighting the deficiencies of subsections 78(4) and (5) of the Act. The potential effects of a constricting market on the price and availability of directors' and officers' liability insurance on the protection of directors and senior managers will be postulated.

1.7.7 Chapter 7: Summary, Conclusions and Recommendations

The last chapter will summarise the findings and show how the definition of 'director' has been, in respect of certain sections of the Act, extended to include various persons, including prescribed officers.[79] These 'prescribed officers' and senior managers are therefore subject to the same onerous duties, standards, and liabilities of directors. Even the rules relating to the indemnification of directors apply to the so-called non-directors such as prescribed officers.

Possible solutions that will be considered such as the amendment to the provisions of sections 78(2) and 78(4) concerning exemption clauses and the indemnification of directors and senior managers.

The sustainability of personal risk management liability insurance policies measures that directors could consider using to protect themselves, such as personally purchasing directors' and officers' liability insurance, from potential personal risk will be explored and other practical that the courts should play in the interpretation and application of the relevant sections.[80] Directors and senior managers can purchase Personal Management Policies in the open market and at their own cost. The desirability of this proposed solution will be evaluated and whether such policies are affordable and practically accessible. It will be suggested that the courts should interpret the provisions applicable restrictively and qualify the extent of the ambit of the definition of 'prescribed officer' in certain instances where practical risk mitigation methods will be demonstrated.

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[79] See sections 75(1); 76(1); 77(1); and 78(1) of the Act.
[80] Section 75 to 78 of the Act.

CHAPTER 2

THEORETICAL FOUNDATION

2.1 Introduction

The purpose of this chapter is to survey the foundational principles relating to corporate directors' and senior managers' liability and the fundamentals of the applicable regulatory design in reducing policy failure. In recent years, the government's response to corporate failures has been to increase the regulation of directors' and officers' conduct and to increase accountability for misdeeds.[81] The desire for greater accountability is largely aimed at preventing future corporate failures. This policy has tended to channel lawmakers, such as is

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[81] Countries such as Australia and the United Kingdom are among those that recently undertook extensive reviews of their company laws which culminated in the passing of the Corporations Act 50 of 2001 (Aus.) and the Companies Act of 2006 (UK.). South Africa followed suit and passed the Companies Act 71 of 2008 which became operational in 2011.

the case with South African policymakers, to focus legal enforcement on regulation without much thought to the protection of directors and officers in certain justifiable circumstances.[82] The relationship between accountability and the need to protect directors and officers creates an enduring problem and is a dilemma for lawmakers in that both conflicting policy considerations are equally valid.[83]

Those who argue for increased accountability and regulation of directors' conduct cite the recent corporate failures as merits for their position, the lack of meaningful enforcement and accountability for egregious conduct, the impunity with which some directors have behaved lately in the short-term pursuit of profits, and the concern that over-protection of directors will erode the threat of liability which is meant to be a deterrent for aberrant behaviour.[84]

On the other hand, the argument for the protection of directors is made from the point of view that suggests that the lack of adequate protection would mean that directors face the real prospect of personal financial harm if they are held liable even for legitimate actions taken in the performance of their duties and furtherance of the company's business.[85] This potential liability becomes a financial disincentive for serving as a director and could have the effect that directors become overly cautious in their decision-making to not attracting any liability.[86] The net effect is that corporations will not be able to attract or retain suitably qualified individuals, moreover, directors will be afraid to take good faith risks essential for the growth of the business and economy. It has also been argued that a strict accountability regime would lead to a reduction of the 'efficiency of corporate decision making'.[87]

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[82] Mongalo op cit note 10 at 141.
[83] Veasey N 'The Defining Tension in Corporate Governance in America' (199) *BUS.LAW*. 393 – 406 at 403.
[84] Ulrich H 'Indemnification of Corporate Directors: A Disincentive to Corporate Accountability in Indiana' (1982) 17 *Val. U. L. Rev.* 229 – 280 at 234. See also Gevurtz F 'The Business Judgment Rule: Meaningless Verbiage or Misguided Notions?' (1994) 67 *CAL. L. REV*. 287 – 337 at 312 and 333.
[85] William T, Jacobs J, Strine Jr L 'Functions over Form: A Reassessment of Standards of Review in Delaware Corporation Law' (2000) 56 BUS.LAW. 1287 – 1321 at 1296 wherein it is stated that '…directors make decisions in an environment of imperfect information…given the limited investment in publicly held firms that typical corporate directors are able or willing to make, any risk if liability would likely dwarf the incentives for assuming the role.'

[86] See Keay A & Loughrey J 'Business Judgment and Director Accountability: A Study of Case-Law Over-time (2020) 20 Journal of Corporate Studies 359 – 387 at 361. See also M Spisto's D and O Insurance for directors and officers. What is it, and is it a viable option in South African law? (1996) 29 *CILSA* 61 – 70 at 61 and Mongalo supra op cit note 10 at 156.
[87] Bainbridge S 'The Business Judgment Rule as Abstention Doctrine" (2004) 57 *VAND.L.REV*. 83 – 130 at 129. However, mere deference to the board's authority would also entail 'a risk of opportunism and even plain carelessness'.

Instead, we must look through and beyond the conflicting underpinning policies and consider the normative and social aims sought to be secured and maintained by increased accountability and protection of directors. In doing so, we shall be able to find a creative middle-way solution that will promote the effectiveness (regulation) through the existing statutory provisions relating to accountability while also furthering the important aim of providing directors protection for monetary damages in the case of bona fide negligent errors or breach of care in the discharge of their duties that insulates them from financial liability in certain instances as a means to allow corporations to retain suitably qualified individuals. We need to look at a new model of regulation and protection that carefully balances the conflicting policy considerations.[88]

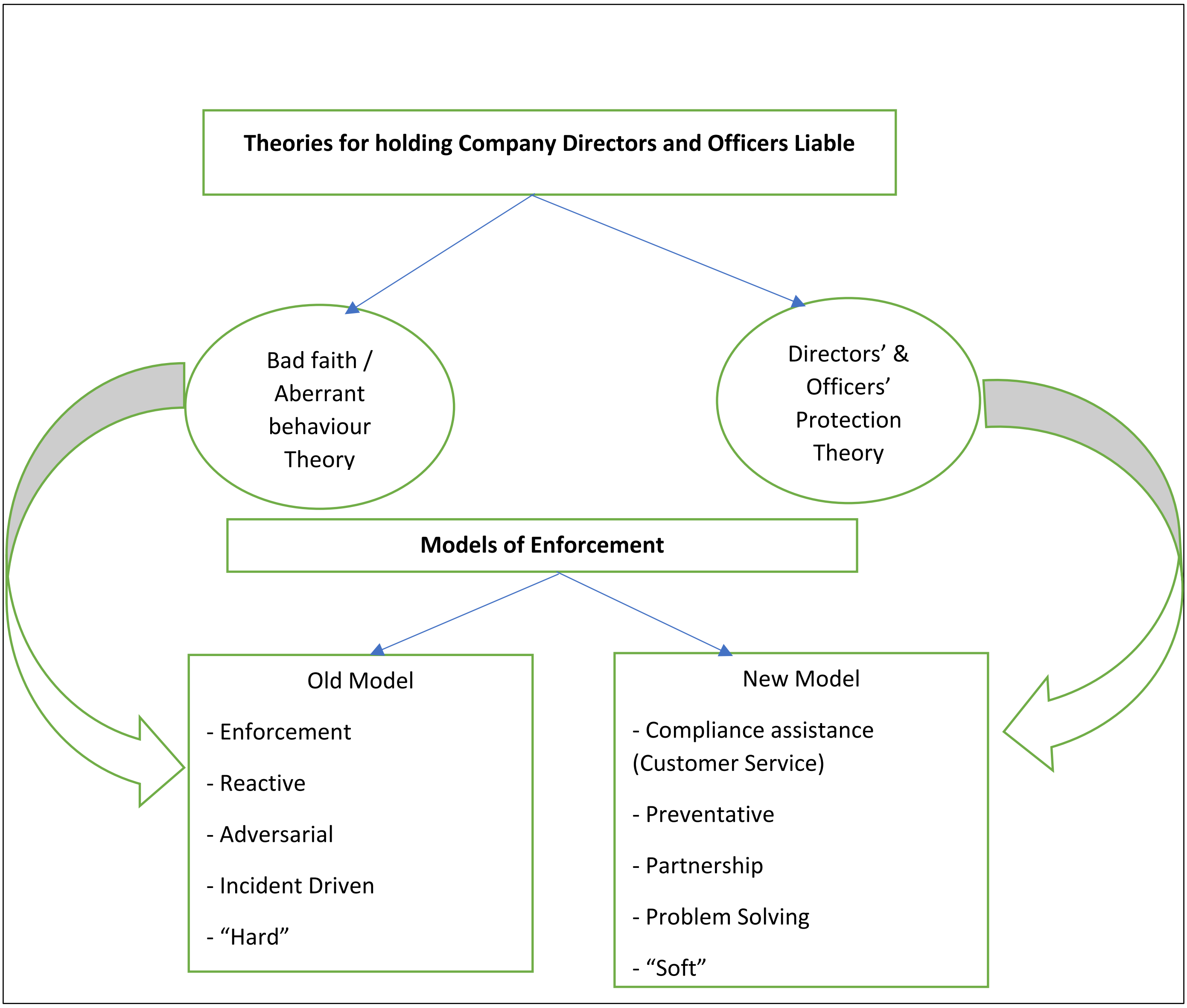
The intention here is not to debate whether increased accountability is justified, or indeed to enquire if it will prevent further corporate collapses. The point is also not to claim that by protecting directors from liability, such protection will lead to better decision making on their part. Instead, the study will identify the different policy considerations that have a bearing on the need to carefully balance the two conflicting underpinning policies, i.e., to encourage suitable persons to take up the position of director and to protect corporations and shareholders from the consequences of wrongdoing by their directors. It is also important to examine how the regulatory design contributes to achieving policy objectives by highlighting emerging issues for regulatory compliance in South Africa and projecting whether the levels of compliance will be high or low based on the current legal enforcement framework.

As stated in Chapter 1, the main aim of this thesis is to determine whether the formulation of the current legal enforcement framework regulating directors' and senior managers' conduct provides clear and sustainable provisions to encourage and protect those in effective management to take necessary good faith risks in pursuing value for all stakeholders concerned. To address this question, it is necessary to have a sound theoretical foundation concerning the enforcement of corporate law on directors' and senior managers' duties and liabilities. This Chapter focuses on the various theories of the legal enforcement framework and models that are based on them and which relate to the objectives of accountability and protection of directors and senior managers.

[88] Slaughter S op cit note 57 at 187. See also Johnston J 'Corporate indemnification and liability insurance for directors' and officers' (1978) 33 The Business Lawyer 1993 – 2053 at 1993.

The problem of directors and senior managers' liability is premised on the debate whether the potential for liability for monetary damages may result in being a disincentive for suitably qualified individuals to take up the role of director and senior managers in South Africa and thus the unavailability of qualified directors and senior managers may trigger a crisis for the South African economy. In this chapter, two competing theories and approaches to directors' and senior managers' liability are examined: the directors' and officers' protection theory, which advocates for the protection of directors and the bad faith or aberrant theory that castigates errant behaviour on the part of directors and senior managers. Key concepts relevant to the statutory and non-statutory measures relating to liability and protection of directors and senior managers from liabilities incurred in the discharge of their functions, and the models of enforcement aimed at achieving regulatory compliance are considered. Before the interaction between the standards of care, skill, diligence, and the business judgment rule under the Act can be considered, the theoretical framework regarding the liability and protection of directors and senior managers relevant to this study must be looked at in a contextual framework. It is also considered vital in this Chapter to clarify the nature of the relationship between the theories and the model of regulation adopted in legislation and as espoused in literature. A combined theory is proposed relating to the balance that should be struck between the competing policy considerations of accountability and the protection of directors and senior managers, with the view of providing a middle ground between encouraging fiduciaries to violate their trust and discouraging them from serving at all.

These theories and models are illustrated in the following diagram, which serves as a point of reference for the discussion below:



2.2 The need for reform of the corporate legal enforcement framework with particular focus with a particular focus on directors' and officers' duties and liabilities

A serious concern that was noted, as far back as 2004, in the Policy Paper related to the rules that govern the conduct and behaviour of directors and senior managers.[89] According to the Policy Paper, company law did not contain 'clear rules regarding corporate governance and the

[89] The ABA Report supra op cit note 12 at 20 also remarked that it was important for foreign investors to understand the "rules" which govern the behaviour of directors in South African corporations and the remedies that are available for violations (see page 20 of the ABA report supra op cit note 12 dealing with directors under Chapter VIII).

duties and liabilities of directors'.[90] The framework largely left these matters to 'the common law and Codes of Practice'. The point was made that there was no extensive statutory scheme covering 'the duties and obligations of directors and their accountability in cases of violations'. The Policy Paper thus remarked that an important part of the company law review was to 'ensure that directors are made as accountable to shareholders as is practicable'.[91]

It is thus clear that, in the aftermath of corporate global collapses and the failure of various corporate governance systems in corporations, the approach to the reform of company law and the corporate legal enforcement framework sought to improve corporate governance by making directors accountable to shareholders as much as possible. It had been noted that there were 'serious defects in the prevailing standard of corporate governance and the administration of the law' that resulted in investors suffering extensive losses.[92]

Central to the development of appropriate corporate governance standards and rules was the need for certainty and the need to protect shareholders through the adoption of a general statement on the duties and liabilities of directors.[93] However, the lack of enforcement was highlighted as the 'most significant deficiency' in the corporate enforcement framework in that it failed to provide effectual mechanisms for the enforcement of the duties prescribed in law.[94] There was increasing fragmentation of enforcement responsibility which opened the way for unequal regulation and regulatory arbitrage between the different enforcement agencies.[95] The lack of enforcement and means to meaningful recourse was also partly attributed to the disincentives created by litigation and caused by the structure of the court system.[96] This begs the question of whether the current legal enforcement framework which has been brought in by the Act is properly aligned with the enforcement model in place to achieve the appropriate balance between the policy objectives of higher proprietary standards for directors and officers while providing adequate protection to directors and officers that enables them to aggressively take good faith risk in the interest of the corporation and ultimately its shareholders and stakeholders.

Regulatory reform represents an opportunity to effect changes to the legal enforcement framework that improve regulatory quality to enhance the performance, cost-effectiveness, or

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[90] The Policy Paper supra op cit note 15 at 15.
[91] The Policy Paper supra op cit note 15 at 17.
[92] The Policy Paper supra op cit note 15 at 17.
[93] The Policy Paper supra op cit note 15 at 23.
[94] The Policy Paper supra op cit note 15 at 17.
[95] The Policy Paper supra op cit note 15 at 17.
[96] The Policy Paper supra op cit note 15 at 17.

legal quality of regulations. The approach to reform by South African lawmakers represents a missed opportunity, as there was a collective failure to understand the opportunity concerning the regulation of directors' and officers' duties and liability. The model is still largely reactionary in that enforcement is case-by-case or is incident-driven, the recent collapse of the Steinhoff group of companies being a classic example.[97]

As a consequence of the recent corporate -law review process, the Companies Act, of 2011, now provides for a partial codification of directors and senior managers duties as well as including a statutory business judgment rule.[98]

According to Grower a '…central part of company law is concerned with providing a framework of rules which, on the one hand, constrains the potential abuse by directors of their powers, whilst on the other hand does not so constrain the directors that the efficiency gains from having a strong centralised management are dissipated.'[99] He further remarks that '…this is an age-old problem for company law and one that is constantly re-visited by successive generations of rule-makers, for no one approach can be shown to have struck the balance appropriately.'[100]

2.3 Director liability versus Director protection

Two perspectives are relevant concerning the enforcement of corporate law about directors' and senior managers' liability. The first concerns the aberrant director theory that holds that directors and senior managers should be held liable in connection with any negligence, default, breach of trust or breach of duty with the company, and thereby, protect companies and shareholders from the consequences of wrongful acts of the company's directors and senior

[97] The collapse of Steinhoff in 2017 was a result of regulatory failures at several levels some being the delay of publication of financial statements and the restatement of earlier financial statements with some senior executive management being accused of fraud and dereliction of duties. See *Financial Mail* news article accessed from https://www.businesslive.co.za/fm/fm-fox/2019-06-26-exclusive-pay-back-the-money-steinhoff-demands-r874m-from-markus-jooste/ and https://www.news24.com/fin24/steinhoffs-r1bn-claim-against-jooste-and-la-grange-5-things-you-need-to-know-20190701.

[98] Section 76(3) of the Act is considered to be part codification of the standards for directors and senior managers expected standards while section 76(4) of the Act introduces the business judgement rule.

[99] Davies PL & Worthington S Gower's Principles of Modern Company Law (10th edn Sweet & Maxwell 2016) 462.

[100] Ibid at 462.

managers.[101] The second perspective concerns the director protection theory.[102] In terms of this theory, corporations should be permitted to adopt certain mechanisms that limit the extent to which their directors and senior managers are exposed to personal liability for negligence, breach of trust and duty or other defaults in the performance of their functions and thus enable companies to find and retain suitably qualified persons willing to serve as directors and senior managers.[103]

As far as 1996 a call was made to South African lawmakers to solve the problem of directors' and officers' liability.[104] It was stated that a middle ground needed to be sought between the conflicting policies encouraging directors to violate their trust and discouraging them from serving at all. The need to punish faithless directors had to be balanced against the need to provide protection to aggressive directors and senior managers willing to take good-faith risks in the pursuit of profits. It was recommended that methods be developed for the protection of directors and officers against personal risks to ensure that capable persons are attracted to serving in the role of directors and officers. The point was made that a successful business system required corporations to take risks, which would be undermined if directors and officers were not able to protect themselves against personal financial disasters arising from lawsuits alleging negligence, the result would be that the dangers of risk-taking would far outweigh the rewards.[105]

The accountability and protection of directors were also debated during the company law review process in South Africa.[106] The drafting of a new Companies Act provided an ideal opportunity to resolve this issue, and to provide a long-term solution capable of balancing the conflicting underpinning policies and the practical methods available to directors to protect themselves from personal liability in respect of claims for monetary damages for alleged

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[101] W Bishop & DD Prentice 'Some legal and economic aspects of fiduciary remuneration' (1983) 46 *MLR* 289 – 301 at 289. According to Cassim et al op cit note 32 at 683 – 684: the fiduciary duties of directors and senior managers are protective of the company, its shareholders and indeed even of the public interest.

[102] Cassim et al op cit note 32 at 1045.

[103] Cassim et al op cit note 32 at 1045. Cassim et al contend that without these mechanisms, companies would find it difficult to find suitable persons willing to serve as directors. According to Cassim et all the Act provides for a more effective means of enforcing the duties of directors and a more derivative action in terms of section 165; therefore, the perception is that the need for protective measures for directors has been magnified.

[104] Spisto M 'D and O Insurance for directors and officers – what it is and is it a viable option in South African law? (1996) 29 *CILSA* 61 – 70 at 61.

[105] Ibid at 61.

[106] The Policy Paper supra op cit note 15 at 38.

negligent conduct. However, as indicated, the drafters of the Act h not addressed the problem sufficiently.[107]

2.4 Theories and Policy Considerations Justifying the Holding of Directors and Senior Managers Personally Liable

2.4.1. The Content of the Theory

This theory primarily advocates that the provision of protection too liberally to directors and senior managers will defeat the underlying goal of laws imposing liability on aberrant behaviour.[108] The theory is premised on the argument and belief that good corporate governance is best achieved by focusing on the accountability of directors. In terms of this theory, it is further argued that the accountability of directors is the basis for the success of all other principles of corporate governance. It is widely posited and accepted that holding directors and officers accountable for their behaviour and decisions is fundamental to good corporate governance.[109]

The basic question is why duties and liability ought to be imposed on directors and senior managers at all. According to Mongalo, the true and ultimate purpose of directorial duties is the supervision of the use of corporate power.[110] He advocates for a departure from the conventional shareholder corporate legal enforcement framework that limits the right of action to protect the interest of companies to shareholders only. The argument in simple terms is that duties and liability ought to be imposed on directors and senior managers to deter acknowledged forms of undesirable conduct and to compensate parties adversely affected by the undesirable conduct. The exclusive protection of shareholders' interests can no longer be

[107] See the discussion on subsections 78(2) and (4), (5) and (7) of the Act and the problem with the construction of the protection and relief available to directors and senior managers in Chapter 6.
[108] Slaughter S op cit note 57 at 186 referring to an argument that was first raised by Johnston J ‘Corporate indemnification and liability insurance for directors’ and officers’ (1978) 33 *The Business Lawyer* 1993 – 2053 at 1993. Johnston J is a strong proponent
[109]Keay A ‘Stewardship theory: is Board Accountability Necessary?’ (2017) 59 *Journal of Law and Management* 1292-1314 at 1294. See also Botha M ‘Are senior managerial employees prescribed officers in terms of the Companies Act 71 of 2008, and are they treated the same as executive directors? (2012) 4 TSAR 786 at 786, wherein it is stated that the duties of directors, even though contentious, are important in that they play an important role in ensuring the promotion of corporate governance.
[110] Mongalo T ‘Supervision of the Use of Corporate Power as the Ultimate Purpose of Directorial Duties and the Advisability of Corporate Law Enforcement in the Public Interest’ (2017) 3 (1) JCCLP 17 – 48 at 17.

accepted and justified as the purpose of directorial duties. Mongalo is of the view that 'policy makers should accept that the supervision of the use of corporate power to minimise or eradicate the potential for directorial self-serving conduct is the ultimate purpose of such duties'.[111]

A further reason for the imposition of duties and liability on directors and senior managers is that it raises the standards of corporate and directorial behaviour.[112] According to Bishop, in the context of remuneration of fiduciaries, the way the duties and rules have been designed is to operate prophylactically and to place a maximum deterrent on undesirable conduct. This was also the object of partial codification of the fiduciary duties of directors and senior managers in the Act which was to make the law clear and more accessible for directors.[113]

In light of the foregoing, the essence of this theory and the philosophy advocating for accountability and effective control of directors and senior managers can succinctly be summarised in the statement by the Cadbury Committee, which reiterated that:

> '…. No system of corporate governance can be proof against fraud or incompetence. The test is how far such aberrations can be discouraged and how quickly they can be brought to light. The risks can be reduced by making the participants in the governance process as effectively accountable as possible.'[114]

2.4.2. The Primary Proponents of the Theory and Some of the Documented Justifications of the Theory

Andrew Keay observes that the availability of insurance (protection) as a means of overcoming the problem of risk-taking faced by directors and senior managers because of the imposition of duties may have undesirable aspects. According to him, insurance provides directors and senior managers with a safety net, with the result that directors knowing that they are insured might

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[111] Ibid at 18. See also Havenga M 'Corporate Opportunities: A South African Update' (1996) 8 *SA Merc LJ* 40 – 55 at 40 wherein she affirms that control over management is vital in the interests of the company, its shareholders and other stakeholders.
[112] Cassim et al op cit note 32 at 684.
[113] W Bishop & DD Prentice op cit note 97 at 309.
[114] Cadbury Committee Report of the Committee on the Financial Aspects of Corporate Governance (1992) United Kingdom par 7.2.

be encouraged to adopt unreasonably high-risk policies that are unwise and prejudicial to shareholders and have the potential to cause adverse social harm, such as job losses should the company fail. Thus, the negative side of the protection or insurance is that directors and senior managers may take even higher risks because of the comfort of knowing that they have an insurance safety net.[115]

In addition, the concern is that over protection of directors and senior managers may have a counterproductive effect in that it may undermine or nullify the objects of any laws or rules designed and aimed at preventing and imposing liability for aberrant behaviour. Slaughter and Johnston have said that the protection of directors must be delicately balanced against the possibility that if protection is too liberally granted to directors, it will defeat the underlying goal of laws imposing liability for aberrant behaviour. This would result in an untenable position that 'faithless' directors would not be punished. The threat of personal liability will act as a deterrent and restraint for inappropriate conduct on the part of directors.[116]

Ulrich contends that modern indemnification statutes with liberal indemnification provisions have thwarted the ultimate goal of achieving appropriate levels of accountability by enabling directors to escape personal liability for their conduct. The argument is based on the premise that such indemnification is contrary to the utilitarian principle, which imposes liability upon directors not solely for the reason of compensating individuals or groups of individuals that have suffered a loss, but for the purpose and reason of curtailing the abuse of private power exercised to the detriment of society. Therefore, the primary purpose of imposing liability on directors is not merely to provide compensation to individuals for losses or harm suffered by them as a result of a breach. However, the primary purpose of liability must be viewed as a deterrent policy aimed at precluding future breaches.[117]

2.4.3. The Shortcomings of the Theory

While the argument on which the theory is based suggests that the primary purpose for imposing liability is to provide deterrence against negligence and other misconduct by directors

[115] Keay A 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' (2003) 66 *Modern Law Review* 665 – 699 at 685.
[116] Johnston J
[117] Ulrich H supra op cit note 84 at 231.

and senior managers appears to lend itself to the conclusion that by protecting directors and senior managers the deterrence effect would be eliminated or reduced, it is nevertheless too simplistic to assume that deterrence adequately strikes the balance between constraining potential abuse by directors and senior managers of their powers and granting them enough freedom to gain from a strong centralised management.[118]

The hypothesis that suggests that the availability of directors' and officers' liability insurance creates a moral hazard problem for shareholders and weakens the discipline effect of stakeholder litigation has been rejected and refuted as being unsupported by empirical evidence.[119] It has been found that the influence of directors' and officers' liability insurance on directors' actions is that it does not change directors' monitoring functions but may influence their decision whether they accept the role of serving as directors. It is suggested that it is likely that directors will decline to serve as directors if a company does not offer directors' and officers' liability insurance.[120] The purchase of directors' and officers' liability insurance facilitates the recruitment of independent directors who are independent of management and more likely to protect the interests of shareholders.[121] Some research on the influence of directors' and officers' liability insurance has demonstrated that it has had no significant impact on the company's ability to generate future shareholder value, thus implying that insurance has had very little effect on corporate governance.[122] Therefore, the availability of directors' and officers' liability insurance does not alter the behaviour of directors and senior managers from that which would have occurred in the absence of such cover.

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[118] Davies P and Gower S supra note 99 at 462 the author maintains that company law enforcement framework needs to grapple with and find an appropriate balance between rules that constraint potential abuse by directors and provide protection and freedom for decision making within an organisation.

[119] MacMinn R & Ren Y, Han L 'Directors, Directors and Officers Insurance, and Corporate Governance' (2012) 35 *Journal of Insurance Issues* 159 – 179 at 161 and 166.

[120] Ibid at 161.

[121] Barrese J and Scordis N 'Managerial bias in corporate governance and the effect of D&O insurance: A literature review and synthesis' (2006) 3 *International Journal of Disclosure and Governance* 185 - 196 at 190.

[122] O'Sullivan N 'Insuring the Agents: The Role of Directors' and Officers' Insurance in Corporate Governance' (1997) 64 *The Journal of Risk and Insurance* 545-556 at 545. See also Holderness C 'Liability Insurers as Corporate Monitors' (1990) 10 *International Review of Law and Economics* 115 – 129 at 121 who suggested that directors' and officers' liability insurance has a vital monitoring function role in that before the issuance of an insurance policy directors and officers undertake a thorough examination of the persons for whom the cover is sought, which promotes corporate governance as it helps to monitor the corporate governance of the insured company.

2.4.4. Concluding Observations

In the final analysis, the bad faith aberrant director theory disregards the need to protect directors and senior managers because of the assumption that such protection will eliminate or reduce the deterrence value of rules imposing liability. The suggested justifications are unsustainable, as they fail to appropriately strike a balance between the prevention of potential abuses by directors and the need to provide directors and senior management freedom to take good faith risks in pursuance of value for stakeholders and ultimately for a healthy business system. Moreover, the availability of directors' and officers' liability insurance does not create a moral hazard problem in that it does not alter directors' and senior managers' conduct or behaviour, and its availability facilitates the recruitment and retention of suitably qualified individuals capable of serving in the role of director and senior managers.

2.5 Theories and Policy Consideration Supporting the Protection of Directors and Senior Managers

2.5.1. The Content of the Theory

In terms of the director protection theory, corporations have a legitimate interest in providing protection mechanisms to directors and senior managers as a means to attract qualified individuals to serve in the position of director.[123] Under the common law agency, it is a recognized principle that a principal is under a duty to indemnify an agent for all losses or liability duly incurred by the agent in the execution of the mandate, or directly caused to the agent by the execution.[124] However, the application of this principle is unclear when it is applied to directors and senior managers as 'agents' acting within the corporate structure. There is also a debate about whether directors and senior managers should be classified as 'agents' of the corporation.[125] What is clear is that there were serious deficiencies or gaps in the protection afforded to directors and senior managers under common law. In *Blair v*

[123] Keay A supra note 115 at 684.
[124] O'Sullivan N supra note 122 at 546.
[125] Cassim et al op cit note 32 at 552.

Consolidated Enfield Co.[126] the Supreme Court of Canada expressed the view that indemnification or protection is intended to create a balance between accountability when directors act improperly, and encouraging the growth of commercial innovation when directors act reasonably. The court expressed the view that[127]:

> 'Permitting [an individual] to be indemnified is consonant with the broad policy goals underlying indemnity provisions; these allow for reimbursement for reasonable good faith behaviour, thereby discouraging the hindsight application of perfection. Indemnification is geared to encourage responsible behaviour yet still permits enough leeway to attract strong candidates to directorships and consequently foster entrepreneurism...A balance must be maintained.'

The rationale for permitting protection for directors and officers of companies was best expressed in the UK White Paper: Company Law Reform 2005, where it was stated that:

> '…the law on directors' liability needs to strike a careful balance: on the one hand, the law must be firm and robust to deal fairly with cases where something has gone wrong, as a result of either negligence or dishonesty: on the other, Britain needs a diverse pool of high-quality individuals willing to assume the role of company director, and a willingness by directors to take informed and rational risks.'[128]

Companies have long recognized the extensive personal liability risk posed to directors and senior managers for their role in corporate faults or corporate failures.[129] To minimize the consequences of personal liability, companies and directors have attempted to adopt certain measures and precautions to protect and insulate directors and senior managers, such as requiring that the company include provisions that exclude such liability in their service contracts or the company Memorandum of Incorporation and through the purchase of liability insurance.[130] Viewed from this perspective, the protection provided to directors and senior managers is not only crucial and instrumental for companies to encourage talented individuals to serve in the role of director and senior manager but also for these individuals to do so without

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[126] (1995), 128 D.L.R. (4th) 73 (S.C.C.).
[127] Ibid at 96.
[128] Chapter 3, (Enhancing Shareholder Engagement and a Long Term Investment Culture), (2017) at 23.
[129] *In re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425 (ChD) and *In Re City Equitable Fire Insurance Co Ltd* ([1925] 1 Ch 407 (CA).
[130] Davies P and Gower S supra note 99 at 589.

being overly conservative in the management of the company due to the fear or threat of potential personal liability and harm.[131]

2.5.2. The Primary Proponents of the Theory and Some Justifications of the Theory

Daniels and Hutton[132] caution against the danger that may result if rules imposing liability are overzealously interpreted and enforced by the courts, thereby creating excessive levels of deterrence. These commentators are of the view that the impact of liability will affect both the care and activities of the targeted individuals. A tempered approach is recommended by them to prevent excessive care and activity reactions to liability by permitting corporations to indemnify their directors and senior managers for reasonable costs incurred in defending, settling or satisfying a judgment or award. The protection ought to be limited to instances where the director acted 'honestly and with good faith with the view to the best interest of the company'.[133] The appropriate deterrence to be accorded to the notions of fault and personal liability needs to be carefully balanced with the commensurability of the costs and benefits of enhanced liability. The absence of insurance coverage will result in directors and senior managers being risk-averse, reducing the benefits of increased liability.[134] This view is also shared by Finch, who argues that the absence of directors' and officers' liability insurance may encourage an overly conservative approach to the management of the company, which is not likely to be in the interest of the corporation and its shareholders. Company directors will become excessively risk-averse to the point that they become unwilling to take commercially justifiable risks because of the fear of triggering personal financial liability.[135]

O'Sullivan suggests that the corporate purchase of directors' and officers' insurance not only fulfils an important monitoring function on publicly held companies but that it

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[131] Bekink M supra op cit note 6 at 91. See also Daniels R & Hutton S 'The Capricious Cushion: The Implications of the Directors' and Officers' Insurance Liability Crisis on Canadian Corporate Governance' (1993) 22 *Canadian Business LJ* 182 at 184 wherein they state that in the absence of insurance directors even though there are justifiable economic reasons can be expected to refrain from activities which are deemed to be too costly or risky because they raise the spectre of personal liability for directors.

[132] Daniels R & Hutton S 'The Capricious Cushion: The Implications of the Directors' and Officers' Insurance Liability Crisis on Canadian Corporate Governance' (1993) 22 *Canadian Business LJ* 182 -203 at 187.

[133] Ibid at 187.

[134] Ibid at 184.

[135] Finch V supra op cit note 49 at 886.

facilitates the recruitment of outside directors whose objectiveness and independence are required for the safeguarding of shareholder welfare.[136]

Some of the primary justifications for the protection of directors include the following benefits:

(1) Protection of directors and senior managers results in a significant reduction of director and officer resignations and increases the availability of qualified persons to take on these roles. According to this argument, companies need methods to mitigate the financial disincentives to corporate service.[137] Thus the availability of protection will reduce the problem of director and senior manager resignation. In instances where there is no protection available, directors and senior managers are more likely to resign because they have no insulation from liability. It is argued that the possibility of individuals serving as directors and senior managers being subject to high costs of defending lawsuits and exposure for adverse judgment awards will outweigh the benefits of serving in the role of director or senior manager. This argument is based on the premise that in recent the amounts and costs involved in litigation have increased substantially and it will be difficult to persuade or encourage responsible individuals to serve as directors and senior managers if they had to personally bear the costs of defending their conduct in every instance where it is challenged.[138]

(2) The availability of protection encourages desired corporate behaviour and good faith risk-taking on the part of directors and senior managers. It is suggested that availability protection serves as a catalyst to desired corporate behaviour by encouraging good faith risk-taking. Risk-taking inherently invites lawsuits, but is it seen as necessary for corporate success and profitability? It thus accepted that if there is protection available, directors and senior managers will be more likely to feel freer to take good faith risks because if they are sued, they will be reimbursed and protected. Whereas, if there is no protection directors and senior managers will avoid all risks to avoid being sued.[139]

(3) Protection limits undesirable over-cautiousness in decision-making by directors and senior managers. The argument is extended to the point that there is a need to protect aggressive directors and senior managers who are willing to take good-faith risks within

[136] O'Sullivan N supra op cit note 122 at 545.
[137] Slaughter S supra op cit note 57 at 181.
[138] Slaughter S supra op cit note 57 at 185.
[139] Keay A supra note 115 at 681.

the scope of their fiduciary duty in the search for profits. Keay argues that it is axiomatic that companies need to take risks to prosper.[140] However, when directors are stifled by liability, rather than taking risks, they will adopt a defensive posture, by becoming extremely cautious and risk-averse. Directors and senior managers will recoil and minimise the taking of risks or refuse to take any risks at all. The net effect of this approach is that the company ends up with a lower positive net value. It is argued that director caution may change the role of directors and managers from one of active mode to one of 'passive asset-preservation' and directors focus on protecting their positions.[141] He cautions that there is a clear line between acceptable risk-taking and irresponsible risk-taking. Directors and senior managers should be permitted to take risks where the decision concerned is made in the informed, good faith belief that the action will enhance the company's long-term wealth.[142] Spisto further argues that in South Africa indemnity insurance is not only vital for the survival of most companies and the economy as a whole, but that 'it is also necessary if directors are to take good faith risks in the best interest of their companies without being concerned too greatly about liability attaching to them and, the associated personal financial ruin that may attach should ventures fail…'[143]

(4) The availability of protection facilitates the corporation's ability to attract and retain suitable directors and senior managers. This last argument, and most probably the most convincing, is that for policy reasons corporations should be permitted to indemnify their directors and senior managers by encouraging innocent directors to resist actions without merit and to induce responsible businessmen to accept the role of director and senior managers.[144] Johnston[145] remarks that methods must be developed for the protection of directors and senior managers against inordinate personal liability, to ensure that the most capable individuals are attracted to serve as directors and senior managers. He warns that a middle ground needs to be found between encouraging directors to violate their trust and discouraging them from serving at all.

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140 Keay A supra note 115 at 682.
141 Keay A supra note 115 at 682.
142 Keay A supra note 115 at 683.
143 Spisto M supra op cit note 104 at 61.
144 Ulrich H supra op cit note 84 at 234.
145 Johnston J 'Corporate indemnification and liability insurance for directors' and officers' (1978) 33 The Business Lawyer 1993 – 2053 at 1993.

2.5.3. The Shortcomings of the Theory

It has been suggested that the imposition of liability on directors and senior managers serves as an aid in aligning directors' and senior managers' incentives with the interest of shareholders by providing shareholders with a mechanism to recoup losses occasioned by directors' and senior managers' wrongdoing. By allowing shareholder suits, such liability acts as a disciplinary force on directors and senior managers. However, the deterrence effect of the shareholder liability threat is greatly reduced and mitigated by the corporations' purchase of directors' and officers' liability insurance. According to Boyer, there are reasons why the purchase of directors' and officers' insurance could enhance the value of the company.[146] He gives two main reasons. First, the purchase of directors' and officers' liability insurance may improve the company's management, in that liability may induce directors and senior managers to forego risky projects.[147] Second, risk-averse directors may be difficult to attract due to the threat of personal liability.[148]

The availability of insurance against the liabilities of directors has been criticised as depriving rules relating to directors' duties of any deterrent effect. Insurance operates as a means of smoothing out any losses that a company may suffer due to directors' conduct and breaches. However, it has been suggested that this argument has to be assessed within certain qualifications which relate to how directors' and officers' liability insurance operates. First, the availability of the coverage depends on the extent to which the insurance market is prepared to make it available. There are certain limitations to the extent of the coverage that insurance companies can provide. Insurance companies cannot provide cover for consequences of a breach of duty involving fraud or willful default, as doing so would be contrary to public policy. Furthermore, insurance policies are subject to monetary limitations, which means that a director may remain personally liable for the balance of the loss in the case of large claims. Secondly, insurance companies will increase the premium payable or refuse to insure directors and managers with bad claims history. Thus, there is a financial incentive for a company to monitor the conduct of its directors and senior managers. Lastly, qualified persons may be

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[146] Boyer M and Tennyson S 'Directors' and Officers' Liability Insurance, Corporate Risk and Risk Taking: New Panel Data Evidence on the Role of Directors' and Officers' Liability Insurance (2015) 82 *The Journal of Risk and Insurance* 753-791 at 754.
[147] Ibid at 755.
[148] Ibid at 755.

unwilling will take up the position of director and senior manager without the benefit of directors' and officers' liability insurance.

2.5.4. Concluding Observations

The director protection theory appears to be the better approach for balancing the imperatives of holding directors accountable for liable willful and egregious breach of their duties while being lenient in instances when the breach involved is negligent conduct is involved where directors have acted in good faith and the interest of the company and its stakeholders. In this theory, it is accepted that the protection of directors and senior managers is not without limits. There are public policy considerations that justify holding directors and senior managers personally liable where the deviation from the appropriate standards is so shocking that such behaviour is considered to be egregious, willful and faithless.

2.6 Models of Enforcement of Directors' Duties and Liabilities

As indicated above, the models of enforcement of corporate law concerning directors and senior managers having a bearing on corporate governance, and specifically accountability and protection of directors, are based on the aforementioned theories. The model of the legal enforcement framework discussed below highlights the normative enhancement of directorial duties and liabilities and the protection of directors and senior managers with a particular focus on the regulatory approach or style and its aims elected by regulators. Chapters 7 to 9 of the Act deal with remedies, enforcement and regulatory agencies.[149] Cassim observed that one of the main objectives of the company law reform is 'the establishment of a predictable and effective regulatory environment'.[150] The important work of enforcement is shared among various agencies each with a specific focus that fits like a jigsaw puzzle in the regulatory environment under the current enforcement.[151] The full bouquet and how regulators

[149] See sections 156 – 219 of the Act.
[150] Cassim et al supra op cit note 32 at 1136.
[151] Cassim et al supra op cit note 32 at 1137 notes that new bodies have been added while pre-existing bodies were allowed to transition into the current enforcement framework.

complement each other in their separate and related enforcement objectives under the Act fall beyond the scope of this research and it is suggested that it is an area for further study.[152] This section will briefly consider the role and constraints facing the Companies and Intellectual Property Commission ("CIPC").[153]

As stated before, the legal enforcement framework relating to directors and senior managers has been changed by the Act but the question that remains is whether the enforcement model in place carefully achieves the balance between enhanced liability and the need to protect directors and senior managers, especially for honest errors of judgment made in good faith and risk-taking aimed at maximising value for relevant stakeholders.[154] The regulatory style adopted by South African lawmakers has brought changes relevant to directors and senior managers. A relevant question has been raised whether '…a different corporate legal enforcement aimed at mitigating the effects of aggressive directorial pursuit of profit to satisfy the short-term interest of shareholders would have helped in minimizing the effects of the [2008 global] crisis.'[155] However, the legal current enforcement framework has been criticised in that even though the statutory formulation of directors' duties and liabilities includes an all-inclusive normative statement suitable for the protection of shareholders and non-shareholder constituencies its weakness lies in its enforcement framework. The point was made that a forward-looking normative statement which does not have an enforcement mechanism is in essence not worth the paper that it is written on.[156]

It is argued that the current corporate legal enforcement framework adopted in the Act is misaligned with the theoretical approach underpinning the Act, and this has led to unintended consequences. The continued undue insistence on enhanced liability for directors and senior managers has not supported or created a legal enforcement framework that adequately balances the imperative of accountability on the one hand, and the protection of directors and senior managers on the other hand, in certain instances, of directors and senior managers by making available to the appropriate relief (protection) for liability to monetary damages in the discharge of their duties to the company. Of particular concern, is whether the current corporate legal

[152] See Chapter 7 at para 7.8.
[153] The CIPC was established in terms of section 185(1) of the Act. Its objects are stated in section 186, and the functions prescribed under section 187 of the Act.
[154] The stakeholder debate falls outside the focus of this research. Many writers and commentators have looked at it.
[155] Mongalo T supra op cit note 110 at 17.
[156] Mongalo T *Corporate Actions and the Empowerment of Non-Shareholder Constituencies* (unpublished PhD thesis, University of Cape Town, 2015) at page 1.

enforcement framework applicable to directors and senior managers has the effect of deterring suitably qualified individuals from accepting positions as directors and senior managers, and if the potential exposure for personal liability for monetary damages threatens the quality of the pool of individuals available to manage corporations in South Africa.

It is argued that the legal enforcement framework needs to be efficient and responsive by changing incentives and cultures in corporations, based on a regulatory style or approach that is aimed at procuring compliance rather than solely relying on enforcement and the assumption of deterrence as a purpose of imposing duties and liabilities on directors and senior managers.[157] The regulatory approach must be sufficiently flexible and responsive enough to protect directors and senior managers from liability for good faith risk-taking.

Keay further remarks that the United Kingdom now has ‘elegant, dynamic and comprehensive directors’ duties that are highly respected and that they are regarded as being at the heart of corporate governance’.[158] However, according to him, the reform relating to the duties and the enforcement intensity of the rules and law matters more in promoting the impact of the rules and laws than its substantive content. He suggests that enforcement powers are important in bringing about a ‘change in the culture’ of corporations.[159] Similarly, the approach taken by South African lawmakers in reforming the duties of directors was flawed by an obsession with the normative statement of directorial duties and responsibilities without the complimentary enforcement mechanisms to create a ‘change in the culture’.[160] The view that directors’ duties should be limited to the shareholder-friendly enforcement mechanism such as shareholder voting and derivative action is to narrow the corporate legal enforcement framework and to disregard the true purpose of directorial duties being the supervision of corporate power.[161] The corporate legal enforcement framework relating to any breaches of directorial duties is limited to private enforcement through derivative actions. It is proposed that the UK should consider including provisions in statute that provide for the public enforcement and regulation of directors’ duties. This recommendation is also relevant for South

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[157] Organisation for Economic Co-operation and Development (2000) ‘Reducing the Risk of Policy Failure: Challenges for Regulatory Compliance’ at 3. See also Malcolm Sparrow In ‘Imposing Duties: Government’s Changing Approach to Compliance’ wherein he remarks that a trend has developed in which regulatory institutions are moving away from traditional approaches, that rely heavily on enforcement and the assumption of deterrence. These institutions now seek to develop more sophisticated and more effective methods of procuring compliance and adopt a broader range of tools to achieve this.

[158] Keay A ‘The Public Enforcement of Directors’ Duties: A Normative Inquiry’ (2014) 43 *Common Law World Review* 89 – 119 at 89.

[159] Ibid at 90.

[160] Mongalo T supra op cit note 156 at 1.

[161] Mongalo T supra op cit note 156 at 1.

Africa, as there is currently nobody who has the power to enforce breaches of directorial duties. The role of such a body would also be to drive 'change in the culture' by developing a model of compliance and regulation that introduces ethos and outcome-based compliance. The CIPC should be capacitated and adequately funded to fulfil its objectives which include among other things 'the promotion of compliance with this Act, and any other applicable legislation' and 'the efficient, effective and widest possible enforcement of this Act'.[162]

The regulatory style to compliance has been best described and presented as a dichotomy between the 'Old model', which is largely reactive and adversarial and the 'New model', which encourages compliance and is preventative. These approaches are discussed in paragraphs 2.6.1 and 2.6.2.

2.6.1. The Old Model: Regulatory Style Approach to Compliance

Under the 'Old Model' of enforcement the aim is a stringent enforcement of a 'rule-based system'. Sparrow referred to Fred Goldberg Jr.'s 1991 testimony to Congress regarding tax compliance and he observed that the focus of the compliance effort was principally 'after-the-fact' and amounted to 'case-by-case' enforcement.[163] The problem with this approach to regulation is that it is reactive and adversarial.

Davis in describing the enforcement scheme under company law stated that it is a primary goal of company law to ensure through proper systems of corporate governance the disclosure and exposure of wrongdoing and to discourage and punishment of such conduct.[164] However, the enforcement of the provisions has traditionally been left to 'shareholders [and directors], the liquidator in winding up, and the Director of Public Prosecutions.[165] He concludes that 'Experience has shown that these methods of enforcement are inherently defective.' He further observed that '[a]nother type of regulatory interventions is enforcement of corporate and security laws through supervisory agencies and criminal sanctions'.[166]

[162] Section 186(6) an (7) of the Act. See Chapter 7 at para 7.9.
[163] Fred Goldberg Jr. was the head of the United States Internal Revenue Service. See presentation 'The Regulatory Craft' by M Sparrow (18 May 2000) - https://www.iosco.org/library/annual_conferences/pdf/ac25-13.pdf - accessed 26 February 2024.
[164] Davis DM 'Dealing with Corporate Defaulters: Curbing the Unfettered Exercise of Criminal Law' in Mongalo TH (ed) Modern Company Law for a Comparative South African Economy (2010), at 411.
[165] Ibid at 413.
[166] Ibid at 413.

What appears to be indisputable is the fact that the traditional enforcement scheme under company laws, as described by Davis, typically that the traditional regulatory approach merely establishes the standards for behaviour but not the legal enforcement mechanisms. Mongalo remarked that this unfortunately perpetuated shareholder-friendly enforcement mechanisms, which consisted primarily of shareholder voting and derivative litigation.[167]

Bergloff and Sting[168] have recognised that enforcement of corporate laws is more important for transitioning and developing countries than regulations and codes, as this means that more emphasis is placed on achieving effectiveness than 'laws-on-books'. Policy makers in transitioning and developing countries have identified that 'enforcement more than regulations and laws-on-books' is the key challenge facing corporate governance. An assessment of compliance and adherence to written rules reflects that directors are repeatedly ignoring written rules relating to corporate governance and undertakings to comply are not followed up by actions. Bergloff and other academics have remarked that creating an efficient enforcement framework is extremely complicated but is vitally important for development.[169]

The old model of regulating directors' compliance has been criticised as revolving around formal, precise rules and is viewed as being adversarial and punitive. It is also stated to be based on an underlying mistrust of the regulated community.[170]

It is argued that although the statutory formulation of directorial duties and responsibilities in the Act represents an all-inclusive normative statement aimed at enhancing responsibility and accountability, the main weakness is in the enforcement framework adopted by the Act. A fundamental question that regulators need to answer is 'Who is the customer?'[171] this question is particularly complex given that regulated entities include listed companies, private companies, ring-fenced, incorporated and non-profit entities and the regulator's conduct is public service for the greater good of the South African public and economy

[167] Supra op cit note 126 at 1.

[168] Berglöf E and Claassens S 'Enforcement and Good Corporate Governance in Developing Countries and Transition Economies' (2006) 21 The World Bank Research Observer 123-150, at 124.

[169] Ibid at 135. See also MK Sparrow *The Regulatory Craft: Controlling Risks, Solving Problems and Managing Compliance* (2000) The Brooking Institution Washington at 33.

[170] Sparrow MK *The Regulatory Craft: Controlling Risks, Solving Problems and Managing Compliance* (2000) The Brooking Institution Washington at 33.

[171] This is a question posed by Sparrow to governments who seek to introduce regulatory reforms with regard to which customer the government is seeking to please through the regulation. He is of the view that improving customer service now lies at the heart of any proposal for the reform of regulatory practice – [171] Sparrow MK *The Regulatory Craft: Controlling Risks, Solving Problems and Managing Compliance* (2000) The Brooking Institution Washington at 31.

participants or those affected in the value chain regulated by the CIPC.[172] Regulatory reform must be based on the improvement of client service which the Old Model lacks. The Organization for Economic Cooperation and Development has remarked on regulatory reform and stated that:

> 'Reform is based on screening out regulations and formalities that are outdated or ineffective; streamlining and simplification of those that are needed; use of a wider range of market incentives and more flexible and international regulatory approaches; and introduction of greater discipline, cooperation, and transparency with regulatory processes. The Canadian government has called this "regulating smarter", while the European Commission has announced "less action, but better action." In the longer term, the goal is to move movements from a culture of "control" to a culture of "client services".'[173]

The failure of the Old Model to identify "Who is the customer" and the fact is not based on "Client service" creates ambiguities and does not improve the enforcement and effectiveness of the normative duties and responsibilities of directors and officers.

2.6.2. The New Model: Regulatory Style Approach to Compliance

In this chapter, the primary question is also presented as being, in essence, whether the traditional company law enforcement framework is suitable to accommodate the enhanced normative standards for directorial duties and responsibilities. It is highlighted with the observations of Sparrow that the traditional model or style of enforcement of directors' and officers' duties and responsibilities is not suitable for the accommodation of a legal enforcement framework that is both flexible and responsive enough to provide appropriate protection to directors and officers in instances where they have acted negligently while taking good faith risks.[174] This chapter further highlights that a regulatory enforcement approach that is similar to 'responsive regulation' advanced by Braithwaite and Ayres,[175] may be more

[172] Given the broadness the of question, the CIPC is better placed to give direction on how it views its mandate as formulated in sections 185 – 187 of the Act.
[173] The Organisation for Economic Co-operation and Development Report on Regulatory Reform Synthesis (1997) at 9.
[174] Sparrow K supra op cit note 171 at 2.
[175] Braithwaite J and Ayres I *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press Oxford 1992) at 4.

suitable for holding directors and officers liable for serious and egregious conduct such as fraud, reckless and faithless acts but encourages directors and senior officers to take good faith risk for the company and its stakeholders, which are propagated for in this thesis.

The New Model is regarded as being softer, more results-oriented, and less wed to rules, stressing responsiveness and forbearance and preferring tools involving trade-offs, gaming tactics, persuasion, and negotiation.[176] According to Sparrow regulators should be able to vary their stance as they deal with different issues.[177] He recommends responsive regulation as an approach to regulating director conduct. Aryes and Braithwaite, with regards to the style of regulation, have remarked that the time had come to escape what they described as a long history of barren disputation…between those who think that corporations will comply with the law only when confronted with tough sanctions and those who believe that gentle persuasion works in securing compliance with the law.'[178]

Responsive regulation has been defined by Aryes and Braithwaite as 'An attitude of responsiveness does not generate different policy ideas that do not transcend the divide between regulatory and deregulatory solutions. But for the responsive regulator, there are no optimal or best regulatory solutions, just solutions that respond better than others to the plural configuration of support and opposition that exist at any particular moment of history.[179]

Sparrow argues that the New Model should foster compliance assistance through customer service.[180] Through the adoption of information strategies risks and risk factors can be communicated to affected actors such as directors and senior managers to bring pressure on them to act in socially responsible ways.[181] It has been stated that 'Information strategies are non-coercive…and life is better for everyone when there is less ordering people around.'[182] One of the methods of promoting voluntary compliance, such as persuasion and education, is the availability of escalating severity available to the regulators that it can use. The basic

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[176] Sparrow K supra op cit note 171 at 33.
[177] Sparrow K supra op cit note 171 at 37.
[178] Braithewaite J and Ayres I supra op cit note 176 at 21.
[179] Braithewaite J and Ayres I supra op cit note 176 at 5. It has been argued that the basic principle of responsive regulation is that regulators should be responsive to the culture, conduct and context of those that they seek to regulate when deciding whether a more or less interventionist response is required. Responsive regulation also recognises the need for a diversity of regulatory strategies and the imperative for the strategies to be practically grounded and context-appropriate – Sparrow M (2000) 'The Regulatory Craft: Controlling Risks, Managing Problems and Managing Compliance' at 36.
[180] Braithewaite J and Ayres I supra op cit note 176 at 42.
[181] Braithewaite J and Ayres I supra op cit note 176 at 42.
[182] Braithewaite J and Ayres I supra op cit note 176 at 32.

principles of responsive regulation are best illustrated in Ayres and Braithwaite's 'regulatory pyramid'.

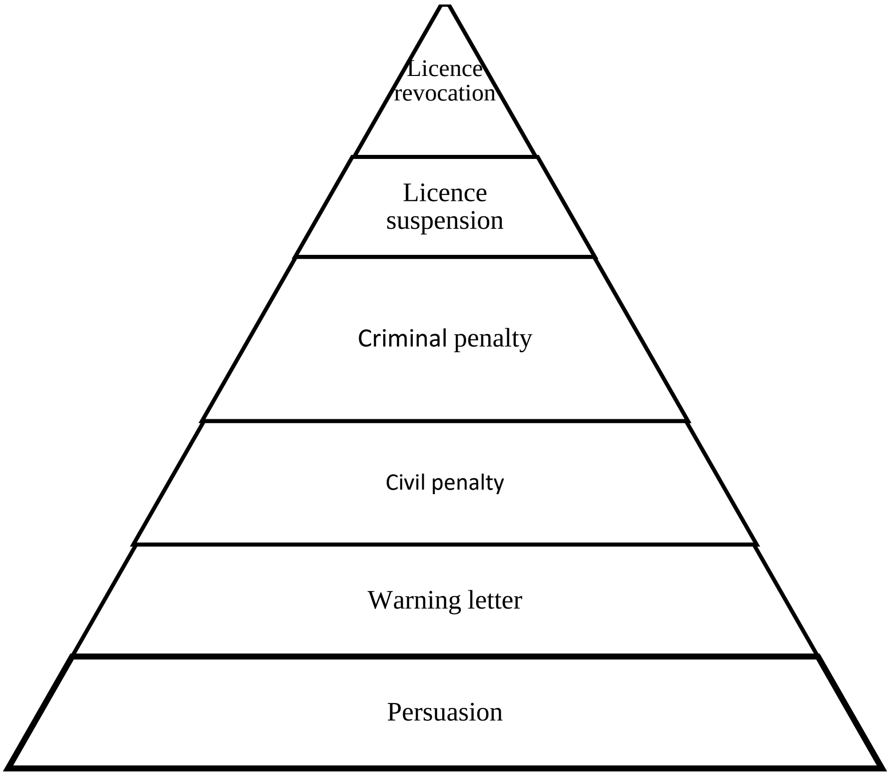

Figure 2.1 Example of an Enforcement Pyramid[183]

Source: Ayres and Braithwaite

The structure of sanctions is generally referred to as the 'enforcement pyramid'[184] or the 'compliance pyramid'[185]; the shape theoretically intends to show that the most severe sanctions, which form the apex of the pyramid, are frequently used less when compared to the persuasion-focused methods aimed at resolution that are at the base of the pyramid.[186]

[183] Braithewaite J and Ayres I supra op cit note 176 at 35.
[184] Braithewaite J and Ayres I supra op cit note 176 at 35.
[185] Braithewaite J and Ayres I supra op cit note 176 at 31.
[186] Braithewaite J and Ayres I supra op cit note 176 at 35, Ayres and Braithwaite remark that most regulatory action occurs at the base of the pyramid, where the initial attempts are aimed at coaxing compliance through persuasive methods.
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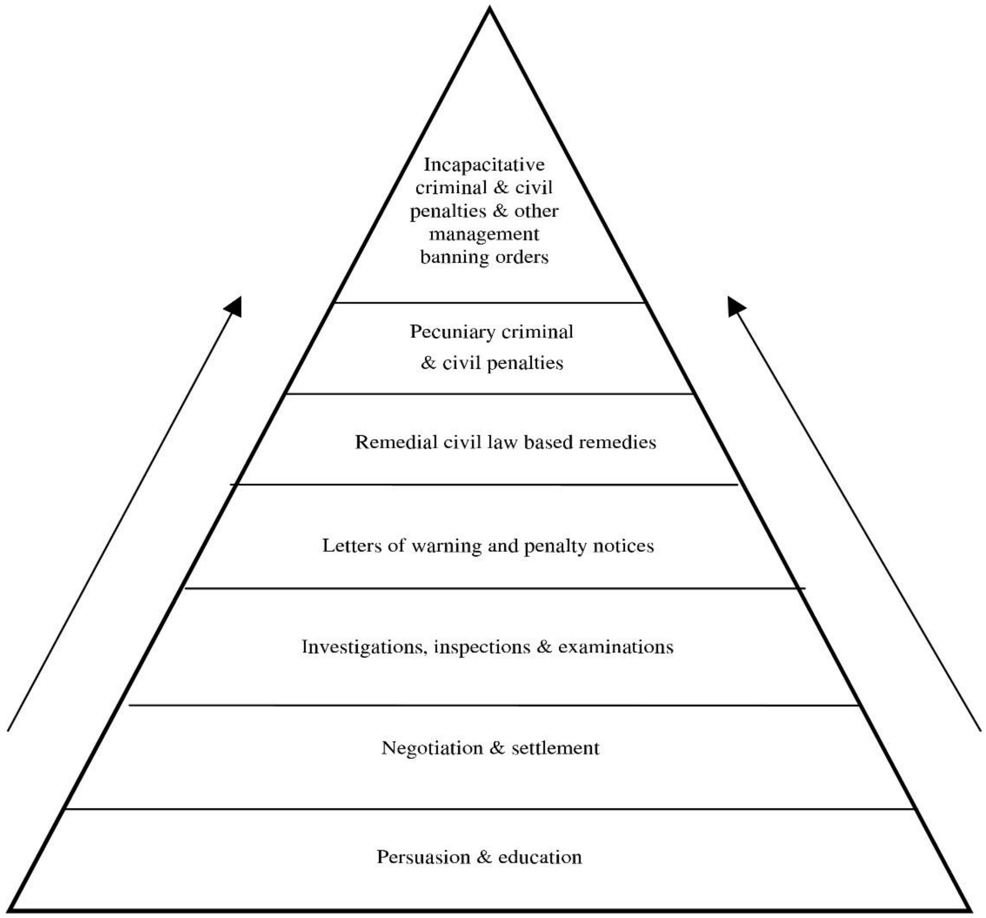

Figure 2.2 Example of an Enforcement Pyramid Regarding Directors' and Officers' Duties

The lower levels of the enforcement pyramid represent a series of incentives or 'carrots' that are meant to encourage compliance and avoid unnecessary antagonism between the regulator and the regulated thus removing the adversarial approach under the Old Model.[187] The model has been described as being proactive in that it is preventive as opposed to merely being reactionary. Ayres & Braithwaite have commented that it is essential that the enforcement of corporate law be proactive rather than simply reactive.[188] They have also commented that the success of regulatory delegation to the regulator by policy makers will depend on whether the delegation is capable of engendering compliance and problem-solving.[189]

According to Sparrow, it is important work for regulators to figure out where private sector managerial methods, and customer-focused, management techniques ought to be used,

[187] Braithewaite J and Ayres I supra op cit note 176 at 38.
[188] Braithewaite J and Ayres I supra op cit note 176 at 131.
[189] Braithewaite J and Ayres I supra op cit note 176 at 161.

and where they ought not to in adopting a regulatory style. He is of the view that regulators cannot 'ignore or escape the substantial pressure to emulate private industry's use of these techniques to provide better service.'[190] It is argued that the South African regulator will have to grapple with the incorporation of 'customer service' and identifying 'who the customer is' in its approach to enforcement of corporate law on directors and senior managers.

It is unfortunate that in South Africa, the role and impact of the CIPC, as one of the regulators, is largely limited to administrative functions such as company registration and ensuring that companies comply with the Act and other relevant legislation.[191] South Africa relies heavily on private enforcement of directorial duties in the Act by way of shareholder voting and through derivative litigation. However, Mongalo made the point that the enforcement of breaches of directorial duties relying solely on private mechanisms has generally been ineffective and provides for a rather narrow corporate legal enforcement framework, which does very little to promote the substantive content of directorial duties and responsibilities.[192] It is worthwhile to consider the provisions of the Act should not be amended to make provision for the public enforcement of directorial duties and responsibilities by the CIPC.[193] Furthermore, the mandate of the CIPC should be extended to include inter alia the power to institute civil action for the recovery of damages and property, making rules and programs aimed at ensuring compliance and the integrity of financial markets.[194]

It is submitted with reference to the arguments of Sparrow[195] that the legal enforcement framework needs to be efficient and responsive by changing incentives and cultures of corporations, based on approaches that are aimed at procuring compliance rather than merely relying on enforcement and the assumption of deterrence as a purpose of imposing duties and liabilities on directors and senior managers. The regulatory approach to enforcement must be

[190] Sparrow K supra op cit note 171 at 31.
[191] Sections 185 to 192 of the Act address the mandate of the CIPC. See also Anna Elizabeth Oost *A "Safe Harbour" for Directors in South Africa? A Comparative Study of the Business Judgement Rule* (unpublished LLD thesis, University of South Africa, 2020) at 276, where she notes that the CIPC has 'a very limited control over the corporate environment' when compared to the ASIC in Australia, which has instituted several actions against corporations relating to directors' and officers' duties of care.
[192] Mongalo T supra op cit note 156 at 1.
[193] See Davis D supra op cit note 164 at 411, who considered that the traditional approach of company laws leaves the enforcement of its provisions to 'shareholders, the liquidator in winding-up, the Director of Public Prosecutions. Experience has shown that these methods of enforcement are inherently defective.'
[194] See Comino V 'Effective Regulation by the Australian Securities and Investment Commission: The Civil Penalty Problem' (2009) 33 *Melbourne Univ. Law R.* 803- 832 at 829 – 832, which highlights some functions of the ASIC that may be considered for the South African position.
[195] [195] Sparrow K supra op cit note 171 at 37.

sufficiently flexible and responsive to protect directors and senior managers from liability for good faith risk-taking.[196]

2.7 Alternative Combined Theory Balancing the Conflicting Underpinning Policy Consideration: The Middle Ground Approach

The proposed model operates from the premise that the legal enforcement framework must be structured in such a way that it is stringent with fraudulent and willful conduct while being lenient with negligent conduct and errors made in good faith and the pursuance of the greater good of the company as a whole.

Owing to the flaws in the old model and theory relating to the enforcement of corporate liability mentioned above and based on the fact that this theory discussed above does not provide directors with the necessary protection needed for them to make good faith decisions, the proposed combined theory on the protection of directors is recommended in this section. It is argued below that this proposed theory is based on a 'middle ground approach'.

The starting point of a sound model of corporate governance should be the fundamental principle that directors should be held accountable for their actions and conduct. However, it should also be recognised that for a properly functioning economy and for companies to retain suitably qualified individuals some measure of protection should be afforded to directors and officers in instances where they take good faith risk which proves to be wrong.

A combined theory is proposed relating to the balance that should be struck between the competing policy considerations of director accountability and the protection of directors and senior managers with the aim that it provides a middle ground between encouraging fiduciaries to violate their trust and discouraging them from serving at all.

As stated, the finding in the *S v Van Gorkom*[197] case, set in motion corporate law developments which initiated a jurisprudential trajectory that attempted to find a middle-ground position between holding directors accountable and the need to protect them from liability in certain instances. The decision led to a severely restricted market for director and

[196] Ibid at 37.
[197] 488 A2d 858 (1985).

officer liability insurance. Also, as a result of the court's finding and the personal liability for directors that had complied with the requirements of the business judgement rule directors resigned from the position of director and refused to be re-elected or to take up the position of director. The policy makers in the state of Delaware opted to create a legislative framework that protected directors from personal financial liability if they acted honestly and in good faith in the discharge of their duties and in making decisions. The threat of liability was not removed for egregious conduct but companies were allowed through legislative provisions to adopt provisions or clauses in the articles that exempt directors from personal liability for negligence and errors made in good faith, i.e. losses that result from good faith risk-taking.

The primary objective of the proposed model is essentially two-pronged; first it advocates for a scheme of enforcement for directors and officers for egregious conduct to be clear against faithless directors and senior managers[198] and second, it propagates for a scheme of enforcement that recognises the need for companies to retain suitably qualified directors by protecting instances where the concerned director or officer have acted reasonably and in good faith.[199] The proposed model is in response to the potential harm that may result if a South African court were to find directors and senior managers liable for negligence even in circumstances where they acted in good faith and within the context of the business judgment rule. It has already been pointed out that the operation of liability insurance and the business judgment rule may be limited in the protection it may provide to directors and officers. For example, a company may elect not to take any cover to protect its directors or the fact that the business judgment rule is limited to actual decisions made by the board of directors, thus meaning that action for negligence based on a failure to make a decision or omissions are not contemplated in the protection afforded by the business judgement rule. The business judgment

[198] There is no justification for directors and senior managers to enjoy protection for conduct that is irrational, wilful or fraudulent. Section 77(9) of the Act provides a vital caveat that no fraudulent or wilful breaches will be excused. Section 77(9) reads as follows: In any proceedings against a director, other than for wilful misconduct or wilful breach of trust, the court may relieve the director, either wholly or partly, from any liability set out in this section, on any terms the court considers just if it appears to the court that – (a) the director is or may be liable, but has acted honestly and reasonably; or (b) having regard to all the circumstances the case, including those connected with the appointment of the director, it would be fair to excuse the director.' See also *Cape Empowerment Trust Limited v Druker and others* (2016) JOL 36987 (WCC); *KLM Royal Dutch Airlines v Hamman* 2002 (2) SA 818 (W); and *Rustenburg Platinum Mines ltd v South African Airways and Pan American World Airways Inc* 1977 (1) Lloyds LR 19 (QB (Com Ct)) 564. It was also held in *Ex Parte Lebowa Development Corp Ltd* 1989 (3) SA 71 (T) that 'wilful breach of trust or wilful misconduct means that the director failed to act 'honestly'.

[199] See Finch V 'Company Directors: Who Cares About Skill and Care?' (1992) 55 *The Modern Law Review* 179-214 at 179; Riley C 'The Company Directors' Duty of Care and Skill: the Case for an Onerous but Subjective Standard' (1999) 62 *MLR* 697 – 709 at 697.

rule is not available to a director or officer who has failed to make a decision or omitted to act in a certain manner.

In addition to the events which followed the *S v Van Gorkom*[200] decision in the USA and in particular the state of Delaware, the restriction of the insurance market and the shrinking of the director pool, these provide a timely warning to other jurisdictions, such as South Africa, that the protection of directors and officers from personal financial liability merely through directors' and officers' liability insurance is wholly inadequate to provide effective protection and that the threat of liability affect companies' ability to attract and retain quality individuals to serve in the role of director and officer. The availability of high-quality individuals to serve as directors and officers is necessary for the proper functioning of the economy.

Furthermore, the approach to be taken by regulators in enforcing the rules applicable to directors and officers should be responsive enough to excuse directors and officers who have acted in good faith from liability. Regulators should design and develop innovations and systems that encourage good faith risk-taking rather than merely imposing penalties reactively for errors in judgment. It is also argued that the South African model requires a more prominent enforcement regulator as is the case in Australia with ASIC and SEC in the United States whose mandate includes introducing and driving a culture of compliance. These bodies also are tasked with strategic problem-solving necessary for compliance that is proactive and it may be of benefit to South Africa if the scope and mandate of the CICP were also extended to include these functions and focus.[201]

Authors Slaughter and Johnston also recommend the use of non-statutory responses as a means to protect directors and officers from personal liability in the form of captive insurance. Corporations are as an alternative method permitted to create a subsidiary company as their source of directors' and officers' insurance.[202] The benefit of such captive insurance is that it provides a means for companies to counteract the consequences of the general unavailability and inadequacy of general commercial insurance. This form of protection is then seen as a substitute for the protection offered by commercial insurers which is subject to market forces. There are important areas of potential liability for directors and senior managers that are not covered by general commercial insurance. Captive insurance in South Africa is permissible

[200] 488 A2d 858 (1985).
[201] Keay A supra op cit note 158 at 91.
[202] Slaughter S supra op cit note 57 at 184 and Johnston J supra op cit note 145 at 2031.

under sub-section 78(4) of the Act.[203] However, its viability will depend on the company's financial means to fund the captive for it to be a sustainable measure to protect directors and senior managers.

To summarise, the proposed theory states that the applicable legal enforcement framework to directors and officers should be stringent with willful and egregious conduct. However, the scheme of enforcement should be lenient on directors and officers if they have acted with good faith in the discharge of their duties and were merely found negligent. The way to achieve the middle ground between holding directors accountable and protecting them from liability when they have taken good faith risk is through allowing companies to include exemption clauses in their Memorandum of Incorporation and other agreements between them and their directors and offices that exempt them from liability for losses occasioned by mere negligence. The regulatory enforcement approach or style must be flexible and responsive enough to protect directors and officers for good faith risk-taking.

2.8 Conclusions and Chapter synopsis

This Chapter is intended to outline the theoretical foundation and conflicting policy considerations for holding directors and senior managers liable and, in certain instances, providing protection. The bad faith or aberrant director theory was discussed.[204] In terms of the bad faith or aberrant director theory, the imposition of liability is essential to deter aberrant behaviour, which will undermine the underlying goal of imposing liability if protection is too liberally provided to directors and senior managers. The Chapter opened with the consideration of the policy considerations which are supportive of the imposition of liability to directors and senior managers as a necessary deterrence for acknowledged forms of undesirable conduct and to provide compensation to affected parties. The main argument is that the imposition of duties and liability raises the standards of corporate and directorial behaviour. The duties and threat of liability act prophylactically and place a maximum deterrent on undesirable conduct. The

[203] It is contemplated in section 78(4) of the Act that a company may 'advance expenses' section 78(4)(a) to a director and directly or indirectly indemnify a director from liability even if expenses have been advanced section 78(4)(b) the funds are capable of being earmarked through a cell captive insurance established by the company for such purposes. A cell captive insurance company will have to comply with the requirements of the Insurance Act 18 of 2017.
[204] See para 2.4.

theory insists that the provision of protection through the availability of insurance creates a moral hazard in that it creates a safety net that may encourage directors and senior managers to adopt unreasonably high risks that are unwise and unprejudicial to the company and its shareholders.

The theory assumes that deterrence and increased liability adequately strike the balance between constraining potential abuse by directors and senior managers of their powers and the need to grant them the freedom to take good-faith risks. This view presupposes that the availability of protection reduces the deterrent effect of rules governing directors and senior managers. On the contrary, there is a lack of empirical evidence that the availability of protection weakens the disciplining effect of shareholder litigation and that it does not influence directors' and senior managers' monitoring functions. The availability of directors' and senior managers' liability insurance may influence their decision to accept the role of serving in the role of director and senior manager.

The second theory discussed was the director protection theory, which is supportive of protecting directors and senior managers from liability for good faith risk taking.[205] Under the director protection theory, it has been argued that the essence of the theory is that corporations have a legitimate interest in providing protection mechanisms to directors and senior managers as a means to attract and retain suitably qualified to serve in the position of director and senior managers.

It was pointed out that the protection of directors and senior managers was not only crucial and necessary for companies to attract and retain talented individuals but that the protection encourages directors and senior managers to serve in such capacity without being overly conservative in the management of the company due to the fear of potential liability and harm. The availability of protection could be a catalyst for desired corporate behaviour by encouraging good faith risk-taking.

The Chapter also considered the regulatory approach and style of enforcement of corporate law to directors and senior managers.[206] Addressing the corporate legal enforcement framework adopted in the Act, it was pointed out that the theoretical approach underpinning the Act is misaligned. The insistence on enhanced liability of directors and senior managers has not created a legal enforcement framework that balances the imperative of accountability

[205] See para 2.5.
[206] See para 2.6.

and the need to protect directors and senior managers in certain justifiable instances. It has been shown that the Old Model approach to the enforcement of directorial duties and responsibilities merely establishes the standards of behavior but not the legal enforcement mechanisms.

It has been seen that the New Model is more suitable for the accommodation of a legal enforcement framework that is both flexible and responsive enough to provide relief to directors and senior managers from liability for good faith risk-taking while holding directors liable for egregious conduct. This regulatory approach is softer and aimed at procuring compliance. A strong feature of the New Model is the prominent and substantive role played by the regulator through education and escalation of enforcement and interventions where appropriate to persuade compliance.

Finally, arguments for and against the imposition of liability and protection of directors and senior managers were considered. Several shortcomings of both theories were identified.[207] Given these shortcomings, an alternative combined theory was recommended to balance the conflicting policy considerations.[208] In terms of this theory, it cannot be denied that directors and senior managers ought to be held accountable for willful, reckless and faithless conduct. The legal enforcement framework should be stringent with fraudulent and willful conduct but lenient to protect directors and senior managers from personal liability for negligent errors made in good faith. The protection that should afforded to directors and senior managers for good faith risk-taking will provide a middle-ground approach meant to encourage fiduciaries from violating their trust and discouraging them from serving at all.

[207] See para 2.4.3 and 2.5.3.
[208] See para 2.7.

CHAPTER 3

THE DUTIES AND LIABILITY OF DIRECTORS AND SENIOR MANAGERS

3.1 Introduction

The focus of this Chapter is on the office of directors and senior managers and the duty of care and skill, and civil liabilities of directors and senior managers. The legal framework applicable to directors and senior managers and affecting these matters is largely stated in the company's Memorandum of Incorporation and the Act, but the common law rules and principles also have an important role to play.[209] Subsection 76(3) of the Act has partially codified directors' duty of care and skill.[210] This Chapter also includes a discussion of the definition of 'director' and the concept of 'prescribed officer', in the context of the director's duty of care and skill and the implications of the definitions and imposition of the duty.[211]

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[209] In South Africa, the review process to revamp company law began in 2004 when the Department of Trade and Industry published the Policy Paper, which, amongst other things, sought to clarify directors' and senior managers' duties and liabilities. See Mongalo T 'An Overview of Company Law Reform in South Africa: From the Guidelines to the Companies Act 2008' (2010) 12 *Acta Juridica xiii-xxv at xviii*, wherein he reflects on the law reform process and states that '[I]n the aftermath of the global corporate collapses and failure of corporate governance systems, deliberations on this point centred on the improvement of corporate of corporate governance in appropriate circumstances and the consideration of the adoption of a general statement on the duties of directors and director liability. Thus, appropriate improvement of corporate governance standards, centred on the principle of certainty, guided the reform of this area.'

[210] This represents a significant innovation by the Act because, for the first time in South African corporate law, the fiduciary duties of directors and senior managers to exercise and display reasonable care, skill, and diligence have been partially codified. See also Katz M 'Governance Under the Companies Act 71 of 2008: Flexibility is the Keyword' (2010) 1 *Acta Juridica* 248 – 262 at 248.

[211] A starting point in understanding the current legal enforcement framework relating to directors and senior managers is considering the formulation of the definition of 'director' and 'prescribed officer' and the implications of these definitions as contained in the Act. See para 3.2.1 and 3.24.

This builds on the foundation laid in Chapter 2, in which the misalignment of the current legal enforcement framework that applies to directors and senior managers was highlighted, and the emphasis on enhanced liability without providing adequate protection for breaches of the duty of care and skill. This approach is referred to as the aberrant director theory.[212] An important question of this thesis whether the insistence on the imposition of personal liability for directors and senior officers for breaches of the duty of care and skill will have unforeseen consequences such as the shrinking the pool of talented individuals willing to serve in the role of director and senior managers and if the threat of personal liability for breaches of the duty of care will affect directors' and senior managers' conduct causing them to become overly cautious in their decision making in an attempt to avoid attracting liability. Primarily, the focus of this study is on the enforcement framework applicable to directors and senior managers.[213]

Arguments for and against a stringent enforcement framework that imposes liability for ordinary negligence or mere errors of judgment made in good faith are considered, and the potential impact of personal liability on decision making, or whether competent persons will be dissuaded from corporate service because of the exposure of excessive liability.[214]

As a consequence of the company-law review process, the Companies Bill 2007, introduced a partial codification of directors' duties, including directors' duty of care and skill. The Bill was later replaced when the Act became operational, which similarly partially codified directors' duties and included a statutory business judgment rule. It will be pointed out how subsection 76(3) of the Act does not provide a well-developed explication of the standard of care.[215] Furthermore, consideration is given to the view that the business judgment rule appears to muddle the application of the underlying principles of the duty of care and the fiduciary duties.[216] Furthermore, a list of certain instances where directors and senior managers will not enjoy the protection of the business judgment rule, even though they have acted in good faith and complied with the requirements of the rule will be analysed.[217]

[212] See para 2.4.
[213] A starting point is understanding some key concepts and definitions, which form an integral part of the current legal enforcement framework applicable to directors and senior managers under the Act. See para 3.2.
[214] See para 3.4.4 and 3.5.
[215] See para 3.4.3.
[216] Bouman N 'An Appraisal of the Director's Duty of Care and Skill under the Companies Act 71 of 2008 (2009) *SA Merc LJ* 509 – 534 at 509. See para 3.4.4.
[217] See para 3.2.7.

Further, the Chapter highlights the specific liabilities that directors and senior managers may be held liable for in terms of the Act and other relevant legislation.[218] The import of section 218(2) of the Act that purports to extend liability under the Act is also discussed.[219]

Lastly, the relief provided by the Act to directors and senior managers will be discussed.[220] In particular, the deficiencies of the business judgment rule are highlighted with a breach of the duty of care and skill. It will be shown that the relief provided to directors and senior managers under the current legal enforcement framework is inadequate and insufficient in the absence of exemption clauses and extensive indemnification through liability insurance.[221]

3.2 An Introduction to Some Key Concepts and Definitions

3.2.1 Definition of Company Director

A 'director' is defined in section 1 of the Act as a member of the board of a company, as contemplated in section 66, or an alternate director of a company and includes any person occupying the position of director or alternate director, by whatever name designated.[222]

It is important to identify the directors of a company and the scope of their role within the company given the crucial role that they play in the management of a company.[223] However, it is clear from the definition of 'director' in section 1 that the definition is broad, deliberately vague and is to some extent framed in terms that are unclear.[224] It has been suggested that the law is concerned with rendering directors liable because they have the power to manage the company's affairs and make vital decisions relating to the management of the company.[225] In

[218] See para 3.5.
[219] See para 3.5.3.
[220] See para 3.6.1.
[221] See para 3.7.
[222] Section 1 of the Act. The Act, in section 66(1), has, for the first time in South African corporate law, given the board of directors the legal duty and responsibility to manage the affairs of the company. See Cassim et al supra op cit note 32 at 523.
[223] Cassim et al supra op cit note 32 at 540.
[224] According to Hennochberg the definition of director under the Act does not attempt to define the word 'director' as such, but merely assumes the ordinary meaning of the word and provides that a person who occupies the position of director is a director for reasons concerning the Act regardless if he is described as a director or not - P Delport *Henochsberg on the Companies Act 61 of 1973* 5 ed (2011) at 22.
[225] Ibid at 403.

an attempt to hold liable individuals that may wish to evade being formally classified as directors the definition is broad to establish the accountability of individuals about their conduct in managing the affairs of the company.[226]

The use of the word 'includes' in the definition suggests that the policy maker intended that the description should be expansive and inclusive and not exhaustive.[227] In *Philips v Fieldstone Africa Ltd*[228], the Supreme Court of Appeal held that under common law the expected standard for directors extends to anyone that occupies a position of trust within the company. The meaning of the term 'director' must be drawn from the words and provisions of the Act, as a whole. *In Re Lo-Line Electric Motors Ltd*[229], it was stated that the formalities are not crucial in attempting to identify those persons who are directors of a particular company. Therefore, for purposes of the Act it is any person that occupies the position of director, irrespective of whether they have been formally appointed as director or not that is considered as director.[230] In *Strut Ahead Natal (Pty) Ltd v Burns*[231], an action was brought against an individual that was not registered or formally held out as a director of the company but who had factually performed duties and functions of a duly appointed director of the company. The defendant argued that because he was never formally appointed by the company, he could not be held accountable as a director and he sought to distance himself from the company and its affairs. However, the court found that the defendant acted as a director of the company and more pertinently that he had recklessly managed the company's affairs. The defendant was held personally liable for the losses sustained in terms of section 424 of the 1973 Act, because of his part in knowingly carrying on the company's business in circumstances where it constituted reckless trading.[232]

Also included in the broadened definition of 'director' in section 1 of the Act are individuals or persons that are considered to be 'occupying the position of director' at any relevant time. The 'position of director' is understood to mean 'the position which would be occupied by a person in whom in terms of the Memorandum of Incorporation of that company and the Act the ultimate powers of management of the company's affairs are vested to the

[226] Coetzee L & Van Tonder JL 'The Fiduciary Relationship Between a Company and its Directors' (2014) 35 *Obiter* 285 – 315 at 311.
[227] Cassim et al supra op cit note 32 at 523.
[228] 2004 2 All SA 150 (SCA) 159.
[229] [1988] 2 All ER 692 699.
[230] Henochsburg P supra op cit note 225 at 22 to 23.
[231] 2007 3 All SA 190 (D).
[232] Ibid at para 606.

exclusion of anyone else other than the shareholders in general meeting'.[233] The meaning of the phrases 'occupying the position of a director' and 'holding an office' were considered in the matter *Corporate Affairs Commission v Drysdale*[234] and it was found that the words 'occupying the position of a director' to denote persons that acts in the position of director, with or without lawful authority, whereas the words 'holds an office' denotes a person who is a lawful holder of the office of director.[235]

The phrase 'by whatever name called' covers alternative descriptions that may be given to an individual by the company in its Memorandum of Incorporation such as 'manager'[236]. Therefore, the title given to an individual is not the determining factor in deciding whether a person is a director. The court in *Re Mea Corporation Ltd*[237] affirmed that it was not what a person calls himself that matters, but rather that what he does determines whether he or she is a director.

It is must be noted that the Act has for the first time in section 66(1) explicitly recognised that the affairs of the company are to be managed under the authority of the board of directors and imposes a legal duty to the board of directors to manage the affairs of the company.[238] The business of the company now has to be managed by the directors who exercise all powers of the company. In terms of section 66(1) of the Act:

> 'The business and affairs of a company must be managed by or under the direction of its board, which has the authority to exercise all the powers and perform any functions of the company, except to the extent that this Act or the company's Memorandum of Incorporation provides otherwise.'

The phrase 'affairs of a company' implies the internal relations of the company. On the other hand, the 'business of the company' implies those relationships with third parties or the external relations of the company.[239]

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233 Henochsburg P supra op cit note 225 at 24.
234 (1978) 141 CLR 23634.
235 Ibid at 242,
236 *Re Lo-Line Electric Motors Ltd* [1998] BCLC 698, 706.
237 [2007] BCC 288 para 82.
238 Cassim et al supra op cit note 32 at 523.
239 Esser I & Delport P _The duty of care, skill and diligence: The King Report and the 2008 Companies Act' (2011) 74 *THRHR* 449 at 452 to 453.

3.2.2 The Extended Definition of Director and Types of Directors

The significant point is, however, that in each relevant section in the Act the definition of 'director' has been extended to include persons who are not directors of a company. Cassim explains that the result is that it is possible that persons, although not directors, now have legal responsibility without any decision-making powers.[240] For example, section 76(1)(a) of the Act states that directors' duties and standards of conduct as contained in this section, will also apply to 'prescribed officers'.

In addition, section 76(1)(b) extends the definition of 'director' to include persons who are members of a committee of the board and audit committees.

Furthermore, section 1 of the Act, includes 'alternate directors' who are defined as 'a person elected or appointed to serve, as the occasion requires, as a member of the board of a company in substitution for a particular elected or appointed director.' The Act recognises four types of directors a director that is appointed in terms of the Memorandum of Incorporation[241], an ex officio director[242], an alternate director[243], and a director who has been appointed by the shareholders[244].

The Act does not distinguish between executive and non-executive directors. However, King III distinguishes between executive directors and non-executive directors as follows: an executive director is involved 'in the day-to-day management of the company or being in the full-time salaried employment of the company (or its subsidiary) or both' and a non-executive director is not involved in the management of the company and 'plays an important role in independent judgement of management issues of the company[245]. It has been suggested that the Act does not explicitly define an executive director or a nonexecutive director, nor does it make a distinction between the two because all directors are equally bound by their common law and statutory duties. In *Howard v Herrigel*[246], the court stated that '…once a person accepts an appointment as a director, that person becomes a fiduciary with the company and is obliged to display the utmost good faith towards the company and in his dealings on behalf of the

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[240] Farouk HI Cassim *The practitioner's guide to the Companies Act 71 of 2008* (2011), at 82.
[241] Section 66(4)(a)(i) of the Act.
[242] Section 66(4)(a)(ii) of the Act.
[243] Section 66(4)(a)(iii) of the Act.
[244] Section 66(4)(a)(iv) of the Act.
[245] King III annexe 2.2 and 2.3 at 53.
[246] 1991 (2) SA 660 (A) 678.

company'. In addition, it was stated in *Re Elgindata*[247] that it is unhelpful and even misleading to classify company directors as 'executive' and 'non-executive directors' for purposes of ascertaining a director's duties in relation to the company. It can be accepted that the Act makes it mandatory for all directors to perform their functions 'in the best interests of the company'[248] irrespective of their designation as executive directors or non-executive directors by the company.

3.2.3 Evaluation

It is clear from the definition of director that the name or description of the role or position given to a person by the company becomes irrelevant in determining if that person is a director for purposes of the Act. It is more likely that the court, in assessing whether a person fulfils the requirements of the definition, will examine the substance of the person's activities and functions within the company in deciding whether he or she occupies the position of director.[249]

It can be observed that the current framework applicable to directors under the Act has enhanced the liability of directors through a normative statement of directorial duties and liabilities.[250] The extended definition of director means that the duties and liabilities are extended to an even greater number of persons. The objects of the definition and its extended form are consistent with the director's aberrant theory, which seeks to make the net for accountability as wide as possible. It has been suggested that an increased emphasis on personal liability of directors could be advantageous in many respects. First, corporate creditors would benefit as they would have an additional avenue to pursue their claims, other than the insolvent company.[251] Second, awareness of the great danger of personal liability would cause directors to act more 'prudently in the management of the affairs of the corporation, which would result in fewer spectacular collapses'.[252] Daniels remarked that the 'burgeoning growth of statutory duties and liabilities of directors' may seem legitimate, but it is nevertheless a serious concern if it results in mass resignations of directors of Canada's leading corporations, as was the case

[247] 1991 BCLC 959 at 985.
[248] Section 76(3) of the Act.
[249] Cassim et al supra op cit note 27 at 541.
[250] McLennan J 'Directors' Fiduciary Duties and the Companies Bill' (2009) 1 *TSAR* 185 – 190 at 185.
[251] Lombard S 'Importation of a Statutory Business Judgement Rule into South African Company Law: Yes or No? (2005) 68 *THRHR* 614 – 627 at 614.
[252] Ibid at 615.

in 1992.[253] This enforcement framework can be criticised as not being sufficiently balanced to protect from personal financial liability to directors and senior managers in instances where they have acted in good faith, taking necessary risks for the benefit of the company and its stakeholders.[254]

An argument has been raised against the director aberrant theory, suggesting that directors' conduct might be influenced by the potential for personal liability.[255] Directors' conduct may be influenced in that they may become resistant to taking the necessary risks. Keay has asserted that this can harm the company's wealth maximisation, such a conservative approach would thus not benefit the corporation and its stakeholders. In other words, directors would rather protect their positions than take necessary risks to maximise value for the company.[256] However, a way to overcome this problem of risk-taking is to provide the necessary protection for directors and senior officers through the inclusion of exemption clauses in their service contracts and taking out liability insurance. With the availability of protection and a safety net for liability for good faith risk-taking, directors and senior managers will be encouraged and willing to continue to take necessary risks. The net effect or advantage of these measures, if properly formulated, is that faithless directors and senior managers would not be able to escape liability, whereas directors and senior managers of companies that have failed, through no fault of their own, would be able to avail themselves of these protective measures and thus be able to escape personal liability for good faith errors.[257]

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[253] Daniels R 'Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Directors in Corporate Governance' (1994) 24 *Canadian Business LJ* 229 – 258 at 232. See also Glasbleak H 'More Direct Director Responsibility: Much ado about what? (1995) *Canadian Business LJ* 416 - 441 at 421.

[254] Ibid Glasbeek H at 429 states that '…[T]he quality of this increasing number of obligations…that not only is the legal model of the corporation coming under pressure, but the usefulness of the corporation as a vehicle through which to do business also may be imperilled. It may be that last possibility, that of the threat of efficiency, which may be central to the law and economics critique of the developing personal responsibility of directors.'

[255] Lombard S supra op cit note 252 at 615 who suggest that '…[e]ven if companies are able to find persons willing to serve on boards despite the increased threat of personal liability hanging over their heads, the question remains whether it is desirable that directors should be more "careful" when managing the affairs of a corporation. Successful ventures require directors to take calculated business risks. Should directors be hamstrung in doing so out of fear of personal liability, profitability might be sacrificed. It is a widely acknowledged fact that this result would not be desirable.'

[256] Keay A supra op cit note 109 at 685.

[257] Lombard S supra op cit note 252 at 615. See also proposals in para 7.3.1 and 7.4.

3.2.4 Definition of "Prescribed Officer"

In terms of section 1 of the Act, a 'prescribed officer' is defined as meaning a person who, within a company, performs any function that the minister has designated in terms of section 66(10) of the Act. The definition is couched in very wide terms, meaning that a wide group of persons have been designated as prescribed officers of a company.[258] In terms of section 66(10), the Minister 'may make regulations designating any specific function or functions within a company to constitute a prescribed office for the Act'. Regulation 38[259] of the Act defines 'prescribed officer' as follows:

'(1) Despite not being a director of a particular company, a person is a 'prescribed officer' of the company for all purposes of the Act if that person –

(a) exercises general executive control over and management of the whole, or a significant portion, of the business and activities of the company; or

(b) regularly participates to a material degree in the exercise of general executive control over and management of the whole, or a significant portion, of the business and activities of the company.

(2) The regulation applies to a person contemplated in sub-regulation (1) irrespective of any particular title given by the company to -

(a) an office held by the person in the company; or

(b) a function performed by the person for the company.'

It is crucial to note that under the Companies Act 1973 the term 'prescribed officer' was absent. The 1973 Act referred to the term 'officer' which included, unless the context indicated otherwise, any managing director, manager, or secretary, but excluded a secretary that was a

[258] Cassim F supra op cit note 223 at 78. For purposes of this study, the term 'senior managers' is used interchangeably to denote 'prescribed officers' and indicates the broadness of the definition of the latter under the current enforcement framework. However, it is clear that not every senior manager or employee will be classified as a prescribed officer for purposes of accountability under the Act. It is my submission that while Regulation 38 does give some guidance as to who may be regarded as a prescribed officer, it is unfortunately couched in unnecessarily broad terms, and this fits the theme of increased liability and accountability by the current enforcement framework without appropriate qualification in certain circumstances. See Botha M 'Are Senior Managerial Employees Prescribed Officers in Terms of the Companies Act 71 of 2008 and Are They Treated the Same as Executive Directors?' (2012) 4 *TSAR* 786 – 800 at 787 and Idensohn K supra op cit note 1 at 718.
[259] GNR 351 GG 34239 of 26 April 2011.

body corporate.[260] Notably, the Act has not retained the term 'officer' as the legislator has opted to introduce the concept of 'prescribed officer'. Undoubtedly, the term prescribed officer builds on that of officer under the 1973 Act. However, the question is: by how much and to what extent do the two terms differ?

The current definition of prescribed officer contained in Regulation 38 differs from the previous one that was published in Regulation 45 in the 2007 Bill[261]. The draft definition contained in Regulation 45 provided that:

> 'For all purposes of the Act, a person is a 'prescribed officer' of a company if, despite not being a director of the company, that person-
>
> (a) has general executive authority over the company, (such as a President, Chief Executive Officer, Managing Director, Executive Director or similar office holder) by whatever title the office is designated;
>
> (b) has general responsibility for the financial management of the company (such as a Treasurer, Chief Financial Officer, Chief Accounting Officer, or similar office holder) by whatever title the office is designated;
>
> (c) has general responsibility for the management of the legal affairs of the company (such as a General Secretary, General Counsel or similar office holder) by whatever title the office is designated; or
>
> (d) has general managerial authority over the operations of the company, (such as a Chief Operating Officer or similar office holder) by whatever title the office is designated; or
>
> (e) otherwise directly or indirectly exercises, or significantly influences the exercise of control, over the general management and administration of the whole or significant portion of the business and activities of the company, irrespective of any title assigned by the company to any office held by that person, or function performed by that person.'

There is a substantial difference between the definition contained in Regulation 38 and that contained in Regulation 45. The definition contained in the Act is very wide and is capable

[260] See section 1 of the 1973 Act.
[261] The Draft Companies Regulations Pursuant to the Companies Act, 2008 (GG 32832 of 22 December 2009).

of including various categories of persons, whereas the previous definition was restrictive and included specific examples of persons that may be regarded as being 'prescribed officers'. Botha argues that the current definition of prescribed officer blurs the distinction between the definition of 'director' and the concept of 'manager'.[262] Previously the court in *R v Mall*[263] the court had held that there is a material difference between the terms 'director' and 'manager' and stated that:

> 'Directors are required by statute; they are essential to a company, and their functions and duties are defined by law. They are appointed by the shareholders and are vested with the management and control of the company. They represent the company, and there is a degree of permanence attached to their position. They act as a body, save so far as powers are lawfully delegated. Their identity, the law intends, should be undoubted and easily discoverable from the company's records. *To regard as a director a person with no appointment, a person meddling in the company's affairs, runs counter to the whole idea of company law…A manager, on the other hand, is an employee of the company and his services are engaged by the directors...'*
>
> (Own emphasis added).

3.2.5 Some Considerations in Interpreting the Definition of Prescribed Officer

The definition of the prescribed officer has also been described as being 'very loose and open-ended' in particular regarding its use of phrases such as 'exercises general executive control' over a significant portion', 'regularly participates in' and 'to a material degree'.[264] It is correctly pointed out that these phrases are capable of very wide construction, and more importantly, there is nothing in the provision that indicates a limit to the criteria. Idensohn points out that there is no indication in the definition 'on the nature, degree, consistency, or reach of the participation or control' that would be regarded as sufficient to deem a person a prescribed officer.[265]

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262 Botha M supra op cit note 259 at 794.
263 1959 4 SA 607 (N) at 622 – 623.
264 Idensohn K supra op cit note 1 at 718.
265 Ibid at 718.

The provisions of Regulation 38 relating to the designation of senior managers need to be sufficiently tested and scrutinised to determine if they are clear and whether they are unnecessarily broad. Idensohn's view is that the courts will have to find an appropriate interpretation that rationalises and justifies the consequences that attach to the definition of prescribed, and which interpretation is acceptable in terms of both principle and policy.[266]

An important consideration in the interpretation of the definition is whether the focus and regulatory object, in the current legal framework, on increased accountability of directors, justifies equating senior management with directors of the company for purposes of regulation and accountability. The existence of the director's aberrant theory and approach to the imposition of liability may result in there being a conflation of the difference between the two concepts and their legal implications.[267] It is submitted that given the far-reaching legal implications of the definition, the courts ought to interpret the definition restrictively and identify factors for determining whether a person exercises sufficient influence and control to be a prescribed officer.[268]

3.2.6 Evaluation

In certain instances, the definition of director and related provisions that apply to directors are also applicable to prescribed officers of the company[269]. Cassim asserts that the extension of the definition of director and certain provisions to prescribed officers 'the object is to ensure that prescribed officers are thus subject to the same strict statutory duties and accountability as the directors of the company'.[270] This object is consistent with the focus of the current legal enforcement framework which is to enhance accountability and liability for those in effective management of the affairs of the company, however, without regard to the consequences that may ensue to corporate South Africa should the courts impose personal liability to directors and senior managers for breaches of the duty of care, as was the case with the *Smith v Van*

[266] Ibid at 718.
[267] Ibid at 725.
[268] I am in agreement with Idensohn K ibid at 718 who states that 'It will accordingly be up to the courts to find an appropriate interpretation that rationalises and justifies the consequences that attach to it, and which is acceptable in terms of both principle and policy'.
[269] See section 69 of the Act - disqualification of directors, section 75 – directors' personal financial interest, section 76 – standards of directors' conduct, section 77 – liability of directors and prescribed officers.
[270] Cassim F supra op cit note 223 at 78.

Gorkom[271] decision in 1985 in the state of Delaware. This potential liability for directors and senior managers is of great concern for those who serve in such roles, and given the wide formulation in the Act of the definitions and the extended imposition of the statutory duties, a wide group of persons are vulnerable and need protection from the possibility of devastating judgments. The lack of adequate protection for directors and senior managers in the current legal enforcement framework will have serious ramifications for corporate South Africa and for corporations' ability to attract and retain suitably talented persons to serve in the role of director and senior managers, without being risk averse or overly cautious in their decision making.

In addition, the definition of prescribed officer can be criticised as blurring the distinction between the role of director and other office bearers of the company. The current legal enforcement framework applicable to directors and senior managers conflates the distinct roles of the different office bearers in pursuance of enhanced liability. Moreover, the current framework offends the logic of the well-known adage that there is 'no power without responsibility' or 'with great power comes greater responsibility'. However, with the current formulation of the definitions and the extension of the duties of directors to prescribed officers, there is instead 'greater responsibility without great power'.[272] This is because under the current legal enforcement framework, the statutory duties of directors are imposed on prescribed officers, i.e. senior managers even though they are not necessarily members of the company's board of directors or the fact that they have the right to vote at the board level.[273] Therefore, senior managers are subject to the same onerous duties and liabilities as directors, even if they have no material decision-making powers over the whole affairs of the company. It is argued that although the rationale adopted by the current legal enforcement framework was to seek to ensure that certain functions performed by senior managers within the company should be subject to enhanced standards of transparency and the duties of directors, the approach is too broad and lacks qualification in its pursuit of increased accountability.

It is submitted that the argument for the inclusion of exculpation clauses and greater protection for directors and senior managers from personal liability, under the current legal enforcement framework, for honest breaches of the standard of care is predicated on important

[271] 488 A.2d 858 (Del.1985).
[272] Cassim F supra op cit note 223 at 80 - 81.
[273] Cassim F supra op cit note 223 at 80 - 81.

policy and fairness considerations.[274] These fairness and policy considerations should also take into account the special characteristics of corporate service by different corporate officers.[275] An important part of this thesis is the comparisons drawn between how the South African enforcement framework protects corporate officers, and those of other jurisdictions discussed in this thesis, a further recommendation, amongst others, based on the Delaware model is that shareholders be permitted under subsection 78(2) of the Act the option to elect to include exculpation clauses in the company's Memorandum of Incorporation to shield both directors and senior managers from personal liability for money damages for honest breaches of the duty of care.[276] It is submitted that the same protection should be afforded to senior managers as directors, placing them on similar footing with directors, as they will also be targets of shareholder lawsuits due to the increased potential liability for personal liability for monetary damages for breach of care violations under the current enforcement framework.[277]

3.2.7 The Meaning of the Business Judgment Rule

The business judgment rule, which, in its basic form, applies to the process of directors' decision-making. The rule consists of a rebuttable presumption that, in making business decisions, directors of a company have acted on an informed basis, with good faith, and in the honest belief that the course of action adopted was in the best interest of the company.[278] The rule enjoins the courts from interfering, in retrospect, with the board of directors' judgment

[274] See Mongalo T supra op cit note 10 at 155; Spisto M supra op cit note 104 at 61; Johnston J supra op cit note 145 at 1993 to 1994; Slaughter S supra op cit note 57 at 185; Bekink M supra op cit note 6 at 91 and Gower & Davies' Principles of Mordern Company Law 8ed (2008) Sweet & Maxwell at 476.

[275] Idensohn K supra op cit note1 at 718.

[276] In the aftermath of the Smith v. Van Gorkom decision, the Delaware legislature responded to the subsequent Directors' and Officers' liability insurance crisis, resulting from a severely restricted market, and director depletion due to mass resignations by amending its company laws to include section 102(b)(7) of the Delaware General Law ("the DGCL") in 1986. Section 102(b)(7) of the DGCL permitted corporations to include a provision in their certificate of incorporation, a charter provision exculpating directors from liability for money damages for breach of care violations (but expressly excluding acts or omissions not in good faith). For over 40 years, there was a lack of clarity on the question of whether section 102(b)(7) of the DGCL also applied to senior corporate officers of Delaware corporations. The question was answered affirmatively by the Delaware legislature by the amendment of section 102(b)(7) of the DCGL that authorised the exculpation of certain senior officers of Delaware corporations from personal liability for monetary damages in connection with breaches of their duty of care. See Breheny B & Skadden R 'Officer Exculpation under Delaware Law-Encouraging Results in Year One' available at https://corpgov.law.harvard.edu/2023/06/01/officer-exculpation-under-delaware-law-encouraging-results-in-year-one/ 1-4 at page 1 (accessed on 16 April 2025). See also para 5.3.4.

[277] Ibid at 1 and 2.

[278] Jones R 'Rethinking Corporate Federalism in the Era of Corporate Reform' (2004) 29 *J of Corporation Law* 625 – 663 at 647. Also see *Aronson v. Lewis* 473 A.2d 805, 812 (Del. 1984) and Jones E 'Directors' Duties: Negligence and the Business Judgement Rule' (2007) 19 *SA Merc LJ* 326 – 336 at 329.

absent unusual exceptions, in honest and reasonable business decisions of the directors of the company.[279]

The rule serves to protect directors and senior managers from personal liability to the company or its shareholders for losses that may result from poor decision-making. However, the practical effect and extent of countering or alleviating directors or senior managers from personal liability for a breach of the duty of care, skill and diligence is doubtful under the current legal enforcement framework.[280] First, this is because the proper relationship between the business judgment rule and the duty of care, skill and diligence is not clear, nor what its scope of application should be for breaches of the duty.[281] Second, the rule is not available to directors and senior managers for liability that emanates from negligence in the context of directors or senior managers' passivity or inactivity, and where no actual decision has been taken.[282] Lastly, a trend has emerged recently where the courts appear to be moving to a more restrictive application of the rule and more vigorous enforcement of directors' and officers' duties.[283]

Subsection 76(4) of the Act now encompasses the USA-style business judgment rule[284] which provides, in material terms, that '…a particular director of a company will have satisfied the obligations of subsection (3)(b), relating to the duty to exercise the powers and performing the functions of director in the best interest of the company, and (c), relating to the duty of care, skill and diligence, if (i) the director has taken reasonably diligent steps to become informed about the matter; (ii) either (aa) the director had no material personal financial interest in the

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[279] Cassim et al supra op cit note 32 at 759.
[280] Lombard S supra op cit note 252 at 625 has remarked that '[T]he exact parameters and application of the business judgment rule presents even in jurisdictions of its origin. The failure to define the parameters of the business judgment rule results in attempts to quantify the degree of care that a director owes his or her corporation, being substantially stifled.' The business judgment rule under subsection 76(4) of the Act has yet to be tested by the courts. It is submitted in this thesis that South African courts may be persuaded to follow the hardening stance adopted by US courts, which in effect 'restricts the limits of the protection offered by the business judgment, and moving towards more vigorous enforcement of directors' duties – see Jones E supra op cit note 274 at 327.
[281] Lombard S supra op cit note 252 at 623 states that [T]he exact relationship between the business judgment rule and the duty of care is a great source of confusion, with some seeing the business judgment rule as defining the contents of directors' duty of care. Others, however, regard it as a "tool of judicial review rather than a standard of conduct".
[282]Havenga M 'The Business Judgement Rule-Should we Follow the Australian Example?' (2000) 12 *SA Merc LJ* 25 – 37 at 28. See also Lombard S supra op cit note 252 at 617, who states that '[I]t should furthermore be noted that the business judgment rule only applies in respect of actions taken or decisions made by directors. Refraining from doing anything would thus not entitle directors the protection afforded by the business judgment rule, unless it was a positive decision, meeting all the standards for decision-making under the business rule, to do nothing. The business judgment rule would, therefore, on the face of it not seem to be available in respect of directors' oversight functions…'
[283] Jones E supra op cit note 274 at 327.
[284] Cassim et al supra op cit note 32 at 759.

subject matter of the decision, and had no reasonable basis to know that any related person had a personal financial in the matter; or (bb) the director complied with the requirements of section 75 with respect to any interest…and (iii) the director made a decision, or supported the decision of a committee or the board, with regards to that matter, and the director had a rational basis for believing, and did believe, that the decision was in the best interest of the company…'[285]

Understanding the application of the business judgment rule under the current legal enforcement framework is important in how it relates to the duty of care and skill. The protection of directors and senior managers under the business rule is not certain and is subject to limitations that show that directors and senior managers may be held liable for breaches of the duty of care and skill even if they have complied with the requirements of subsection 76(4)(a). By way of illustration, this was the case in the *Smith v Van Gorkom*[286] case where the shareholders of the Trans Union Corporation brought a class action suit, among other things, for damages against the directors of the company for allegedly agreeing to sell the shares of the company without considering the shares' intrinsic value. The court, on the facts, decided that the directors had failed to adequately inform themselves of the value of the company's business in approving the cash-out merger for the company. The court found the directors liable, although the directors had approved the sale of the company's business at a board meeting. The court's decision was based on the fact that the board meeting had lasted a mere two hours, during which *Van Gorkom,* the chief executive and chairman of the company, made a twenty-minute presentation to the board. According to the court, the board uncritically accepted the recommendations of *Van Gorkom* of the price at which the company's business should be sold without having sought any other valuation or an independent valuation of the shares of the company. The court found the directors personally liable for damages of $ 23 million for failure to exercise reasonable care, skill and diligence, even though they had complied with the requirements of the business judgment rule.[287]

The deficiencies and limitations in the application of the business judgment represent a serious concern for directors and senior managers under the current legal enforcement framework. The lack of adequate protection implies that directors and senior managers may be found liable by a court for negligence and breaches of the duty of care, skill and diligence, even if they have acted honestly and reasonably in terms of the requirements of subsection 76(4)(a)

[285] Section 76(4)(a) of the Act.
[286] 488 A.2d 858 (Del.Supr.1985).
[287] See para 5.3.4 for an in-depth analysis of the *Smith v Van Gorkom* 488 A.2d 858 (Del.Supr.1985) judgement and its aftermath on corporate law in Delaware and beyond.

of the Act. Directors and senior managers could still incur liability for errors of judgment or poor business decisions even if the requirements of the business judgment rule are satisfied. It is submitted that 'the perceived value of the business judgement rule as a 'safe harbour' for directors and senior managers under the current legal enforcement framework is 'over-estimated'.[288] This submission is based on the limited application of the business judgment rule, and the protection it affords to directors and senior managers as a viable measure of relieving or shielding them from personal liability for mere errors of judgment made in good faith or the failure to exercise due care in their oversight functions.[289]

It was correctly observed by Bainbridge that the reference to a 'rational business purpose', properly understood, does not contemplate substantive review of the decisions' merits'.[290] However, the courts in the state of Delaware have recently been changing their approach by restricting the limits of the protection offered by the business judgment rule, and appear to be moving towards a more vigorous enforcement of directors' duties.[291] There is a real possibility that South African courts will follow this trend and approach, given the fact that the business judgment rule's origin is Delaware, and their development of the rule is of persuasive value in the South African context.[292] However, this approach is inappropriate because it equates being 'rational' with conceivable or imaginable. Dooley argues that courts should 'not even look at the board's judgment if there is a possibility that it was actuated by legitimate business reason'.[293] He goes on to correctly observe that 'it does not mean, and cannot legitimately be cited for the proposition, that individual directors must have, and be prepared to put forth, proof of rational basis for their decisions'. [294]The current legal enforcement framework's focus on increased accountability has eroded and offset the protection that was meant to be afforded by the business judgment rule.

[288] Lombard S supra op cit note 252 at 626.
[289] Lombard S supra op cit note 252 at 617 and 626.
[290] SM Bainbridge *Corporation Law and Economics* (2002) New York, N.Y. Foundation Press, at 274.
[291] This has been clear from four decisions that have been handed down in the matters of *In Re Walt Disney Co Derivative Litigation* 825 A.2nd 275 (Del Ch 2003), *Texlon Corp v Meyerson* 802 A.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). In addition, the Delaware court recently handed down another judgment on 31 January 2024 in the matter between *Richard J. Tornetta v Elon Musk & Others*, C.A. No. 2018-0408-KSJM, dealing with the business decisions of the board of directors. See para 5.3.3 for an analysis of these decisions.
[292] Section 5(2) of the Act provides that 'to the extent appropriate, a court interpreting this Act may consider foreign company law'.
[293] Dooley MP 'Two Models of Corporate Governance' (1992) 47 *Bus. Law.* 461 – 483 at 478.
[294] Ibid at 479.

A recent decision handed down by the Court of Chancery in the state of Delaware on 31 January 2024 in the matter between *Richard J. Tornetta v Elon Musk & Others C.A. No.*[295] further confirms the trend or the hardening stance by Delaware courts to enforce strictly the rules against directors thereby depleting the sufficiency of the business judgment rule as a viable means to provide directors and senior managers with the necessary protection that their decisions will not be second-guessed by judges i.e. the necessary judicial deference from hindsight biases or armchair critical judges.[296]

3.3 The Duty of Care and Skill

3.3.1. The Duty of Care and Skill under the Common Law

At common law, directors were not only expected to exercise their powers and functions in good faith and also for the benefit of the corporation, but they were also required to act with the requisite degree of 'care' and 'skill'.[297] The duty of care and skill and the rules governing the standards required of directors were formulated in English decisions.[298] In sharp contrast to the onerous fiduciary duty of good faith and loyalty, which were rigorously enforced by the courts, the common law historically demanded very little from directors in respect of the standard of duty of care, skill and diligence, and the courts adopted a rather lenient stance in the enforcement of the latter duty.[299] In early cases involving allegations of the breach of the duty of care, skill and diligence a director was held liable only if gross negligence could be established and a mere errors of judgment were insufficient grounds for a director to be held

[295] 2018-0408-KSJM.
[296] The *Richard J. Tornetta v Elon Musk & Others C.A.* No 2018-0408-KSJM decision is discussed more in-depth in Chapter 5, para 5.3.
[297] Bouman N supra op cit note 217 at 510. Subsection 76(3)(c)(ii) of the Act, which partially codifies the common law duty of 'care' and 'skill', has added the requirement of 'diligence' that may be reasonably expected, which may vary from 'person to person' (See Bouman N supra op cit note 217 at 510.)
[298] Bekink M supra op cit note 3 at 97. Some of the decisions included: *Sheffield and South Yorkshire Permanent Building Society v Aizlewood* [1889] 44 ChD 412, *In re Brazilian Rubber Plantations and Estates Ltd [1911] 1 Ch 425 and Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392, and *Re National Bank of Wales Ltd* [1899] 2 Ch 626.
[299] Bekink M ibid at 97. See also Cassim et al supra op cit note 32 at 747. See also Mclennan J supra op cit 251 at 186, where he states that '[T]here has always, of course, been a measure of overlapping between the fiduciary duty and the duty of care and skill: a director who acts negligently can hardly be said to be acting in the best interest of the company. Nevertheless, the courts have traditionally treated the duties differently. The fiduciary duty has been rigorously enforced…But when it came to applying the law of tort, the courts have been lenient, if not downright lax…'

liable for losses sustained by the company.[300] The reasoning for the court's lenient approach was the view that shareholders were ultimately responsible for the competence of the directors appointed by them.[301] The lenient approach was achieved by focusing on the subjective test concentrating on the specific director's intelligence and experience.[302] However, the traditional lenient approach needed revision as it no longer suited society's needs and expectations, which had changed over time, regarding the standard of care that directors should adhere to.[303] A new test was developed that included both subjective and objective elements.[304]

In South Africa, the common-law position was summarised in the case of *Fisheries Development Corporation of SA Ltd v Jorgensen Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) & Others*[305] in three broad principles that were influenced by the earlier decisions of *In re Brazilian Rubber Plantations and Estates Ltd*[306] and *In re City Equitable Fire Insurance Co Ltd*[307]. The three principles were summarised by Margo J as follows:

'(a) The extent of a director's duty of care and skill depends to a considerable degree on the nature of the company's business and any other particular obligations assumed or assigned to. The degree of care required will therefore differ between non-executive directors and executive directors. It may not be required of non-executive directors that they give continuous attention to the affairs of the company or attend every meeting. However, it would be expected of executive directors they devote their attention to the day-to-day management of the company and thus a higher level of care would be expected.

(b) A director is not expected to have specific business acumen, knowledge, expertise or experience in the business of the company. Directors are expected to exercise the degree of care and skill which an ordinary person may exhibit in the same circumstances. However, they need not exhibit, in the performance of

[300] *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.
[301] Cassim et al supra op cit note 32 at 747.
[302] Bouman N supra op cit note 260 at 511.
[303] Bouman N supra op cit note 260 at 512. See also Du Plessis J 'A comparative analysis of directors' duty of care, skill and diligence in South Africa and in Australia' (2010) *Acta Juridica* 263-289 at 266.
[304] *In re D'Jan of London Ltd* [1993] BCC 646 (Ch D (Companies Court)).
[305] *Fisheries Development Corporation of SA Ltd v Jorgensen 1980 (4) SA 156 (W); Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) & Others* 1980 (4) SA 156 (W).
[306] *In re Brazilian Rubber Plantations and Estates* Ltd [1911] 1 Ch 425.
[307] [1925] Ch 407 (CA).

their duties, a greater degree of care and skill than may be reasonably expected from a person of their knowledge and skill. A director is not liable for mere errors of judgment.[308]

(c) In respect of all duties that may properly be left to some other official, a director is, in the absence of specific grounds for suspicion, justified in trusting that official to perform such duties honestly. He is entitled to accept and rely on the judgement, information and advice of the management unless there are proper reasons for questioning such.[309] A director exercising reasonable care would not accept information blindly. He would accept it, and he would be entitled to rely on it, but he would give it due consideration and exercise his judgment accordingly.'[310]

In the matter of *Howard v Herigel & Another NNO,*[311] the court confirmed that the director's duty was to observe the utmost good faith towards the company and in doing so, to exercise reasonable care and skill. The Appellate Division, contrary to the finding in *Fisheries Development Corporation of SA Ltd v Jorgensen Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) & Others,*[312] expressed the view that it was unhelpful and even misleading to classify company directors as 'executive' and 'non-executive' for purposes of ascertaining their duties to the company. The court held that as a general rule once a person accepts an appointment as director, he becomes a fiduciary to the company. This was also confirmed in the case of *Philotex (Pty) Ltd & Others v Synman & Others*[313] where the court held that the test for recklessness was an objective one. A director's actions have to be measured against the standard of a notional reasonable person. Therefore, it may be observed that over a period of time, the common law approach to the directors' duty of care, skill and diligence in South Africa became stringent and it mirrored developments in the United Kingdom.[314] In *Philotex,* the court also held further that although the standard of care, skill and diligence by which the director's conduct was measured is largely an objective one, the courts

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[308] *In re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425.
[309] Ibid at 429 -430.
[310] *Fisheries Development Corporation of SA Ltd v Jorgensen 1980 (4) SA 156 (W); Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) & Others* 1980 (4) SA 156 (W).
[311] 1991 (2) SA 660 (A).
[312] 1980 (4) SA 156 (W).
[313] 1994 (2) SA 710 (T).
[314] Cassim et al supra op cit note 32 at 750.

are permitted to also have regard to subjective considerations such as the unique qualifications, knowledge and experience possessed by the director concerned.[315]

A director or senior manager who fails to observe their duty of care and skill will be liable to the company for any loss suffered as a result of such failure in delict.[316] Therefore, before a director or senior manager can incur liability to the company for any losses sustained by the company, it is required that the general elements of the law of delict must be proved against him or her.[317] The director's liability will be based either in delict or breach of contract if there is a contract between the director and the company.[318] In *Du Plessis No v Phelps*[319] the position was explained as follows:

> 'Apart from their statutory duties, directors owe fiduciary duties to the company as well as a common law duty to take reasonable care in the management of the company's affairs. Liability in the event of a director failing to take reasonable care in the management of the company affairs is based on the principles of the *Lex Aquilia*. The basis requisite for liability under the *Lex Aquilia* is the fault, i.e. dolus or culpa, which results in loss to the plaintiff.'

The delictual element of fault can take either of two forms, namely, intention or negligence. The question of a director's liability does not pose any problems when the dolus is involved. However, the question is more complicated about instances where negligence is involved. The test that has been used by the courts to determine negligence was formulated authoritatively in *Kruger v Coetzee*[320] where the court held that a defendant is negligent if is established that a reasonable person in the position of the defendant would have foreseen the real possibility of his or her conduct causing harm to another and would have taken reasonable

[315] *Philotex (Pty) Ltd & Others v Synman & Others* 1998 (2) SA 138 (SCA).
[316] See Havenga M 'Breach of Directors' Fiduciary Duties: Liability on what basis?' (1996) 8 *SA Merc LJ* 366 – 376 at 367 and 370, wherein it suggested that the Aquilian action is the proper basis for a director's liability for breach of duties. It has been submitted that subsection 77(2) of the Act makes provision for contractual liability to co-exist with delictual liability – Horney J supra op cit note 13 at 53. See also the discussion on the instances and/or the basis on which directors and senior managers can be held liable under para 3.5.
[317] Van der Linde K 'The Personal Liability of Directors for Corporate Fault –An Exploration' (2008) 4 *SA Merc LJ* 439 – 461 at 439, states that '…[t]here has not been a systemic study of the nature and scope of directors' personal liability for corporate conduct' in South Africa. It is submitted that this assertion is also true for the question of collective liability of the board of directors versus individual liability and whether a factual enquiry will be necessary to establish when and to whom liability must be imposed or imputed to especially if subsection 66(1) of the Act is taken into consideration regarding the powers and responsibilities of the board of director vis-à-vis the authority to handle the affairs of the corporation. This is an interesting question that still needs to be considered in further research and is not pertinent to the focus of this thesis.
[318] Ibid Havenga M at 371. See Bekink M supra op cit note 3 at 101.
[319] 1995 (4) 165 (C) at 170.
[320] 1996 2 (SA) 428 (A) 430E.

precautionary steps to guard against such occurrence, which the defendant in the facts of the matter failed to do. Therefore, where a director breaches his or her duty of care and skill, whether intentionally or negligently, the consequence is that delictual damages are recoverable by the company against the particular director concerned.[321]

3.4 The Development of the Duty of Care and Skill

3.4.1. The King Reports on Corporate Governance of 1994 – 2016

The King Codes on Corporate Governance have influenced the duty of care, skill and diligence in South Africa. The King Report on Corporate Governance for South Africa 1994 ('King I'), containing a Code of Good Practice, dealt with several fundamental concepts of corporate governance that accentuated directors' responsibilities regarding corporate governance.[322] Compliance with the principles contained in the King Reports is not prescribed by law but is based on self-regulation. The King I Report sought to introduce principles that balanced the directors' and senior managers' need for freedom in the management of the corporation, and the equally valid imperative for accountability in favour of the interests of stakeholders.[323] King, I recommended the codification of the duty of care, skill and diligence as a means of ensuring proper performance by directors of their duties and responsibilities.[324] This was seen as setting the stage for a necessary debate on future legal and regulatory developments on the

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[321] *Ex parte Stubbs NO: In re Wit Extension Ltd* 1982 (1) SA 526 (W) at 532.

[322] Corporate governance may be defined as 'the system by which companies are directed and controlled', thus referring to all aspects of the control and management of companies- see the Cadbury Report (Cadbury Report of the Committee on the Financial Aspects of Corporate Governance (1992) at 14. It has been stated that 'there is an interrelationship between a company's management, its board, its shareholders and other stakeholders'…' see Bekink M supra op cit note 3 at 107. The concept of corporate governance incorporates matters such as directors' duties, financial accounting, and the protection of the interests of various stakeholders – see Du Plessis J 'Corporate and the Cadbury Report (1994) 6 SA Merc LJ 81 - 102 – at 82. In addition, directors and senior managers have an important role to play in the promotion of corporate governance and have certain duties and responsibilities imposed on them- Botha M 'The Role and Duties of Directors in the Promotion of Corporate Governance: A South African Perspective' (2009) 30 *Obiter* 702 – 715 at 703.

[323] Bekink M supra op cit note 3 at 108, where she states that '[G]ood corporate governance thus entails that a company and especially its directors abide by the law and manage the company responsibly by taking the interest of all stakeholders into account. However, conforming to good corporate governance standards usually results in constraints on management. The key challenge for the drafters of the King I Report was to seek principles striking an appropriate balance between the freedom to manage, accountability, and the interests of stakeholders. Consequently, directors have to ensure that they act with the necessary care and skill in perform *(sic)* their responsibilities'. See also Botha D & Jooste R_'A Critique of the Recommendations in the King Report regarding a Director's Duty of Care and Skill' (1997) 114 *SALJ* 65-76 at 68. See Havenga M supra op cit note 2 at 310.

[324] King I paras 3.4 and 3.5. See also Bekink M supra op cit note 3 at 108.

issue.[325] However, King I poignantly recommend that directors should not be held liable for a breach of the duty of care, skill and diligence if the decision or error concerned was made in good faith, constituted an informed decision, and was rational based on all the facts of a particular case and provided that there was self-interest on the part of the director.[326]

King II[327] expanded on and replaced King I in 2002, and it was submitted that King II proposed collective accountability for directors and placed ultimate responsibility on the board of directors for good corporate governance.[328] A distinction was drawn between the roles of executive and non-executive directors. In addition, King II also determined that directors must not only exercise the degree of care and skill that may be expected from persons of their skill and experience but that directors must also 'qualify themselves continuously with a sufficient, or at least general, understanding of the company's business and the effect of the economy to discharge their duties properly, including where necessary relying on expert evidence'.[329] King II also referred to the business judgment rule with the view of protecting honest directors from risks in the hindsight review of their unsuccessful decisions. However, for the business judgment rule to apply, the decision concerned ought to have been made by the directors concerned on an informed basis, in good faith, without any conflict of interest, and based on the decision being rational. King II recommended that the Standing Advisory Committee on Company Law amongst other things also investigate if South African corporate law required the incorporation of the business judgment rule type of protection for directors.[330]

King III replaced King 11 in March 2010, before the coming into operation of the Act, with a wider application irrespective of nature, size, or form of incorporation or establishment.[331] King III suggested that there was a clear link between good governance systems and compliance with the law by corporations. Further guidance was also given on the

[325] The Report was considered to be a reference point for policy makers 'in the examination and development of legal and regulatory frameworks for corporate governance' - Bekink M supra op cit note 3 at 108.
[326] King I paras 3.4 and 3.5.
[327] King on Report on Corporate Governance South Africa (Institute of Directors in South Africa) March 2002.
[328] Bekink M supra op cit note 3 at 109, where she states that this recommendation was criticised, as some commentators pointed out that collective responsibility has never been part of South African company law.
[329] King on Report on Corporate Governance South Africa (Institute of Directors in South Africa) March 2002 at 55 para 2.3.
[330] Ibid at para 3.3. In *Minister of Water Affairs and Forestry v Stilfontein Gold Mine Co Ltd* 2006 (5) SA 333, the court ruled that directors had not acted with the necessary care and skill by failing to comply with the King II. The decision confirms that the courts will take the King Reports into consideration when assessing whether directors and senior managers have acted with the necessary care and skill in a particular situation.
[331] The King Report on Corporate Governance March 2010 ('King III'). It operated on an 'apply or explain regime' in which the board are required to explain how the recommendations were applied, or if they were not applied, then an explanation of why they were not applied.

standard of care and skills that should be required from directors. Directors in the exercise of their duty of care and skill should attempt to resolve disputes expeditiously, and efficiently, and ensure that 'prudent and reasonable steps have been taken in regard to IT governance'.[332] Directors are also required to inform themselves adequately on the contents of applicable laws, rules, codes and standards so that they can discharge their fiduciary duties and duty of care, skill and diligence adequately.[333] Furthermore, non-executive directors who should 'honestly apply their minds to their workloads and abilities to discharge their duties'[334] are required to take up offices of directorship above those reasonable to exercise due care, skill and diligence.[335]

King IV[336] replaced King III in 2016, but it does not deal in any much detail with directors' duties as the Act dealt extensively with directors' duties and their accountability. However, King IV does state that good corporate governance includes that directors and senior managers should adhere to (1) their duty to act with due care, skill and diligence in the discharge of their functions, and (2) their duty to act in good faith in the best interest of the company.[337] It is important to note that King IV, as is the case with its predecessors, remains a set of voluntary principles and good practices. In addition, King IV recognises that good governance is something that does not operate separately from the law and that it may, even though it applies voluntarily, it may trigger legal consequences for directors and senior managers.[338] Courts are expected to consider all relevant circumstances, including what is regarded as accepted best practice in a particular setting or circumstance.[339]

3.4.2. The Partial Codification of the Duty of Care and Skill in South Africa

The Policy Paper advocated for the codification of both directors' fiduciary duties and the duty of care, skill and diligence, and argued that the benefits of a statutory standard would have to be counterweighed against the possible constraints that may be placed on the development of

[332] Ibid at 17.
[333] Ibid at 91.
[334] Ibid at 41.
[335] Ibid at 41.
[336] King IV Report on Corporate Governance for South Africa, 2016.
[337] Ibid at 43.
[338] Ibid at 35.
[339] The Policy Paper supra op cit note 15 at 23 and 37 -38.

the common law.[340] In drafting the Act, policy makers did adhere to some of the proposals made in the King Reports, and the 2007 Bill contained a statutory codification of the common-law duty of care and skill. The 2007 Bill proposed to enhance corporate accountability by codifying directors' duties and retained the subjective and objective elements of the test as set out in the common law.[341] The test was formulated as objective insofar as the directors' actions were measured against the standard of the notional reasonably diligent individual. This sets a minimum standard that all directors have to meet.[342] However, the subjective element of the test sets a standard for directors who have more skill or experience than expected in terms of the objective standard.[343]

A concern was raised about whether the second leg of the test, namely that of the 'general knowledge, skill and experience of that director' rendered the test too subjective.[344] With the result that the objective test might be overshadowed by the addition of further subjective elements, which require the court to consider the 'general knowledge, skill and experience' of that particular director.[345] This may lead to the courts being more confused in the interpretation of the director's duty of care and skill. Bekink argues that the formulation of the standard of the duty of care and skill, in both objective and subjective terms, will improve the objective nature, which will be emphasised while the necessary flexibility is retained.[346] This particular concern is of importance in determining whether the provisions of the current legal enforcement framework applicable to directors and senior managers relating to the partial codification of the duty of care and skill provide unambiguous rules.[347] The 2007 Bill did not

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[340] Bouman N supra op cit note 260 at 510 and Bekink M supra op cit note 3 at 112. Clause 91(1)(a) of the 2007 Bill provided as follows: '(1) Each director of a company, when acting in that capacity, or as a member of a committee of directors, or when gathering information or similarly preparing to act in either of those capacities, is subject to- (a) a duty to exercise the degree of care, skill and experience that would be exercised by a reasonable diligent individual who had both – (i) the general knowledge, skill and experience that may reasonable be expected of an individual carrying out the same functions as carried out by that director in relation to the company; and (ii) the general knowledge, skill and experience of that director.'

[341] McLennan JS 'Duties of Care and Skill of Company Directors and Their Liability for Negligence' (1996) 8 *SA Merc LJ* 94 -102 at 101.

[342] Ibid at 97 and 101.

[343] Bouman N supra op cit note 260 at 511.

[344] Bekink M supra op cit note 3 at 111. See the discussion on the interpretation sub-section 76(3c)(i) and (ii) of the Act regarding the subjective standard of 'the general knowledge, skill and experience of that director' in para 3.4.3.

[345] Bouman N supra op cit note 260 at 512.

[346] Section 7(l) of the Act provides that one of the objects of the Act is to provide 'a predictable and effective environment for the efficient regulation of companies.'

[347] Bouman N supra op cit note 260 at 512.

propose a complete codification of the directors' duty of care, skill and diligence, which left room for the common law to be consulted in interpreting the statutory standards, if need be.[348]

In addition, there were conflicting views regarding whether it was necessary to regulate directors' duties statutorily and, in particular, whether there was a need for an enhanced standard for the duty of care, skill and diligence.[349] Bekink[350] states that:

> '[T]he need for a higher standard for the duty of care and skill has been pointed out since the early 1960s…Arguments in favour of reform and more stringent standards therefore suggest that the current standards for the duty…are inadequate, too modest, reflect legacies of outmoded economic and social philosophy, and do not reflect the commercial realities and prudent business practices…a raised standard might lead to directors engaging in a more thorough decision-making process. However, such a standard should be linked to the role of a director performs within the company, despite his individual talents, so as to ensure that under-qualified director should not enjoy partial immunity.' Some of the points that relate to the discussion of a more stringent duty of care and skill are relevant for the current legal enforcement framework. First, unlike other professions, a director is not required by law to possess any special qualifications to qualify for the office of director. This is because in South Africa, directors are not required by the Act to be a part of a professional body.[351] Second, the current legal enforcement framework has extended the duty of care and skill to senior managers in terms of section 76(1)(a) of the Act without due regard to the distinction between the position of director and senior managers. As observed above, senior managers are not members of the board and thus are not at the same level of control and access as directors within the company.[352] Last, an enhanced standard might lead directors to be over-cautious, the CLR observed that:
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> 'Directors are employed to take risks, often under severe time pressures which prevent the fullest examination of all relevant factors. Some risks will not pay off. The directors'

[348] Bouman N supra op cit note 260 at 511.
[349] Arsalidou D *The Impact of Modern Influences on the Traditional Duties of Care, Skill and Diligence of Company Directors* (2001) The Hague: Kluwer Law International at at 221 - 223.
[350] Bekink M supra op cit note 3 at 113. These observations about the development of the duty of care and skill raised questions that are relevant for the interpretation of subsection 76(3)(c)(ii) of the Act, which is discussed in para 3.4.3.
[351] See para 3.4.4.. See also section 69 of the Act, which deals with the ineligibility and disqualification of persons to be a director or a prescribed officer.
[352] Law Commission, Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties (Consultation Paper No 153, 1998), (UK) para 3.69.

key skill is one of balancing the risk and time factors, recognising that their company's success and failure will depend on their not being unduly cautious as well as avoiding fool-hardiness. What risks are appropriate will depend on a multitude of factors, including the ethos of the company and the character of its business and markets.'[353]

3.4.3. The Statutory Duty of Care: Subjective, Objective, Dual Objective/Subjective Standards of Care & Gross Negligence

Subsection 76(3)(c) of the Act establishes the partial codification of the statutory duty of care, skill and diligence which applies to directors and senior managers concurrently with the common. It provides that a director or senior manager of a company, acting in the capacity of director or senior manager, must display the powers and perform the functions of a director:

> '…with the degree of care, skill and diligence that may reasonably be expected of a *person-*
>
> *(i)* *carrying out the same functions to the company as those carried out by that director*; and
>
> (ii) having the general knowledge, skill and experience of *that director*.'
>
> (Own emphasis added)

When the wording contained in subsection 76(3)(c) of the Act is examined, it is clear that partial codification of the common law duty preserved both the objective and subjective elements standards that were contained in the common law. The test or standard is objective to the extent that the first leg of subsection 76(3)(c)(i) of the Act requires a director or senior manager to exercise the degree of care, skill and diligence that may be reasonably expected of a person carrying out the same functions as the director.[354] The second leg of the test is subjective in that section 76(3)(c)(ii) requires that the knowledge, skill and experience of the director in question must also be taken into account.[355] This means that if the director has any

[353] See Chapter 3 para 2.3.4 – 3.2.6.
[354] Bouman N supra op cit note 260 at 513. See also Cassim et al supra op cit note 32 at 751.
[355] Cassim et al supra op cit note 27 at 751.

special skill or more knowledge or experience, his or her conduct will be measured against this higher subjective standard.[356]

However, the question remains whether the current formulation of the test is sufficiently clear when regard is had to words used that a director is expected to display the same degree of care, skill and diligence that ‘may reasonably be expected of a person carrying’ out similar function relation to the functions carried out by that particular director. The South African position closely resembles the one established in terms of section 174(2)(i) –(ii) of the United Kingdom’s Companies Act, 2006[357] which formulated the expected standards in accordance with the ‘reasonable expectations’ of conduct that directors are required to display when exercising powers and performing functions of directors of a company. It is understood that the use of the so-called reasonable expectations standard allows the court to be able to take into consideration the comparable responsibilities and circumstances of directors in similar situations when deciding whether the requisite standard of conduct has been met by a specific director. Whether a director has complied with the duty in any particular case is objective in the sense that the director’s conduct will be compared with that which may reasonably be expected of a person carrying out the same functions as those carried out by the director concerning the company. The objective standard is regarded as imposing a minimum standard to be expected of all directors. However, some authors have criticised the fact that the test in subsection 76(3)(c)(ii) of the Act also introduces subjective elements to the test, making it impossible to use the ‘reasonable person’ test, rendering the standard overly subjective.[358] Du Plessis points out that the legislators' intentions ‘are simply to ensure that apples are compared with apples and, putting all the apples, as far as that is theoretically possible, in the same hypothetical situation comparable to the facts of the particular case!’[359]

Cassidy also observed that the test for the standard of care, skill and diligence contained in the provisions of subsection 76(3)(c)(i) and (ii) are not a model of clarity, and he submits that the provisions are at best ambiguous.[360] The first leg of the test contained in

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[356] Cassim et al supra op cit note 27 at 751.
[357] Section 174 of the 2006 UK Act provides that: (1) A director of a company must exercise reasonable care, skill and diligence. (2) This means the care, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and (b) the general knowledge, skill and experience that the director has.
[358] Du Plessis J ‘A comparative analysis of directors’ duty of care, skill and diligence in South Africa and in Australia’ (2010) *Acta Juridica* 263 – 289 at 269.
[359] Ibid at 270.
[360] Cassidy J ‘Models for reform: the director’s duty of care in a modern commercial world’ (2009) *Stell LR* 373- 391 at 376.

subsection 76(3)(c)(i) appears to set an objective formulation to the test or standard of care, skill and diligence expected of directors.[361] However, the second leg of the test contained in subsection 76(3)(c)(ii) it seems to suggest that the first leg is largely reduced to a subjective standard. The result is that the section imposes 'a less subjective test and a slightly more demanding standard of care on directors…than the common law.'[362]

Cassim is of the contrary view regarding the interpretation of subsection 76(3)(c) of the Act and states that subsection 76(3)(c)(i) imposes a standard of care that is fair and equitable.[363] The implication of subsection 76(3)(c)(ii) is that the more skilled, knowledgeable and experienced the director is, the higher the standard of care and skill that he or she must exercise.[364] In the case of the more inexperienced director, a lower level of care and skill is expected, provided that he or she at least exercises the reasonable standard.[365]

What is clear is that the current legal enforcement framework applicable to directors and senior managers expects high standards of care, skill and diligence from directors and senior managers. Du Plessis correctly point out that the dangers for South African company directors and senior managers are 'more concealed because of the lack of cases, but that the dangers are there cannot be denied'.[366] Therefore, the enhanced standard of care and liability as partially codified under subsection 76(3)(c)(i) and (ii) poses a significant risk for personal liability for directors and senior managers because of the heightened standard that is expected of them in the discharge of their powers and functions.[367]

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[361] McLennan J supra op cit note 251 at 186 confirms that the formulation of the test was objective and subjective under the Companies Bill and similar to the position under section 174 of the UK Companies Act 2006. He states that 'It will be observed that in (i) the test is objective while in (ii) it is subjective.'

[362] Cassim et al supra op cit note 32 at 750. See also Sutherland P 'The state of company law in South Africa' (2012) 1 *University of Stellenbosch Law Review* 157 – 182 at 172.

[363] Cassim et al supra op cit note 32 at 750.

[364] McLennan J supra op cit note 251 at 186 uses an example to describe how the subjective criterion would work in respect of a higher skill set: '[A] senior employee of a company devises a highly ingenious method of embezzling funds. By the time the defalcations are discovered, the thief has disappeared with vast sums of the company's money. So ingenious was the scam, that the directors cannot objectively be accused of negligence. Director X however, is in a different position. Just a few years ago, he was a director of another company where a very similar scheme had been used and he was one of the investigators who had unravelled and analysed the whole fraud. Had he been reasonably alert this time, he would have detected the same signs and symptoms of the same *modus operandi* and could have called attention to the thefts at an early stage. He would be liable in terms of paragraphs (ii) – the subjective test.'

[365] Cassim et al supra op cit note 32 at 750.

[366] Du Plessis J supra op cit note 318 at 286.

[367] Van der Linde K supra op cit note 318 at 450, she states that '[T]he principle that persons are liable for loss arising from their own wrongful conduct is applied to company directors in an interesting way. Despite the fact that directors were merely executing their normal functions in and on behalf of the company, acting entirely in pursuit of company business, the law of delict has no difficulty attributing the conduct to the directors for the purpose of imposing personal liability.' See also *Administrateur, Natal v Trust Bank van Afrika Bpk* 1979 (3) SA 824 (A), on appeal, it was examined whether liability can attach in the absence of a contractual basis. This

Mongalo expresses the view that South African policy makers missed an opportunity, or that there may have been unavoidable eventualities in the current formulation of the standard of the directors' standards of duty of care under subsection 76(3)(c) of the Act.[368] This argument is premised on 'the socio-demands of South Africa', which requires 'the attraction and retention of talented directors to spur the much-needed economic growth…'[369] The contention is that the subjective standard of the duty of 'skill' amounts to 'overkill as it clearly exposes directors with enhanced skills to the potential risk of personal liability.'[370]

3.4.4. The Nature of the Relationship Between the Duty of Care, Skill and Diligence and the Business Judgment Rule

A primary research question is whether the current legal enforcement framework, which increases the accountability and liability of directors and senior managers, provides suitable protection to directors and senior managers for personal liability for breaches of the duty of care and skill. The business judgment rule was developed and introduced in the United States of America, as far back as 1829, 'because of a desire to protect honest directors and officers from the risks inherent in hindsight reviews of their unsuccessful decisions, and because of the desire to refrain from stifling innovation and venturous business activity'.[371]

It has been pointed out that the business judgement was developed alongside the duty of care and skill with the view that if a director or officer decided in good faith, on an informed basis, which the director reasonably believed was in the best interest of the company, the director or officer concerned cannot incur liability for that decision.[372] The principal aim of the rule is to encourage directors to take part in activities that entail risk-taking because it is feared

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will, for purposes of company directors, depend on whether the directors owed a duty of care to say for example a third party. However, such a duty of care, if any, would be constrained by the foreseeability test together with reliance. This is particularly relevant to the current legal enforcement framework applicable to directors and senior managers as the rules for standing to bring actions under the Act has been extended – see sections 218

[368] Mongalo T 'Directors' Standards of Conduct Under the South African Companies Act and the Possible Influence of Delaware Law' (2016) 2 *JCCCL&P* 1 – 17 at 13.

[369] Ibid at 13.

[370] Ibid at 13. The South African standard of duty of 'care' and 'skill' is comparable to the Delaware law of standard of care and is considered in more detail, see 5.3.

[371] American Law Institute Principles of Corporate Governance and Structure: Restatement and Recommendations (1982), Tentative Draft No 1 at 147.

[372] Bouman supra op cit note 260 at 523.

that without the rule directors may become exceptionally cautious and risk-averse because bad decision-making could expose them to personal liability.[373] The rule is also necessary to persuade competent persons to take up the role of director.[374] It has been stated that in South Africa there is a great need for competent persons to serve as directors especially because there are no specific qualifications required for a persons to possess for the office of director.[375]

Bouman has argued that the formulation of the business judgment rule muddles the application of the underlying principles of the duty of care and skill and directors' fiduciary duties.[376] She reasons that the election by policy makers to provide ‘the same requirements for the satisfaction of one of the facets of director’s fiduciary duty and the directors’ duty of care and skill, it can be foreseen that the once clear delineation between fiduciary duties and the duty of care, skill and diligence in South Africa will be blurred’.[377]

In addition, as stated above the protection provided by the business judgment is limited when regard is had to the fact that the rule is not available to actual decisions taken by directors and senior managers. The rule is not available for liability that emanates from negligence in the context of directors’ or senior managers’ omission. Furthermore, a trend has developed in Delaware where the court’s recent approach to enforcement of directors’ and officers’ duties is moving towards a more restrictive application of the rule and is imposing liability personal liability on directors and officers for breaches of the duty of care.

3.5 The Liability of Directors and Senior Managers

A key question of this research is whether there is any point if the current legal enforcement framework, applicable to directors and senior managers, that has introduced a normative statement of directorial responsibilities and increased accountability rendered less effective in its aim to enhance corporate governance by also providing adequate protection to directors and senior managers for honest breaches of the duty of care, skill and diligence.[378] The discussion

[373] Kennedy-Good S & Coetzee L ‘The Business Judgment Rule (Part 1)’ (2006) 27 *Obiter* 62 -74 at 65.
[374] Ibid at 65.
[375] Bouman supra op cit note 260 at 524.
[376] Bouman supra op cit note 260 at 529.
[377] Bouman supra op cit note 260 at 529.
[378] Finch V ‘Company Directors: Who Cares About Skill and Care?’ (1992) 55 *The Modern Law Review* 179-214 at 179, argues that ‘there is little point in formulating appropriate standards of care if those standards cannot or will not be brought to bear on directors or, indeed, if other methods of controlling competence are likely to be more effective.’

above has sought to clarify the standard of directors' and senior managers' duty of care and the related business judgment rule. Understanding the provisions relating to the duty of care, skill and diligence and the rule is necessary for effective enforcement of the standard. For purposes of enforcement, it is important to have clarity on the standard of the consequences of breach of the standard, hence the imposition of liability in terms of subsection 77(2) of the Act for breach of the duty of care and skill forms part of this chapter. It is also necessary to identify enforcement mechanisms relevant to the duty and the who potential enforcers of the duty could be that are accorded locus standi by the Act to enforce the standard of the duty of care and skill.

Subsections 77(1) to (10) of the Act sets out the statutory liability of directors and senior managers of a company. The section specifically also includes prescribed officers, alternate directors, members of the audit committee board, or a committee of the board in its application.[379]

A director or senior manager may be held liable in accordance with the principles of the common law and subsection 77(2)(b)(i) of the Act relating to a breach of the duty of care, skill and diligence, for any losses, damages or costs sustained by the company as result of the breach. Where company directors or senior managers fails to exhibit the expected standards of care, skill and diligence, will become liable for in terms of the common law which has now subsumed by the Act. Directors and senior managers, whenever they exercise their powers and or when fulfilling their functions in terms of common law and the Act, they are now expected to meet the requisite standards of conduct.[380]

The personal liability of directors and senior managers been broadened and they face serious personal financial for errors and breaches of the duty of care, skill and diligence under the current enforcement framework.[381] It follows that a further result of the wider ambit together with the broadened classes of person that may bring an action on behalf of the company such as shareholders through derivative action means that are greater avenues for directors and senior managers litigation and for them to be held liable for breaches of the duty of care, skill and diligence.[382] However, a detailed discussion of other instances of directors'

[379] Section 77(1) of the Act provides that for purposes of this section director 'includes an alternate director, and (a) a prescribed officer; or (b) a person who is a member of a committee of a board of a company, or of the audit committee of a company, irrespective of whether or not the person is also a member of the company's board.'
[380] Section 76 (3) of the Act.
[381] Cassim et al supra op cit note 32 at 747. See also section 76(3)(c) of the Act.
[382] For example, section 218(2) of the Act states that any person who has contravened any provision of the Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention. Also, section 20(6) of the Act provides that '(6) Each shareholder of a company has a claim for damages against any

and senior managers' liability falls outside the focus of this research which is liability for breach of standards of care, skill and diligence.

3.5.1 The Basis for Liability for Breach of the Duty of Care, Skill and Diligence

Concerning directors' and senior managers' liability for breach of the statutory duty of care, skill and diligence[383], subsection 77(2)(b)(i) of the Act provides that such a director or senior manager may be held liable in accordance with the principles of the common law relating to the law of delict for any loss, damages or costs sustained by the company occasioned by any the breach by the director or senior manager of the duty of care, skill and diligence as contemplated in subsection 76(3)(c) of the Act. In this respect, the Act conforms to the common law position where liability is based on delictual principles.

In instances where a director or senior manager breaches their statutory duty of care, skill, and diligence the proper plaintiff to bring an action against the directors or senior managers concerned for purposes of subsection 77(2)(a) and (b)(i) the proper plaintiff is the company itself since the duties mentioned therein are owed to the company and not the individual shareholders or any other stakeholders. However, shareholders are not non-suited per se and have some means to ensure redress is made for harm done to the company in instances where directors and senior managers in control of the company have no appetite and fail or, refuse to take steps to bring an action against an errant director or senior manager, as the case may be. In such circumstances, shareholders have an extended class of people including, amongst others, directors, senior managers and trade unions may bring a derivative action in terms of section 165 of the Act against a director or senior manager for an alleged breach of the duty of care.[384]

person who intentionally or fraudulently or due to gross negligence causes the company to do anything inconsistent with – (a) this Act; or (b) a limitation, restriction or qualification contemplated in this section, unless that act has been ratified by the shareholders in terms of subsection (2).

[383] Section 76(3)(c) of the Act.

[384] The extension of the derivative action to other classes of people other than shareholders is a commendable feature of the Act. It helps to ensure that directors are held accountable as set out in the Actionable Enlightened Shareholder Value Theory and The Entity Maximisation and Sustainability Model.

3.5.2 Has the Common Law Duty of Care, Skill and Diligence Been Subsumed by the Act?

At common law, a director's liability for breach of the duty of care, skill and diligence is based on delict. The cause of action for the breach of the duty of care is the *Actio Legis Aquilae*. The remedy for breach of the duty of care is delictual damages recovered by the company for the wrongful and culpable (intentional or negligent) causing of patrimonial loss. To be successful, the following elements must be proved: conduct, wrongfulness, fault, damages and causation.[385] In *Du Plessis NO v Phelps*[386] the court stated that:

> 'Liability in the event of a director failing to take reasonable care in the management of the company's affairs is based upon the principles of the lex Aquilia. The basic requisite for liability under the lex Aquilia is the fault (dolus or culpa), which results in loss to the claimant. Liability for a breach by a director of his fiduciary duties, on the other hand, does not necessarily involve dolus or culpa. Nor does such breach necessarily involve a right of recourse by the company against its director - the breach may simply render the transaction voidable at the instance of the company.'

The board and directors are individually required to give effect to the company's internal policies and where there is a contract between a director and the company, liability is based on breach of contract.[387]

Section 77(2)(b) of the Act preserves the traditional common law principles in that delictual liability is imposed on directors and senior managers for a breach of the duty of care and skill.[388] Section 77(2)(b) of the Act has not subsumed the common law and the general elements of the law of delict will have to be satisfied before a director or senior manager can incur liability for a breach of the duty of care and skill.

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[385] J Neethling, JM Potgieter & PJ Visser *Law of Delict* 6 ed (2010) at 4.
[386] 1995 (4) SA 165 (C) 170B-C.
[387] HS Cilliers, ML Benade, JJ Henning, JJ du Plessis, PA Delport, L de Koker & JT Pretorius *Corporate Law* 3rd ed (2000) at 148.
[388] Cassim et al supra note 27 at 786.

3.5.3 The Company as the Proper Plaintiff

The position recognised under common law is that a director owes a duty to exercise reasonable care, skill and diligence to the company and the company alone.[389] The implication is that as a general rule, when wrongs are done to a company, that company alone has the right to sue in its name.[390] However, in certain circumstances and terms of section 165 of the Act through the derivative action remedy shareholders and other stakeholders are entitled to sue for the wrongful acts done to the company on behalf of the company. The derivative action remedy is a notable exception to the rule that the company itself is the 'proper plaintiff' in circumstances where wrong is done against the company. This was confirmed in the *Hlumisa Investment Holdings (RF) Ltd v Kirkinis*[391] case whether the shareholders brought a claim for damages against the directors of the company for their reflective loss. The Supreme Court of Appeal held that the duties owed by the directors in terms of section 76(3) of the Act which includes the duty of care and skill are owed to the company and not individual shareholders. Further, in circumstances of a wrong done to the company in terms of that subsection's provisions, the company is the proper plaintiff to sue for damages. Section 77(2)(a)(b) of the Act provides that a director of a company may be held liable for breaches of the duty of care and skill resulting in any loss or damage sustained by the company. Further, the liability of breaching section 76(3) must be brought in terms of section 77(2) of the Act. The maxim that the general provisions do not derogate from special provisions was confirmed and it was held that the reliance on section 218(2) Act to bring the action against the directors would be a departure from a core principle of company law.

It is trite law that directors and senior managers owe the duty to exercise reasonable due care, skill and diligence to the company and not any stakeholder including shareholders. It is also clear that to sustain a cause of action based on a breach of the duty of care the claim has to be brought in terms of section 77(2)(b) of the Act and not section 218(2).

[389] *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530.
[390] Ibid at 550.
[391] (1423/2018) [2020] ZASCA 83; [2020].

3.6 Other Statutory Basis of Liability for Breach of Standards of Care under the Act

Subsection 77(3)(a) to (e) of the Act provides a list of instances in which a company may recover losses, damages or costs arising from a director's or a senior manager's failure to meet the required standard of conduct when exercising his or her powers and performing functions set out in the Act. This is in addition to the common law basis of liability for breaching the director's duties in subsection 77(2) of the Act. The statutory basis of the director's or senior managers' liability for breach of statutory duties is in line with the enforcement framework of the Act.

The basis of a director's or senior manager's liability to the company is for injury suffered by the company to its interests, as a direct or indirect consequence of violations listed in subsection 77(3)(a) to (e) which is also a breach of the duty of care, skill and diligence. Therefore, A director of a company will, in addition, be held liable where that director: (a) purports to bind the company or authorise the taking of any action by or on behalf of the company without the requisite authority[392]; (b) is party to the carrying on of the company's business recklessly[393]; (c) knowingly or recklessly signs or consents to the publication of a financial statement which is false or misleading[394]; or (d) acts in the name of the company in a way that is false or misleading.[395]

The import of the liability of the listed instances in section 77(3)(a) to (e) is that a director or a senior manager may be held personally liable by the company for any consequential loss suffered by the company.

3.6.1. Judicial Relief from Liability at the Court's Discretion

Section 77 of the Act has created two exceptions that make it possible for a court to absolve directors and senior managers from liability in instances where the result of imposing legal sanctions and liability on a director or senior manager would be unduly harsh and contrary to

392 Section 77(3)(a) of the Act.
393 Section 77(3)(b) of the Act.
394 Section 77(3)(c) of the Act.
395 Section 77(3)(d) of the Act.

the interests of fairness.[396] Subsections 77(5)[397] and 77(9) of the Act confer on the courts judicial discretion and power to grant judicial relief in certain instances. First, in subsection 77(5)(a), which is a new provision by which a director or senior manager that has been held liable or anticipates that they may be held liable for a decision taken by the board that contravenes a provision of the Act is able to bring an application for an order setting the decision or transaction aside.[398] The court may, in addition to setting aside or rescinding the decision, also make a further order that compels the company to indemnify a director or senior manager that has been held liable for his part in any decision made by the board and in terms of section 77. The company may also be required to provide indemnification to the director and senior manager for costs and expenses incurred in bringing an application to set aside the offending decision that contravenes a provision of the Act in terms of subsection 77(5)(a). While subsection 77(5)(a) specifically makes mention of the instances of liability for a director or senior manager for decisions contemplated under section 77(3)(e) of the Act is understood that this includes any decision that contravenes the Act such as a decision by the board in contravention of section 45 where the board adopted a resolution provide financial assistance to a director or senior manager inconsistent with the latter section.[399] The director or senior manager may escape the liability imposed on him or her for participating in the making of the decision if they can convince the court that the decision contravenes the Act, section 45 for purposes of the example, that it should be set aside and request the court to exercise its discretion to relieve them of their liability in terms of subsection 77 and order the company to indemnify him or her for liability of the loss, damages or costs suffered by the company by the decision or transaction concerned, including for costs and expenses incurred by the director and senior manager in bringing an application to set aside the decision in terms of subsection 77(5)(a). Once an application has been made to it under subsection 77(5)(a) by any director or

[396] Bradstreet R ‘Implications of the Re-enacted Discretionary Power to Grant Judicial Relief to Directors in Section 77(9) of the Companies Act 2008’ (2015) 1 *SA Merc LJ* 145 – 153 at 148. See also Cassim et al supra op cit note 32 at 373.

[397] See, for example, a section 45 decision that is contrary to the requirements for financial assistance for directors and senior managers. Section 45 provides a concrete example that involves a decision made by the board that contravenes a provision of the Act, as contemplated in subsection 77(5) of the Act that a director may approach the court to set aside and then also plead for relief and indemnification. This reveals the dual purpose of section 77(5)(a) and (b). It is submitted that the viability of this exception will depend on the court's discretion. This brings into question what will inform the court's discretion and how the court will exercise that discretion. See also Cassim et al, supra op cit note 32 at 374.

[398] Cassim et al, supra op cit note 32 at 374.

[399] Subsection 77(5)(a) of the Act read together with section 45 of the Act which deals with loans or other financial assistance to directors. Section 45 defines ‘financial assistance’ and lists requirements and conditions that must be satisfied for the company or the board of directors to approve the provision of loans or financial assistance to directors and senior managers.

senior manager, the court essentially has two value judgments to make. The first enquiry is whether a case has been made for an order setting aside the decision or transaction either in whole or in part, absolutely or conditionally and any further order that is just and equitable in the circumstances, which may include making an order that (1) rectification of the offending decision, reversal of any transaction, or restoration of any consideration paid or benefit received by any person by virtue boards unlawful decision; and the next enquiry (ii) if there are circumstances or room available make an order that requires that the company ought to indemnify any director or senior manager who has been or may be held liable in terms of section 77 for their participation in the offending decision, this may also include indemnification by the company for costs and expenses that they incurred in bringing an application under subsection 77(5)(a).[400]

The rational for a further order by the court that compels a company to indemnify a director or senior manager for losses, damages and costs sustained by the company under subsection 77(5)(b)(ii) (bb) is difficult to comprehend, in instances where it has already been established that the decision or transaction has been taken in a manner that contravened provisions of the Act.[401] Subsection 77(5)(b)(ii) (bb) does not give clear guidelines as to what circumstances would constitute an appropriate situation that a court could exercise its judicious discretion to effectively grant relief to a director or senior manager that was part of the making of a decision that contravened the Act and for which he is liable for or stands to be held liable for. The logic may be understood if the decision has not been implemented or perhaps in instances where the loss, damage or costs sustained by the company were so negligible that it is incapable of being recovered. It is submitted that the lack of guidelines in subsection 77(5) makes it difficult to understand under which circumstances the court will exercise its discretion to relieve a director or senior manager under this subsection. Therefore, it leaves directors and senior managers with a less than satisfactory situation regarding their protection against personal financial liability since first there is no way of knowing if the court will exercise its discretion, and second how the court will use its discretionary power to grant relief to a director or senior manager in circumstances that it deems to be just and equitable. It is inconceivable that the court could excuse a director or senior manager who had actual knowledge that the decision or transaction was unlawful. It is unlikely that a courts would relieve a director or senior manager from liability and order indemnification under subsection 77(5)(b) where there

[400] Subsection 77(5)(b)(ii) & (bb) of the Act paraphrased.
[401] Cassim et al, supra op cit note 32 at 458 - 459.

is actual knowledge on the part of a director or senior manager that a decision or transaction contravenes provisions of the Act.[402] It appears, that the court may consider exercising its discretion to grant judicial relief to a director or senior manager if the director or senior manager did not 'participate' in the decision by not voting in the meeting of the board that approved the offending resolution or if they merely had 'deemed knowledge' of the unlawfulness of a decision or transaction by virtue of the extended definition of 'knowing' under section 1 of the Act.[403]

Therefore, it raises the difficult question of why a director or senior manager should be relieved from liability and the company ordered to provide indemnity when he or she knew or ought to have known of the inconsistency of the decision or transaction with the provisions of the Act and yet failed to vote against the board's resolution.[404] A director or senior manager liability in terms of section 77 is premised on 'knowing' and it is unclear how a court could make an order granting relief and indemnity to a director or senior manager when the conduct concerned could constitute a lack of honesty or reasonableness on the part of the director or senior manager concerned, and at worse it may be perceived as willful misconduct or willful breach of trust with regards to what the standard set in subsection 76(3)(c) of the Act expects of a director or senior manager when their decision making duties are involved under the duty of care, skill and diligence, that is to say their failure to vote, through passivity or inaction, against a decision of the board that they know or ought to have the requisite knowledge that it contravenes the Act may constitutes a dereliction of the duty of care.[405]

Second, in subsection 77(9), the Act has also re-enacted the court's discretionary power to grant judicial relief to a director or senior manager from liability that was previously contained in section 248 of the 1973 Act.[406] Subsection 77(9) empowers the court, in any proceedings against a director, other than for willful misconduct or willful breach of trust, to relieve the director, either wholly or partly, from any liability set out in section 77, on any terms the court considers just if it appears to the court that-

[402] Intentional and/or dishonest acts cannot be considered to be reasonable - Cassim et al, supra op cit note 32 at 459.
[403] Cassim et al, supra op cit note 32 at 460.
[404] Cassim et al supra note 32 at 372. See also Bradstreet R supra op cit note 399 at 148 where he states that '[T]he new version of the exemption provision, contained in s 77(9) of the 2008 Act, narrows the scope of its application by excluding proceedings for wilful misconduct or breach of trust…The court will thus not be empowered to come to the rescue of a director who has wilfully breached some duties owed by virtue of that office,'
[405] Cassim et al, supra op cit note 32 at 459.
[406] Mongalo T supra op cit note 10 at 153 – 154.

(a) the director is or may be liable, but has acted honestly and reasonably; or

(b) having regard to all the circumstances of the case, including those connected with the appointment of the director, it would be fair to excuse the director.

The scope of subsection 77(9) concerns itself with the judicial discretion that the court may exercise to grant relief to a director or senior manager from any liability set out in section 77, which includes liability for any loss, damages or costs sustained by the company occasioned by a breach of the duty of care, skill and diligence in accordance with subsection 77(2)(b)(i), to a director and senior manager that has acted honestly and reasonably. The courts' discretion to grant relief does not extend to include conduct by a director or senior manager that constitutes willful misconduct or willful breach of trust. The implications of the re-enacted To the extent that subsection 77(9), does makes it possible for directors to be relieved from liability arising from their negligence, it is similar to its predecessor, section 248(1) of the old Companies Act of 1973. It stands to be seen whether section 77(9) is much wider in its scope, thus giving directors a much wider berth to escape liability than was previously the case under the old section 248(1) of the 1973 Act. The latter section provided for exemption from liability in any proceedings against directors for negligence, default, breach of duty or breach of trust. By contrast, section 77(9) appears to cover even proceedings for gross negligence.

Further, before a court could grant relief from liability in terms of section 248(1) of the 1973 Act the court had to be satisfied that the director had acted honestly and reasonably and that, having regard to all the circumstances of the case, including those connected to his appointment, he ought to be fairly excused from liability. On the other hand, the Act requires the court to be satisfied that the director acted honestly and reasonably or having regard to all the circumstances of the case, including those connected with the appointment of the director, it would be fair to excuse the director. The fact that the grounds for relief are couched in the alternative in the new Act appears to imply that a director can be granted relief even where the director acted unreasonably.[407] It is submitted that this appears to give directors an escape from liability, and it does not resonate well with principles of good corporate governance that willful conduct or a gross deviation from acceptable standards should not be condoned.

Another provision related to section 77(9) is section 77(10) of the Act which provides that a director who has reason to apprehend that a claim may be made alleging that the director is

[407] Cassim et al supra note 32 at 779.

liable, other than for willful misconduct or willful breach of trust, may apply to a court for relief, and the court may grant relief to the director on the same grounds as if the matter had come before the court in terms of subsection (9). Section 77(10) also provides directors with an escape route from liability, and the concerns discussed above concerning s 77(9) apply equally to s 77(10).

Mongalo's concern is that this approach leaves the protection of directors at the discretion of the courts, and thus not secured or clear under which circumstances such discretion would be exercised, especially if no proceedings are instituted against the director.[408] He suggests that the solution possibly lies in allowing companies to address such '…matters that can easily be addressed by the corporate constitution be made the subject for a lengthy litigation process, which will in the process deplete the director's resources and, consequently, tarnish his or her reputation.'[409] This argument would also apply equally to senior managers.[410]

3.7 Conclusions

In this Chapter, it was demonstrated that the definition of director has been extended to include senior managers or company officers that have material influence and involvement in the control and management of the business and activities of the company. The extended definition applies to the relevant person irrespective of the title given to him or her by the company or if they are part of the board of the company.[411] It is argued that the current enforcement framework seeks to extend the application of the Act to a wider number of people in effective control of the company.[412] However, the desire to increase the net may have unintended consequences, such as imposing liability on persons with no real power.[413]

The business judgment rule was introduced and its purpose was explained.[414] The business judgment rule was imported from the United States and it grafted into the current enforcement by being supplanted into section 76(4) of the Act. The interplay between the

[408] Mongalo T supra op cit note 10 at 154.

[409] Ibid at 154.
[410] See sections 1 and 66(10) read with Reg 38 of the Act.
[411] See section 1 of the Act.
[412] Sections 1 and 66(10) read with Reg 38 of the Act.

[413] See para 3.2.5 and 3.2.6.
[414] See para 3.2.7

business judgment rule and directors' and senior managers' duty of care, skill and diligence was considered.[415] The duty of care, skill and diligence was traced from its previous lenient standard to the subjective/objective stricter version under the current enforcement framework. It was also suggested the current formulation is confusing because it objectifies the separate aspect of the duty of 'skill.'[416]

It is clear that both in the United Kingdom and South Africa, the duty of care and skill developed as a highly lenient standard expected of company directors.[417] Directors were only liable for gross negligence or crassa negligentia.[418] The standards demanded of directors (and senior managers) have incrementally changed over the years, becoming stricter, and now subject directors and senior managers to higher standards of care than previously applicable to them. It was also noted that there was an effort to partially codify the standard of care in both jurisdictions in their respective company legislation. The extended definition of director in South Africa is a unique feature that has brought into focus the conduct of senior managers who have the same onerous duties imposed on them as directors of the company.[419]

Directors' and senior managers' exposure to personal financial liability has dramatically increased over recent years due to recent local and global corporate failures, according to various sources on the subject.[420]

The protection available to directors and senior managers has, on the other hand, not grown commensurately with the heightened potential liability, especially for honest errors of judgment.[421] The importation of the business judgment rule will not provide a 'safe harbour' to directors and senior managers for good faith errors in the discharge, as expected given certain inherent flaws contained therein and the interpretational approach that has emerged in preeminent jurisdictions such as the State of Delaware.[422] The court's judicial discretion to relieve a director or senior manager from liability is likely to have interpretational difficulties

[415] See para 3.2.7.
[416] See para 3.3.
[417] See para 3.3.1.
[418] See para 3.3.1.
[419] See para 3.4.
[420] This point links back to the observation of Bekink M supra op cit note 3 at 91 and the Policy Paper supra op cit note 15 at 9.
[421] See para 3.4.3 on the discussion of the standard of the duty of care, skill and diligence expected of directors under section 76(3)(c).
[422] See also Chapter 5 for an exposition of some judgements that are expected to influence South African courts' interpretation of subsection 76(4) of the Act.

because of the way subsections 77(5) and 77(9) of the Act is constructed. In addition, there is no guarantee that the discretion will exercise its discretion one way or the other.[423]

CHAPTER 4

THE NATURE AND EVOLUTION OF THE PROHIBITION AGAINST EXEMPTING DIRECTORS AND SENIOR MANAGERS FROM LIABILITY: THE CURRENT POSITION

4.1 INTRODUCTION

4.2 HISTORICAL DEVELOPMENTS OF THE PROHIBITION AGAINST EXEMPTING DIRECTORS AND OFFICERS

4.3 THE PROHIBITION AS CONTAINED IN SECTION 70, SEXT OF THE COMPANIES ACT 1926 AND SECTION 247 OF THE 1973 ACT

[423] See para 3.6.1 regarding the lack of legal certainty regarding the courts' discretionary power to grant a director or senior manager relief under subsection 77(9) of the Act.

4.4 THE CONTINUED PROHIBITION: APPROACHES FOLLOWED IN THE KING REPORTS, THE POLICY PAPER, THE COMPANIES BILL OF SOUTH AFRICA AND SECTION 78(2) OF THE ACT

4.5 CONCLUSIONS

4.1 Introduction

In this Chapter, specific attention will be given to the historical development of the continued prohibition against exempting directors and senior managers from liability in South Africa.[424] This research is aimed at assessing whether the current legal enforcement framework regulating directors and senior managers that has as one of its objectives protecting shareholders against mismanagement through the threat of personal liability on the one hand, and the need to encourage directors and senior managers to take good faith when exercising their business judgment on the other hand, is appropriately balanced.[425] A relevant question is whether a general prohibition against exempting directors and senior managers leaves them with adequate protection in the face of increased liability.[426] Will the threat of personal financial liability dissuade directors and senior managers from engaging in necessary risk-taking and does indemnification and liability insurance provide more appropriate and adequate protection for directors and senior managers under the current framework?[427]

Before section 78(2) of the Act came into operation policy makers had an opportunity to review the prohibition.[428] The American Bar Association ('the ABA') raised a serious concern over the prohibition under the then section 247(1) of the 1973 Act which rendered void any provision contained in the articles or a contract that purported to exempt a director or

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[424] Mongalo T supra op cit note 10 at 141, wherein it is stated that a 'serious concern regarding the prohibition (under the then s 247(1) of the Companies Act, 1973 (Act. No. 61 of 1973) of any provision contained in the articles or contract that purported to exempt any director or officer from liability for negligence, default, breach of duty or breach of trust. The concern was overlooked by policy makers in revamping South Africa's corporate laws as the subsequent Companies Act, 2008 (Act 71 of 2008) carries a similar provision in section 78(2).'
[425] See Chapter 2 para 2.3 and 2.5.
[426] See para 1.3.
[427] Lombard S supra op cit note 252 at 260.
[428] The South African policy makers disregarded the recommendation of the members of the American Bar Association to amend section 247 of the 1973 Act which prohibited the inclusion of any provisions contained in the company's articles of association or contract that purported to exempt any director or officer from liability for negligence, default, breach of duty or breach of trust. The recommendation was contained in the American Bar Association Section of Business Law, Committee on Corporate Laws, Committee on Corporate Laws Report on South African Companies Act NO. 61 of 1973 and Related Legislation, 2001.

officer from liability for negligence, default, breach of duty or trust.[429] At the time, the concern and recommendation to remove the prohibition was overlooked by policy makers, and section 78(2) of the Act was enacted, and it retained the prohibition. The continued prohibition raises serious concerns about whether the current legal enforcement framework places South African directors and senior managers at a competitive disadvantage in comparison to their counterparts in jurisdictions that permit exemption clauses through exculpatory statutes.[430]

The focus of this Chapter is to question whether reform of the prohibition against exemption is warranted in South Africa. It may appear that, at the present moment, because there have been few actions brought against directors and senior managers for breach of duty of care, and thus that the protection under the current framework is satisfactory. However, this situation can change rapidly, as was the case with the *Smith v Van Gorkom*[431] case, especially with directors' and senior managers' duty of care under increased scrutiny.[432]

The conclusions expressed in this Chapter are that the continued prohibition should be revisited under the current legal enforcement framework.[433] Some recommendations are submitted on how to reform section 78(2) of the Act. This Chapter also deals with the history of the prohibition or traces its development to place the discussion in its proper context. It discusses the current position of the general prohibition against exempting directors and senior managers for breach of the duty of care in terms of section 78(2) of the Act under South African law. A comparative analysis of the position in the United Kingdom and the United States of America in Chapter 5 follows this.[434] Attention is given to the historical background that led to the introduction of the general prohibition against the exemption of directors and officers in South Africa and the then relevant policy considerations to determine whether the continued prohibition is still appropriate in light of the enhanced liability introduced in the current enforcement framework relating to directors and senior managers in South Africa.

[429] ABA Report supra op cit note 12 at 21.
[430] Mongalo T supra op cit note 10 at 141.
[431] 488 A2d 858 (1985).
[432] This thesis argues that the full complement of protective measures available to directors and senior managers under the current legal enforcement framework does not adequately insulate directors and senior managers from personal liability for money damages for mere errors of negligence, or honest errors of judgment. See Mongalo supra op cit note 10 at 155; Horney J supra op cit note 13 at 61 – 66.
[433] See Chapter 7 para 7.3.1 for proposed amendments to subsection 78(2) of the Act.
[434] The historical development of the prohibition and the current position in South Africa is first considered and thereafter compared with the jurisdictions of the UK and the State of Delaware with the view to assessing whether the South African approach represents the best model and if there are lesson abroad that may be relevant for the current enforcement framework.

The indemnification and protection of a company of its directors and officers has always been a controversial issue in South Africa, which can be attributed to the poor wording and interpretation of the relevant provisions.[435] The continued prohibition against the exemption of directors and senior managers represents a missed opportunity by policy makers to ensure that the protection in the current legal enforcement framework is in line with the best model, such as the Delaware position.[436] The legislature in Delaware in the face of shrinking director's and officer's insurance sparked a widespread discussion of the need to attract and retain qualified directors and officers that led to important developments and amendments to statutes regulating directors and officers that permitted Delaware companies to limit or eliminate the liability of their directors and officers for duty of care breaches.[437] These statutory amendments allowing for the exculpation of directors and officers are of note to South Africa, as the state of Delaware is regarded as a frontrunner in corporate developments.[438]

Section 78(2) of the Act contains provisions relating to exemption and protection from liabilities of directors and senior managers incurred in the discharge of their duties. Section 78(2) of the Act largely restates and preserves the previous position, which contained a blanket or general prohibition against exemptions and indemnification of directors and officers save for indemnification in certain limited instances for liability that would otherwise attach to a director or officer in connection with any negligence, default breach of trust or duty of care. The South African policy makers have again elected not to consider allowing exemption clauses even for the protection of directors and senior managers for negligence and the breach of the duty of care.

This Chapter deals with the general prohibition on exemptions. The indemnification and protection of directors and senior officers through liability insurance, which is made possible by subsections 78(4) and (5) of the Act, is dealt with in Chapter 6. A key question of this research is whether the protection provided by indemnification and insurance is adequate in the absence of exemption clauses.

[435] Lucian Carmiciumaru supra op cit note 16 at 169.
[436] Mongalo supra op cit note 10 at 141.
[437] Howell L 'Post Smith v. Van Gorkom Director Liability Legislation with a Proactive Perspective' (1988) 36 *CSU Ohio* 559 – 574 at 559 - 560.
[438] Mongalo supra op cit note 10 at 141. Certain foreign jurisdictions in the US, especially the State of Delaware, may have relevance to the provisions of s 78(2) of the Act. The proposed amendments in para 7.3.1 to subsection 78(2) of the Act are supported by both reasoned argument and original research on experience in certain foreign jurisdictions, particularly the state of Delaware in the US.

4.2 Historical Developments of the Prohibition against Exempting Directors and Officers

4.2.1. Developments in English Law

The prohibition against the exemption of directors and officers is based mainly on English Law developments, and South Africa is still following the English law approach. In 1925, in the UK the decision *In Re City Equitable Fire Insurance Co Ltd*[439] brought into sharp focus the practice adopted by companies to include in articles of association provisions exempting directors from liability for loss arising, except in cases where the loss was due to 'their wilful neglect', or in any other case provided that they did not act dishonestly.[440] The decision was criticised by the Greene Committee in 1925.[441] The committee confirmed that the decision had brought the public's attention to the common article that exempts directors from liability except when it's due to their 'wilful neglect or default'. It was also noted that another form of the article had become common that extended the exemption of directors, except in cases of actual dishonesty, which featured in the case of *In Re Brazilian Rubber Estates.*[442]

The Greene Commission was disturbed by the *Re City Equitable Fire Insurance Co.*[443] which recognised the validity of exemption provisions. The commission recommended the prohibition of 'articles and contracts relieving directors and other officers from their liability under the general law of negligence and of breach of duty or breach of trust.' It was the commission's considered view that 'this type of article gives an unjustified protection to directors'. It pointed out that under such an article, 'a director may with impunity be guilty of the grossest negligence provided that he does not consciously do anything that he recognises to be improper'.[444]

The Committee stated that:

> 'We are satisfied that such an enactment would not cause any hardship to a conscientious director or make his position more onerous and, that there is no foundation whatever for the suggestion that it would discourage many otherwise

[439] [1925] Ch 407.
[440] Blackman et al Commentary on the Companies Act (2012 Juta) at 351.
[441] Greene Report supra op cit note 46 at 37.
[442] 1911, 1 Ch 425.
[443] [1925] Ch 407.
[444] Greene Report supra op cit note 46 at 38.

desirable persons from accepting office. A director who accepts office does not consciously do so upon the footing that he may be as negligent as he pleases without incurring liability. It is only when he has been negligent and the company have suffered a loss, that he is content to take shelter behind the article. It is, moreover, in our opinion fallacious to say that the shareholders must be taken to have agreed that their directors should be placed in this remarkable position. The articles are drafted on the instructions of those concerned in the formation of the company, and it is a matter of great difficulty and delicacy for shareholders to attempt to alter such an article as that under consideration.'[445]

Following the recommendation by the Greene Committee, a provision prohibiting the exemption of directors was introduced in section 152 of the English 1929 Companies Act. It was also contained in section 205 of the English Companies Act 1948. The corresponding provision in the English 1985 Act was section 310(1). Section 310 provided for a general prohibition on provisions exempting directors and auditors from liability attaching in respect of negligence in respect of any negligence, default, breach of duty, or breach of trust to the company. In the 2006 Act, the provisions in section 310 relating to the exemption of directors have been replaced by section 232, which preserves the former prohibition relating to exemption.

4.2.2 The Lansdown Commission

In South Africa, following the Lansdown Commission[446], in 1939 the prohibition against exempting directors was introduced into the South African Companies Act. The commission noted that the articles of companies sometimes purported to relieve directors 'of liability for negligence or other default committed in the performance of anything done by them on behalf of the company'.[447] The commission recommended the adoption of the provisions contained in s 152 of the English 1929 Companies Act. However, it added that ‘there should be a power in the court to grant relief in suitable cases'.[448]

[445] Greene Report supra op cit note 46 at 45.
[446] Lansdown Report of the Company Law Commission 1935 – 1936 UG No 45 1936 par 135.
[447] Ibid at 135.
[448] Ibid at 135.

In 1939 the provisions were inserted as section 70sext in the Companies Act 46 of 1926, which provisions were contained in section 247(1) of the 1973 Act. However, the exact wording of the English section contained in section 152 of the English 1929 Companies Act was not adopted. There were notable differences, in that while the English section 310(1) referred to 'any provision, whether contained in the articles of the company or any contract with the company or otherwise', section 247(1) of the 1973 Act omitted the words 'or otherwise'. Further, while the English subsection referred to any provision 'for exempting' such persons from liability, section 247(1) of the 1973 Act referred to any provision 'which purports to exempt' them from liability.

A proviso was added to section 247 of the 1973 Act in 1998 by section 12 of Act 35 of 1998. The proviso makes an extensive inroad on the prohibition. It in effect, enabled the directors of companies to purchase at the expense of their shareholders' liability insurance to compensate the company for losses caused to it as a consequence of their wrongdoing, provided they can obtain the necessary insurance cover.[449]

4.2.3 The American Bar Association Report

Before the commencement of the Corporate Law Reform Project in South Africa in 2003, the ABA was invited by the South African Companies Registration Office and the Department of Trade and Industry with a view to, among other things, analysing possible amendments to the Companies Act, 61 of 1973 and the Close Corporations Act, 69 of 1984, for consideration in connection with a wide-ranging review of those statutes which was about to be commenced in South Africa.[450]

In 2001 Report the ABA made the following recommendation about the prohibition under section 247(1) of the 1973 Act:

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[449] Lucian Carmiciumaru supra op cit note 16 at 170, wherein he states that '…the view that s 247 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 do 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).'

[450] ABA Report supra op cit note 12 at 1. See also Mongalo T supra op cit note 10 at 141 - 143 discussing the report and the role of the ABA.

‘Consider adopting a statute permitting the memorandum or articles to include a provision exculpating the directors from liability for money damages in suits by the company – directly or indirectly – or by the shareholders, subject to exceptions for egregious misconduct, e.g., receipt of an improper personal benefit, active and deliberate dishonesty or commission of a crime.’[451]

In its recommendation for appropriate protection of directors and officers for South Africa, the Report referred to the fact that ‘In the mid-1980s, as a result of the severely constricted market for directors and officers liability insurance and a decision of the Supreme Court of Delaware in *Smith v. Van Gorkom*[452], holding directors of a corporation personally liable for money damages for failure to comply with their duty of care, many directors of U.S. corporations resigned or refused to stand for reelection.’[453]

In response, most of the U.S. states adopted statutes authorising the charter to include a provision exculpating directors, and in certain instances officers, from liability for monetary damages.[454] In their view, exculpation provisions worked well ‘to encourage well-qualified individuals to serve on boards and to provide valuable protection to directors in the exercise of their duties’.[455] They asserted that shareholders should be able to decide for themselves through the inclusion of a provision in the charter whether to forego a claim against directors for failure to perform their duties, provided the exculpation does not extend to include egregious misconduct.[456]

However, the recommendation in the report was not followed when subsection 78(2) Act was enacted. Subsection 78(2) of the Act largely preserved and restated the prohibition of any provision in the Memorandum of Incorporation or a contract that purports to exempt any director or senior manager from liability for negligence, default, breach of duty or breach of trust.[457] The decision to keep the prohibition against exemption clauses has been criticised for leaving directors and senior managers in South Africa at a greater risk of being unable to protect their assets against liability claims for monetary damages in the case of breach of care.[458]

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[451] ABA Report supra op cit note 12 at 22.
[452] 488 A.2d 858 (1985).
[453] ABA Report supra op cit note 12 at 20.
[454] ABA Report supra op cit note 12 at 20. See also Model Act section 2.02(b)(4) and Delaware General Corporation Law section 102(b)(7).
[455] ABA Report supra op cit note 12 at 21.
[456] ABA Report supra op cit note 12 at 21.
[457] Mongalo T supra op cit note 10 at 141. See also Cassim et al supra op cit note 32 at 773 to 774; Horney J supra op cit note 13 at 63.
[458] Mongalo T supra op cit note 10 at 141.

Mongalo argues that argues that as a result of the continued prohibition against exemption clauses, directors of South African companies are at a competitive disadvantage when compared with directors of companies that are formed or incorporated in jurisdictions that make provision for exemption clauses through exculpatory statutes.[459] He correctly notes that a director's liability for monetary damages for breach of the duty of care can be devastating for the director concerned to the extent that their assets may be exposed and used to satisfy an award to a claimant.[460]

4.3 The Prohibition as Contained in Section 70, Sext of the Companies Act 1926

4.3.1 Section 70, Sext of the 1926 Act

Section 70, sext of the 1926 Companies Act, was introduced by Act 23 of the 1939 Act and provided that:

> 'Any provision, whether contained in the articles of a company or any other contract with the company, and whether express or implied, which purports to exempt any director or officer or the auditor of the company from any liability which would otherwise attach to him in respect to any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company, or to indemnify him against any such liability, is void.'[461]

This section was introduced into South African corporate law to alter the existing law that permitted that articles could effectively exempt a director or officers from liability for a loss caused by a breach of duty unless the breach was dishonest or wilful.[462] The section corresponded with section 205 of the English Act which later became section 310 of the Companies Act 1985.

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[459] Mongalo T supra op cit note 10 at 141.
[460] Mongalo T supra op cit note 10 at 142. Horney J supra op cit note 13 at 50, who considers whether the current legal enforcement framework and director liability under the Act does not constitute a potentially dangerous trap due to the lack of adequate protective instruments conducive for 'entrepreneurship and risk taking', while holding directors accountable for 'over stepping' or 'extensive breaches' of their duties.
[461] Section 70, sext of the 1926 Act.
[462] Stevens R 'The Legal Nature of the Duty of Care and Skill: Contract or Delict' (2017) 20 *PER/PELJ* 1-29 at 7.

There was controversy regarding the extent of the prohibition and whether the provision prohibited the exemption from liability only or also it was intended that the prohibition invalidated provisions in the articles that reduced or abrogated any duty of a director or officer.[463] Henochsberg held the view that only those provisions in the articles purporting to exempt a director from or indemnify him against, liability that would exist in the absence of such a provision are prohibited in terms of section 247(1) of the 1973 Act.[464] This would mean that only provisions in the articles or any contract with the company would be invalidated if they purported to exempt or indemnify a director or officer from liability that would otherwise attach to him or her in law if such a provision did not exist. Therefore, according to him provisions in the articles that purported to reduce or abrogate any duty would not be affected by the prohibition. However, in *Movitex Ltd v Bulfield*[465] the court commented on the scope of the prohibition. It was pointed out that the solution that a provision may reduce or abrogate a duty so long it does not exempt the director from liability for breach of it 'leads to the absurd result that an article could, without infringing the section, modify a director's duty to use reasonable skill and care in the conduct of the company's affairs and so avoid a liability for damages for breach of duty which would otherwise arise, a conclusion which seems to me manifestly in conflict with the purpose of the section.'[466]

4.3.2 Section 247(1) of the 1973 Act

Section 247(1) of the 1973 Act stated that directors and officers may not be exempted from or indemnified against liability through private arrangements between themselves and the company, which would otherwise attach to them in respect of negligence, default, breach of duty or breach of trust. The relevant part of this provision reads as follows:

> ‘Any provision, whether contained in the articles of a company or any contract with a company, and whether expressed or implied, which purports to exempt any director or

[463] Spisto M ‘Exemption from Liability Under Section 247 of the Companies Act: to what Extent does ‘the Prohibition’ is this Section Apply in the South African Context? (1997) 30 *CILJ* 60 – 75 at 60.
[464] Henochsburg P supra op cit note 225 at 384.
[465] [1988] BCLC 104.
[466] See also Gregory R 'The Scope of the Companies Act 1948, Section 205' (1982) 98 *LQR* 394-401 at 400 who stated that a weakness in the construction which gives validity to an article prescribing a standard of care lower than the legal standard, is that the section lays it down that to test whether a provision is an exempting clause or not, one has to compare the director's position under that provision with his position under the general law, and not with his position under the general law as modified by that provision.

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 about the company or to indemnify him against any such liability, shall be void.'

The question regarding the precise scope of the provisions section 247(1) of the 1973 Act remained. According to Blackman, the difficulty arose from the lack of clarity of the words 'any liability'.[467] According to him, there was no doubt whether section 247(1) of the 1973 Act rendered void provisions that purported to relieve directors from liability for breach of duty. However, what remained uncertain was whether it also rendered void provisions that purported to release directors and officers from duties. Blackman suggested that this question was best answered regarding the provisions of the kind that were found in Table A of the English Act of 1948. The latter appeared to release directors from certain duties. The South African Act did not contain these provisions but similar provisions were contained in articles of our companies and they had never been questioned.[468]

A narrow interpretation of section 247(1) of the 1973 Act was that it was argued the section prohibited exemption from liability for a breach of duty, but that it did not prohibit release from duties.[469] It was argued that a director who has been released from duty cannot be guilty of a breach of duty. Blackman disagreed with this approach as he was of the view that the narrow construction would lead to undermining the section.[470] He also questioned which

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[467] Blackman M 'Exemption of Directors from Liability and Section 247(1) of the Companies Act, 1973' (1993) 56 *THRHR* 537 – 557 at 538.
[468] Ibid at 538. Article 78 provides that 'A director of the company may be or become a directors or other officer of, or otherwise interested in, any company promoted by the company or in which the company may be interested as a shareholder or otherwise and no such director shall be accountable to the company for any remuneration or other benefits received by him as a director or officer or from his interest in such other company unless the company otherwise directs.' Article 84(1) requires a director to declare his interests in company contracts at a meeting with the directors. Article 84(1) provided that 'A director who is in any way, whether directly or indirectly interested in a contract or proposed contract with the company shall declare the nature of the interest at a meeting of the directors in accordance with section 199 of this Act.' Also relevant was article 85 of Table A, which reads as follows: 'Subject to the provisions of the Act, and provided that he has disclosed to the directors the nature and extent of any material interest of his, a director notwithstanding his office- (a) may be a party to, or otherwise interested in, any transaction or arrangement with the company or in which the company is otherwise interested; (b) may be a director or other officer of, or employed by, or a party to any transaction or arrangement with, or otherwise interested in, any body corporate promoted by the company or in which the company is otherwise interested; and (c) shall not, by reason of his office, be accountable to the company for any benefit which he derives from any such office or employment or from any such transaction or arrangement or from any interest in any such body corporate and no such transaction or arrangement shall be liable to be avoided on the ground of any such interest or benefit.'
[469] Gore-Browne *On Companies* (44ed 1986) Jordan Publishing vol 5-part 5 para 27.21.
[470] Blackman M supra op cit note 470 at 540 – 541.

duties a director cannot be released from.[471] Some authors have suggested that directors cannot be released from the duty of good faith and the duty of care.[472]

On a proper construction of the section, it was argued that the section did not merely prohibit the release from liability for a breach of duty, but that it also prohibited the release from duty.[473] This was the so-called wide construction of section 247(1) of the 1973 Act. Blackman was of the view that if the narrow construction were to prevail, it would legitimise the very position that the Greene Committee sought to prohibit. He cites Gregory in support of his argument, who stated that a director 'is exempted from liability just as effectively by a provision which says that the rules do not apply to him, as by one which says the consequences of a breach of the rules do not apply to him.'[474] The import is that the effect of section 247(1) of the 1973 Act was to void all forms of exclusion of liability, thus not distinguishing exemptions from the scope of the duty and exemptions from the consequences of a breach of the duty.[475] Gregory went on to argue that there was nothing in Table A that permitted directors to hold office with the knowledge that they could act negligently, in default, in breach of duty or breach of trust.[476]

Blackman concludes that it is 'the consequences of an exemption rather than the type of exemption which is the dominant consideration under the section' and that 'the section renders void both an article that purports to exempt a director from liability arising from a breach of duty and an article that purports to release a director from a duty.[477] In both cases, the articles purport to relieve a director from 'liability…which would otherwise attach to him'.[478] Blackman, referring to Vinelott J's reasoning in *Motivex Ltd v Bulfield*[479] observes that the court 'accepted the wide construction of the section, and there can be little doubt that it is correct.'[480] He thus supported the recommendation made by the Greene Committee that the court be given the statutory power to grant relief from liability to remove 'any possible hardship', which he noted that a similar recommendation was made by the Lansdown Commission for the South African position.[481] He also agrees with the finding that an

[471] Blackman M supra op cit note 470 at 541.
[472] Davies P and Gower S supra note 99 at 601.
[473] Blackman M supra op cit note 470 at 541.
[474] Gregory R supra op cit note 469 at 414.
[475] Spisto M supra op cit note 466 at 61.
[476] Gregory R supra op cit note 469 at 414. See also Blackman M supra op cit note 470 at 541.
[477] Blackman M supra op cit note 470 at 543.
[478] Blackman M supra op cit note 470 at 542-543.
[479] [1988] BCLC 104 at 117 -118.
[480] Blackman M supra op cit note 470 at 543.
[481] Blackman M supra op cit note 470 at 543.

interpretation that a provision may reduce or abrogate a duty provided that it does not exempt the director from liability for breach of it 'leads to the absurd result that an article would, without infringing [the section], modify a director's duty to use reasonable skill and care in the conduct of the company's affairs and so avoid a liability for damages for breach of duty which would otherwise arise, a conclusion which seems to me manifestly in conflict with the purpose of the section.'[482]

Blackman also rejected the 'modification theory', which suggests that there is no exemption from liability where the duty is merely 'modified' without being relaxed or abrogated.[483] Similarly, the proposition that certain rules imposed 'disabilities' rather than duties on directors was found not to be supported and to constitute a misunderstanding of the rules.[484]

4.3.3. The Amendment of Section 247(1) of the 1973 Act

Section 247(1) of the 1973 Act, prohibiting a company from exempting and indemnifying directors against liability resulting from a breach of duties, was amended in 1998 to make an express provision for a company to take out insurance on behalf of its directors. The relevant part of section 247(1) reads:[485]

> 'Subject to the provisions of subsection (2), any provision, whether contained in the articles of a company or 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 which he may be guilty of concerning the company or indemnify him from against any such liability, shall be void: Provided that this subsection shall not apply 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.'

There was some uncertainty as to the effect of this amendment on the position of directors and officers. It was suggested that the purpose of amendments permitting the purchase

[482] Blackman M supra op cit note 470 at 544. See also *Motivex Ltd v Bulfield* [1988] BCLC 104 at 117 -118.
[483] Blackman M supra op cit note 470 at 544.

[485] See section 12 of the Companies Amendment Act 35 of 1998.

of insurance by the company on behalf of its directors and officers was to protect the company.[486] It was uncertain, however, whether directors are protected in terms of the amendment to section 247(1) of the 1973 Act.

It was argued by some that the introductory part of section 247(1) of the 1973 Act would become meaningless and directors' common-law duties would in effect become useless, should it be accepted that liability insurance policies also serve to protect directors.[487] It was suggested that the only purpose of the amendment to section 247(1) is to protect the company and not its directors.[488] It was also suggested that a director will not be able to escape liability through the application of normal principles of insurance law, with specific reference to the principle of subrogation, in terms of which the insurance company should be able to recover the compensation paid by the company from the director or officer concerned.[489]

However, this interpretation of the amendments cannot be accepted as correct, as directors and officers would stand to benefit very little, if at all, from insurance taken out by the company. The formulation of section 247(1) of the 1973 Act, however, was amended specifically to allow companies to purchase insurance to protect their directors and officers.[490]

The amendment did not lift the prohibition against exemption clauses and companies were still precluded from inserting in the articles of association or in any agreement a clause that exempted directors and officers from liability for breaches of the duty of care. The amendment merely clarified the position that a company may purchase directors' and officers' liability insurance for and on behalf of its directors and officers.[491]

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[486] Botha D & Jooste R 'A Critique of the Recommendations in the King Report Regarding a Director's Duty of Care and Skill' 1997 *SALJ* 65 – 67 at 65.

[487] Cilliers CH & Benade ML Corporate Law 3rd ed (2000) Butterworths, Durban, 2000 at para 10.56.

[488] Ibid at para 10.57. See also Botha D & Jooste R supra note 489 at 69 wherein they state the concerns regarding the effect of insurance on directors' duty of care and skill and the protection afforded in terms thereof and state that insurance will 'effectively remove such duty and such protection – the incentive to take care having been drastically diminished'.

[489] Ibid at para 10.57.

[490] Lucian Carmiciumaru supra op cit note 16 at 170.

[491] Lucian Carmiciumaru supra op cit note 16 at 170 - 171.

4.4 The Continued Prohibition: Approaches Followed in the King Reports, the Policy Paper, the Companies Bill Of South Africa and Section 78(2) of the Act

In Chapter 3, the duty of care and skill was discussed and how it relates to the business judgment rule. It was demonstrated that directors' and senior managers' potential for liability under the current legal enforcement framework has increased despite the introduction of the business judgment rule.[492] It was argued that even though the business judgement rule has been formally enacted into South African corporation law, its application and the protection it provides to directors and senior managers is limited.[493] This raises the concern whether directors and senior managers under the current enforcement scheme have adequate protection and an appropriate balance has been struck between holding directors and senior managers accountable and providing protection that ensures that companies can attract and retain talented individuals to serve in the role of director and senior managers without being overly cautious, in the absence of exculpatory clauses that exempt them from liability for breach of the duty of care.[494] In this Chapter, the approach by policy makers to retain the prohibition against exempting directors and senior managers is discussed as referred to in the King Reports, the Policy Paper, the Companies Bill and section 78(2) of the Act.

4.4.1 The King Reports

The roles of directors and senior managers were addressed in the King Reports and are important for this research.[495] The protection afforded to directors and senior managers was also dealt with in the Kings Report, in this regard is also relevant. In King I, directors were recognised as being responsible for the fundamental policy and the delegation to professional management of the day-to-day activities of the company.[496]

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[492] See para 3.2.7 and 3.4.4.
[493] See para 3.5.
[494] Mongalo T supra op cit note 10 at 141. See also Horney J supra op cit note 13 at 63.
[495] Botha M supra op cit note 323 at 704, on the role and duties of directors states that '[I]t must therefore be pointed out that for the most part involves the establishment of systems that enable directors to discharge their legal responsibilities.'
[496] See the King Report on Corporate Governance South Africa (1994), Chapter 1 at para 2.1 of the Introduction.

The King I Report noted the serious concern over corporate scandals that arose from fraud and asked the question whether South Africa 'has effective board accountability in our corporate governance systems?'.[497] The importance of entrepreneurship and enterprise were highlighted as important factors that drive business. Therefore, a corporate governance system that focuses on control to the extent that it stifles the enterprise merely adds unnecessarily to the plethora of existing laws and regulations concerning the conduct of directors. It was also stated that if the system of corporate governance is made too onerous, and too much emphasis is placed on controls it would result in stifling enterprise. Recommendations were made to the Standing Advisory Committee on Company Law to revisit the laws in South Africa's governance controls to ensure that they are structured in a manner that encourages enterprise with integrity.[498] Thus it was recommended that, among other things, a proper balance needs to be achieved between the freedom to manage and accountability.[499]

Chapter 4 of King I states that all directors, both executive and non-executive directors are subject to fiduciary duties and duties of care and skill.[500] Chapter 5 further maintains that directors should ensure that they have time to devote to carry out properly their duties and responsibilities to the company.[501] In addition, directors are expected to exercise the care and skill which can be reasonably expected of the person of their expertise.[502]

It is important to note that it was suggested that directors should not be held liable for a breach of the duty of care and skill if they have exercised a business judgment in good faith in a matter where the criteria has been satisfied that: (i) the decision is an informed one based on all the relevant facts of the case; (ii) the decision is rational; (iii) there is no self-interest.[503] It was recommended that an approach which included the business judgment rule by statute would encourage the competitiveness of South African companies to limit the duty of care and skill to encourage entrepreneurship and the acceptance of appointments as non-executives.[504]

King I suggests that, since the duties placed on directors of companies are onerous, section 247 of the 1973 Act, which negates the indemnification of directors, should be

497 Ibid para 4.
498 Ibid para 13.
499 Ibid para 14.
500 Ibid para 16.
501 Ibid para 5.
502 Ibid para 2.1.
503 Ibid para 2.10.
504 Ibid para 3.4.

revisited.[505] However, the recommendation to the South African Standing Committee only related to the amendment of section 247 of the 1973 Act insofar as it related to the indemnification of directors through directors' and officers' liability insurance.[506] A glaring omission that must be pointed out is that the King 1 report failure to consider the value of exemption clauses may have in insulating directors and senior managers from liability for breaches of the duty of care to encourage the competitiveness of South African companies and to encourage entrepreneurship and the acceptance to serve as director and senior managers by suitably qualified persons.[507] It is unclear why exemption clauses were not considered and why indemnity insurance was regarded as being sufficient to protect directors and senior managers in light of the increased and onerous duties that directors and senior managers are subject to, especially for breaches of the duty of care and skill.

King II noted that the recommendation that amendments to section 247 of the 1973 Act be made permitting companies to obtain liability insurance cover indemnifying its directors and officers was heeded and promulgated. However, King II stated that the question of directors' and officers' liability insurance must be revisited, as the amended section 247 of the 1973 Act was ambiguous and did not fully cover the original King Committee 1994 recommendation.[508] King II did not elaborate on the ambiguity contained in the amended section 247 of the 1973 Act. In addition, King II did not raise or consider exemption clauses as a further possible means to protect directors and senior managers from liability for breaches of the duty of care and skill. Nothing of substance is mentioned in the report regarding the exemption or indemnification of directors and senior managers. The crucial issues, relating to the protection and insulation of directors and senior managers from personal financial liability for breaches of the duty of care, and how to encourage entrepreneurship and the acceptance of appointments by directors did not receive any serious attention in the further reports of the King Report III and IV.[509] It would therefore appear that according to the King Reports the

[505] Ibid para 3.5 and 12.
[506] The report was silent on whether exemption clauses could be an appropriate protective instrument – only indemnification was considered.
[507] The first King Report was published in 1994, by which time notable developments in Delaware had occurred in the 1980s following the *Smith v Van Gorkom* 488 A.2d 858 (1985) decision.
[508] The King Report on Corporate Governance for South Africa (2002) in the Recommendation Requiring Statutory Amendments at para 13.
[509] Botha M supra op cit note 323 at 702, suggests that '[W]hen taking cognisance of King II it must be emphasised that the 19th century of the entrepreneur in that the foundations of what corporations currently look like were laid down. Management became the focus in the 20th century. The focus in the 21 st century is on governance of corporate entities not only in South Africa but worldwide.' It is submitted that a discussion on the protective measures available to directors and senior managers was also necessary, since a serious concern had been noted by the ABA in its report in the lead up to the anticipated Act.

protection available to directors and senior managers is sufficient under the current legal enforcement framework because of the adoption of the statutory business judgment rule, and in particular as greatly concerning the potential indemnification of directors and senior managers in terms of liability insurance as permitted in terms of section 78(4) and (5) of the Act. As stated before, the difficulties with the application and scope of the business judgment rule the protection afforded to directors and senior managers is limited and of concern to directors and senior managers that have complied with the criteria and requirements but are still susceptible to personal financial liability for damages for the breach of a duty of care where their business judgment ex post facto proves to be wrong.[510]

I agree with King I that there is a link between the measure of control imposed on directors and senior managers by the applicable corporate government system or as perpetuated by the legal enforcement framework applicable to companies and those in control of companies and the aim to encourage enterprise and the acceptance to serve in the role of director and senior manager by suitable individuals.[511] However, the exploration by the King Reports should have included the question of whether the exemption of directors and senior managers for liability for the breach of the duty of care and skill together with liability insurance for directors and officers could have potentially provided complementary protection that is sufficient to ensure the sustained the competitiveness of the South African model when compared with jurisdictions that in addition to indemnity insurance make provision for the inclusion of exculpatory clauses in statutes exempting directors and officers for breaches of the duty of care such as the United States of America and in particular the state Delaware which introduced statutory exculpatory provisions to insulate directors and officers from liability in the discharge of their duty of the care to the company. This model and its merits are discussed in the comparative Chapter 5 which follows hereafter.[512] Therefore, the approach contained in the King Reports overlooked a viable option to protect directors and senior managers from liability for breaches of the duty of care by only focusing on the protection to be provided through the business judgment rule and the limited focus on indemnity insurance as the main means of ensuring the appropriate balance between the need to manage freely and accountability advocated for by the King Reports.

[510] See para 3.4.4.
[511] Chapter 5 of the King Report (1994).
[512] See Chapter 5 at para 5.3.

4.4.2 The Policy Paper

The Policy Paper issued by the Department of Trade and Industry in May 2004, states that the need for reform in corporate law, in part, was necessitated by a series of spectacular corporate failures that focused the attention on the need for improved corporate governance.[513] The drafters were of the view that there was a great recognition that there is a need for higher corporate governance and ethics. The number of corporate failures in South Africa and other jurisdictions has revealed serious defects in the prevailing standards of corporate governance.[514]

It was stated in the Policy paper that the reform needed to contain clear rules regarding corporate governance and the duties and liabilities of directors. The review ought to examine the inclusion of an extensive statutory scheme covering the duties and liabilities of directors and their accountability for violations.[515] Thus an important part of the review was meant to ensure that directors are made as accountable to shareholders as possible.[516]

The Policy Paper deals with the issue of regulation of directors' conduct and accepts that the regulation of directors' conduct is complicated and a multi-faceted question. The director’s duties represent a limitation on the director's powers and play a fundamental role in ensuring good governance.[517] The drafters were aware of the ABA’s 2001 recommendations and reasoning for the inclusion of exemption clauses as a means of further protection for directors and officers from personal liability against monetary damages for breaches of the duty of care and skill. However, in rejecting this recommendation the drafters were convinced that South Africa’s culture was not litigious and that it was not necessary or desirous to exempt directors against such liability. The Policy Paper stated the following in this regard:

> ‘A common debate in all jurisdictions is whether it should be permissible to exculpate, indemnify or insure directors against liability. As South Africa does not have a litigious culture, it is not necessary or desirable to exculpate or indemnify directors against liability. However, to enable companies to attract and retain highly qualified directors in circumstances where the actions of directors are increasingly under scrutiny, it may

[513] The Policy Paper supra op cit note 15 at 7.
[514] The Policy Paper supra op cit note 15 at 13.
[515] The Policy Paper supra op cit note 15 at 17.
[516] The Policy Paper supra op cit note 15 at 17.
[517] The Policy Paper supra op cit note 15 at 37.

be necessary for a company to be able to indemnify a director against the expenses of successfully defending an action against him or her.'[518]

The drafters of the Policy Paper did not cite any support for the assertion that South Africa was a non-litigious society, especially against directors for the breach of the duty of care and skill going forward. In addition, the recommendation for the protection of directors was limited to indemnification for expenses incurred by a director for legal expenses. The Policy Paper did not contemplate the need for the protection of directors and senior managers for monetary damages for liability liabilities for the breach of the duty of care and skill. As submitted before, the situation could change quickly should a decision such as the *Smith v Van Gorkom*[519] occur in South Africa where the defence of the business judgment rule was negated and the directors of the company were held to be personally liable for damages to shareholders even though the directors had complied with the requirements of the business judgement.

Bekink correctly noted that the risk of litigation against directors and senior managers has increased owing to the increased focus on good corporate governance, the stringency of the Johannesburg Securities Exchange listing requirements, and the passing of the Act.[520] She also notes that the current financial climate requires directors and senior managers to respond to competitive and dynamic markets without the fear of being sued for taking calculated risks.[521] Therefore, the assertion that South Africa does not have a litigious society or that directors and senior managers are expected to be subject to very few actions cannot be sustained. There is now greater public scrutiny of the conduct of directors and senior managers and the increased risk of litigation that they are exposed to is, amongst other things, related to the global economic downturn.[522]

The Policy Paper is somewhat contradictory. This is based upon the fact that the Policy Paper initially states that the current law was deficient in that it does not provide effective means for the enforcement of the duties of directors.[523] However, in addition to this, it is stated that because South Africa as a society is not litigious, it is not necessary to exculpate directors against liability.[524] This brings into question the credibility of the Policy Paper's approach to the protection of directors and senior managers as it seems to indicate that, on the one hand,

[518] The Policy Paper supra op cit 15 note 38.
[519] 488 A2d 858 (1985).
[520] Bekink M supra op cit note 6 at 91.
[521] Bekink M supra op cit note 6 at 91.
[522] Bekink M supra op cit note 6 at 91.
[523] The Policy Paper supra op cit note 15 at 18.
[524] The Policy Paper supra op cit note 15 at 38.

there was a need for provisions within the law which can be readily used through litigation to hold directors liable for breaches of duties, but on the other hand, the paper contends that because South Africa is not a litigious society it is not necessary to enact provisions that will pardon directors and senior managers for their conduct through exculpatory statues.

4.4.3 The Companies Bill 2007

Clause 78(2) of the Companies Bill of 2007 is relevant when evaluating which approach to the protection of directors and senior managers the drafters preferred. It states that a company may not include any provision in an agreement, the company Memorandum of Incorporation, or rules of the company, or a resolution adopted by the company whether directly or indirectly that purports to relieve a director from a duty or negates the legal consequences of an act or omission that constitutes wilful misconduct or wilful breach of trust on the part of that director or senior manager.[525] Clause 78(2) settled the question of whether a director or senior manager could be exempted from the consequences of liability or from a duty that would have otherwise been attached to them. Therefore, it is not permissible to exempt directors and senior officers from both the consequences of liability for a breach, but also provisions that exempt him or her from his or her duties are void.

By stating in clause 78(2) that a director or senior manager may not be exempted from liability through a provision in any agreement or memorandum of incorporation, it appears the drafters of the Companies Bill had opted to continue with the prohibition against exemption clauses.[526] Clause 78(2) thus clarified that even an exemption that purports to narrow or limit the extent of a duty to a lower standard should be void for purposes of the continued prohibition

[525] Clause 78(2) of the Companies Bill 2007 provides that '(2) Subject to subsections (4) to (6), any provision of an agreement, the Memorandum of Incorporation or rules of a company, or a resolution adopted by a company, whether express or implied, is void to the extent that it directly or indirectly purports to— (a) relieve a director of— (i) a duty contemplated in section 75 or 76; or (ii) liability contemplated in section 77; or (b) negate, limit or restrict any legal consequences arising from an act or omission that constitutes wilful misconduct or wilful breach of trust on the part of the director.'

[526] L Carmiciumaru supra op cit note 16 at 166, where he states that '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, 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.'

against exemption of directors and senior managers from liability. The nature of an exemption is that it constitutes a blanket release or extinction of liability.

The operation of clause 78(2) is limited to duties owed to the company, as only the company will be in a position to provide exemption or indemnification for duties owed to it. Clause 78(2), unlike section 247(1) of the 1973 Act, which only referred to articles of a company or any contract, now specifically includes the Memorandum of Incorporation, the rules of the company and any resolution that the company may take in its exemption clause. Given the wide nature of the prohibition against exemption, it would be correct to consider that even partial exemptions are also prohibited.

The Companies Bill provided the policy makers with the ideal opportunity to revisit the appropriateness of the continued prohibition against exemption clauses that exempt directors and senior managers from liability for a breach of the duty of care and skill.[527] With the current drafting, it appeared that the issue received minimal consideration. It can be argued that the traditional approach was retained which prefers a blanket approach to exemption clauses. In contrast, it can be argued that a different approach should have been introduced through the Companies Bill which could have enhanced the protection available to directors and senior managers through exemption clauses for breaches of the duty of care.[528]

4.5 Section 78(2) of the Act

Section 78(2) of the Act sets out the provisions relating to exemption, indemnification and directors' and senior managers' liability insurance.[529] The subsection provides as follows:

> '(2) Subject to subsections (4) to (6), any provision of an agreement, the Memorandum of Incorporation or rules of a company, or a resolution adopted by a company, whether express or implied, is void to the extent that it directly or indirectly purports to— (a) relieve a director of— (i) a duty contemplated in section 75 or 76; or (ii) liability

[527] Mongalo T supra op cit note 371 at 13, ponders whether policy makers 'missed an opportunity' or allowed a 'unavoidable eventuality' in the formulation of directors' standards of conduct. The same question or argument is relevant to the continued prohibition contained in section 78(2) of the Act against exemption clauses – see also Mongalo supra op cit note op cit note 10 at 141.
[528] Mongalo supra op cit note op cit note 10 at 141.
[529] Cassim et al supra opcit note 32 at 774.

contemplated in section 77; or (b) negate, limit or restrict any legal consequences arising from an act or omission that constitutes wilful misconduct or wilful breach of trust on the part of the director.'

In essence, section 78(2) of the Act restated and preserved the general prohibition against the indemnification of directors and senior managers from liability for breaches of the duty of care and skill.[530] Exculpatory clauses are a powerful form of defence because they can provide the basis for a court to dismiss any claim for monetary damages against a director or senior manager by the company or shareholder for breach of directors' or senior managers' duty.[531] By providing authorisation for the inclusion of such clauses in the Memorandum of Incorporation or an agreement between the director and senior manager, section 78(2) Act, would have enabled a court to dismiss a claim for breach of the duty of care and skill, even when it involves negligence.

Primarily, the focus of this research is whether the continued prohibition against the exemption of directors and senior managers as contained in section 78(2) of the Act leaves directors and senior managers with sufficient protection to protect themselves against personal liability for monetary damages under the current legal enforcement framework.[532] The question of balance between accountability and protection of directors has been asked, and it has been stated that the 'major corporate governance problem is the intricate balance between maximising the efficiencies necessary to create wealth and ensuring that the controlling parties are accountable to those with a stake in the enterprise'.[533] Finch goes on to argue that one of the purposes of the rules of corporate law is to "encourage wealth creation yet discourage corporate wrongdoing'.[534] The balance between creating an environment conducive to wealth maximising for the company and its stakeholders, while providing adequate accountability, may be adversely affected by the lack of protection for directors and senior managers through exemption clauses for liability for damages for the breach of the duty of care and skill. Such a gap in the protection of directors and senior managers under the current legal enforcement framework may be perceived to expose directors to personal liability to such an extent that they

530 See section 247(1) of the 1973 Act
531 An example of a statute that permits the inclusion of exculpation clauses is the Model Act section 2.02(b)(4) in the US, which provides that [t]he articles of incorporation may set forth…a provision eliminating or limiting the liability of a director for any action taken, or any failure to take any action as a director…' See also para 7.3.
532 See para 1.2 and 1.3.
533 Swanson C 'Corporate Governance: Sliding Seamlessly into the Twenty-first Century' (1996) 21 *Journal of Corporation Law* 417 – 455 at 418.
534 Finch V supra op cit note 111 at 881.

become excessively risk-averse in the exercise and discharge of their functions. This in turn may lead to wealth creation being sacrificed in favour of accountability under the current legal enforcement framework.[535]

It has also been argued that increased exposure to personal liability will deter many competent persons from being willing to serve on the boards of companies or in the role of director or senior manager, which is contrary to one of the goals of corporate law aimed at 'fostering entrepreneurial talent, rewarding it, and then protecting it from untoward liability'.[536] It is furthermore submitted that the goal of reaching and maintaining the balance between wealth maximisation and accountability will not be attained through the prohibition of exemption clauses. The continued prohibition is undesirable, especially when it involves an honest breach of the duty of care and skill. It increases the vulnerability of corporate creditors and senior managers to personal liability for monetary damages when good faith risk-taking proves unsuccessful in hindsight.[537]

An important part of this research is the question of whether any alternative measures aimed at protecting directors and senior managers are adequate when compared with the protection afforded to directors and officers in jurisdictions that make provision for the inclusion of exemption clauses through exculpatory statutes.[538] In Chapter 3, the limited protection provided by the business judgment rule was discussed. It was argued that the protection that the statutory business judgment rule provides does not give the extensive protection that it is presumed to do to directors and senior managers for liability for breach of the duty of care, skill and diligence.[539] A further mechanism that may be available to directors and senior managers as a measure of providing relief from liability is the re-enacted discretionary power of the court to grant judicial relief. The latter will be considered in the next

[535] Daniels R & Hutton S supra op cit note 108 at 229.
[536] Cranston R 'Limiting Directors' Liability: Ratification, Exemption and Indemnification' 1992 *Journal of Business Law* 197-224 at 209.
[537] Mongalo supra op cit note op cit note 10 at 141; Horney J supra op cit note 13 at 63.
[538] Some of the relief includes the courts' discretionary power to grant a director or senior manager relief under subsections 77(5) and (9) of the Act; the business judgment rule in terms of subsection 76(4); and indemnification and liability insurance permitted in section 78.
[539] It should be noted that the business judgment rule only applies with respect to actions taken or decisions made by directors. Refraining from doing anything will therefore not entitle directors to the protection afforded by the business judgment rule, unless it was a positive decision, meeting all the standards for decision-making under the business judgment rule, to do nothing. The business judgment rule, therefore, on the face of it does not seem to be available for directors' and senior managers' oversight functions, although the possibility of extending the rule to directors' oversight responsibilities is not excluded.

section of this chapter. Whether the protection provided through indemnification and liability insurance is satisfactory is carried over and dealt with in Chapter 6.

4.6 Arguments in favour of the removal of the prohibition against exemption clauses for liability for breaches of the duty of care and skill.

4.6.1. Encouragement of Risk-Taking

It is important for companies and the economy that directors and senior managers be granted the space to be bold and take business risks. Johnston makes the point that there needs to be a balance between 'the need for punishing faithless fiduciaries against the need to protect aggressive managers who are willing to take good-faith risks in the search for profits'.[540] He goes on to warn that eventually, the 'enterprise system itself will be the loser' if directors and senior managers cannot protect themselves against the personal financial disaster arising from lawsuits alleging negligence, because the dangers of risk-taking will appear to exceed the rewards.

Exemption clauses are instrumental in encouraging directors and senior managers to take business risks without the fear of personal liability continuously hanging over their heads.[541]

4.6.1.1 Attracting and Retaining High-Calibre Individuals

The availability of exemption clauses as a means of protecting directors and senior managers will be instrumental in encouraging talented individuals to serve as directors and senior managers.[542] The increased amount of standard of care expected of directors and senior managers will create a disincentive for people to act as directors and senior managers because of the heightened risk of personal liability.

A report remarked that in the US, in particular the state of Delaware, the experience with exemption clauses had appeared to work well to encourage well-qualified individuals to

[540] Johnston J supra op cit note 145 at 1993.
[541] Johnston J supra op cit note 145 at 2035.
[542] Spisto M supra op cit note 104 at 62.

serve on boards and the role of director. Furthermore, they were of the view that exemption clauses provided valuable protection to directors and officers in the exercise of their duties.[543]

4.6.2. The Possibility of a Directors' and Officers' Insurance Crisis

Another way in which directors and senior managers may safeguard their interests in the face of increased exposure to personal liability is through directors' and officers' liability insurance.[544] Section 78(4) to (6) of the Act permits companies to take out and pay for directors' and officers' liability insurance policies on behalf of its directors and senior managers. However, it must be kept in mind that the provisions allowing for directors' and officers' liability insurance do not guarantee protection as increased director and officer liability may result in directors' and officers' policies and contracts themselves providing for even more exclusions or becoming too expensive. Therefore, its viability as a method to allow directors and senior managers relief from liability will be greatly reduced, resulting in insurance eventually becoming unavailable or inadequate.

Manning referred to this as the 'directors' and officers' insurance crisis', which became a real threat in the United States after the *Smith and Van Gorkom*[545] decision. According to Manning, a deterioration in insurance coverage will result in an exodus of independent directors from corporate boards.[546] In the *Van Gorkom* case, the court pierced the business

[543] Spisto M supra op cit note 104 at 91. Lombard S supra op cit note 252 at 620, writing in the context of the business judgment rule, states that '[T]he importance of allowing directors to be bold and to take business risk is emphasised on many levels. The business judgment rule is seen as instrumental in encouraging directors to take business risks without the fear of personal liability continuously hanging over their heads. This, in turn, would attract a high calibre of directors to the office.' It is submitted that these views are relevant in the context of this research, especially in light of the limited application of the business judgment rule to insulate or protect directors and senior managers under the current legal enforcement for negligence and honest errors of good faith breaches of the duty of care – see para 3.4.4. See also the ABA report op cit note 12 at 31.

[544] ABA Report supra op cit note 12 at 22. It may be impossible to predict with certainty how the insurance market may respond to a judgment that exposes directors and senior managers to personal liability for honest errors of judgment or mere negligence. However, this will depend on a number of factors. Key and central is the view and perception of insurers of the relationships between directors, potential claimants and itself as the insurer – see Baxter C 'Demystifying D&O Insurance' (1995) 15 Oxford Journal of Legal Studies 537 -564 at 539 - 540 remarks that '[T]he main danger for the legal analyst or adviser is that, in focusing on directors' liabilities, it is easy to lose sight of the fact that the object of most of their activities is to create legal relationships between the company and third parties. Even before insurers come on to the scene, there will be three parties in a triangular relationship and things passing on one side of the triangle will almost always have some impact on one or both of the others.'

[545] 488 A.2d 858 (Del. 1985).

[546] Manning B 'Reflections and Practical Tips for Life in the Boardroom After Van Gorkom' (1985) 41 *Bus. Law.* 1-14 at 8.

judgment rule and it imposed individual and personal liability on the directors of Trans Union Corporation because the court was of the view that they had not been careful enough, and had not enquired enough, before deciding to accept and recommend to Trans Union's shareholders a cash-out merger at a per-share price that was less than the 'intrinsic value' of the shares. The decision led to a dramatic and unanticipated contraction in the availability of the directors' and officers' liability insurance.[547] It is important for the South African position that we understand the roots of this potential crisis and then make informed predictions on the effect it could have on the South African insurance market and the availability of directors and senior managers. In South Africa, the business judgment rule is yet to be tested by the courts, in the context of the breach of the duty of care, skill and diligence and it is more than likely that a South African court would follow the same course adopted by US courts in *Smith v Van Gorkom*[548], *In Re Walt Disney Co Derivative Litigation*[549], *Texlon Corp v Meyerson*[550], *Krasner v Moffat*[551], *In Re Oracle Corp Derivative Litigation,*[552] and *Richard J. Tornetta v Elon Musk & Others C.A. No*[553]. South African courts may follow the trend adopted by the US courts to restrict the limits of protection available through the business judgment rule and are moving toward more vigorous enforcement of directors' duties. Should the South African courts follow this approach and trend it would trigger a directors' and officers' liability insurance crisis which could result in a contraction in the availability of directors' and officers' insurance which would in turn lead to an exodus of well-qualified persons from serving in the role of director or senior manager.

In addition, Daniels and Hutton point out the fact that the insurance market is vulnerable to cyclical industry-wide fluctuations in capacity and pricing that could greatly undermine the ability of directors and senior managers to insure against future legal liability.[554] In Chapter 6, the nature and extent of the protection available to directors and senior managers through liability insurance as provided for in sections 78(4) to (6) of the Act is discussed and whether directors' and officers' insurance provides adequate relief and protection to directors and senior managers under the current legal enforcement framework which prohibits the inclusion of exemption clauses. It is submitted that the protection afforded to directors and senior managers

[547] ABA Report supra op cit note 12 at 31.
[548] 488 A.2d 858 (Del. 1985).
[549] 825 A.2nd 275 (Del Ch 2003).
[550] 802 A.2nd 257 (Del 2002).
[551] 826 A.2nd 277 (Del 2003.)
[552] 824 A.2nd 917 (Del CH 2003).
[553] 2018-0408-KSJM.
[554] Daniels R & Hutton S supra op cit note 132 at 185.

through directors' and officers' insurance is, in the absence of exemption clauses for liability in the context of the breach of the duty of care, inadequate and raises the potential of personal bankruptcy for directors and senior managers.[555]

4.7 Arguments against the Exemption Clause

4.7.1. Threat to the object of deterrence through the imposition of personal liability

Slaughter warns that the danger of exculpatory statutes is that such provisions strip shareholders of their traditional right to seek monetary damages from directors and officers who are guilty of breaching the duty of care owed to the company.[556] According to her, exculpation frustrates two goals - compensation and deterrence, which are advanced by the imposition of personal liability.[557] She is of the view that liability-eliminating statutes mean that shareholders will not be compensated for pecuniary losses suffered by the company due to the breach of the duty of care.[558] She also remarks that by eliminating liability by way of statute, the efficacy of the deterrence that liability imposes on directors is diminished.[559] She observes that directors will normally want to avoid the consequences of personal liability, which will prevent them from breaching their corporate duties. Therefore, by removing the threat of personal liability, deterrence is reduced.[560]

The effect of liability-eliminating statutes is that it may create a paradoxical situation of increasing the possibility for less scrupulous conduct on the part of directors while diminishing the opportunity for adequate remedial action for shareholders and the company.[561] Slaughter suggests that it may lead to overprotection of directors and does not represent a

[555] Mongalo T supra op cit note 10 at 149, wherein states that '[T]he question is now whether the South African alternative to exculpation is appropriately expansive to address the likely consequences…While indemnification seems to still achieve the goal of deterrence as shareholders retain their right to bring litigation against directors, unlike the case of exculpation, the measure, unfortunately, is a potentially serious disincentive for proactive corporate service, particularly in jurisdictions like South Africa where legal standing for brining legal suits against directors are extensively relaxed.'
[556] Slaughter S supra op cit note 57 at 188.
[557] Slaughter S supra op cit note 57 at 189.
[558] Slaughter S supra op cit note 57 at 189.
[559] Slaughter S supra op cit note 57 at 189.
[560] Slaughter S supra op cit note 57 at 189 - 190.
[561] Slaughter S supra op cit note 57 at 190.

‘balanced solution’.[562] I am inclined to agree with her that if the elimination goes beyond the extent of protecting directors and senior managers who have not been honest or acted in good faith, then it overreaches.[563] Therefore, directors or senior managers who consciously disregard their duty of care and skill or whose conduct amounts to a gross deviation/gross negligence from the expected standard would not enjoy protection through exculpation clauses and should be held accountable for their faithless acts.[564]

4.7.1.1 Protection of Directors and Officers a Disincentive to Corporate Accountability

The imposition of personal liability in the context of the corporate board of directors is said to be premised on two philosophical alternatives. First, to compensate an individual or group of individuals who have suffered harm or loss. However, if the primary and ultimate goal of imposing personal liability is deterrence then the ultimate goal of achieving a satisfactory level of public accountability from modern corporations is thwarted by the enactment of statutes that permit the exclusion of liability that enables directors to evade personal liability for their conduct.[565]

Ulrich observes that liability-eliminating statutes encourage a lax attitude towards compliance with the law. She remarks that the availability of protection through exemption or indemnification goes contrary to the goal of maximising the accountability of corporations to the public.[566] A director faced with litigation would choose to settle the action without the matter going to court to avoid a judicial finding of misconduct. Early settlement or disposal of the matter through exemption clauses means that there is no opportunity for a more thorough

[562] Slaughter S supra op cit note 57 at 190.
[563] Spisto M supra op cit note 104 at 61.
[564] See the recommendation of the ABA Report supra op cit note 12 at 21, where it was stated that ‘Recommendation: Consider adopting a statute permitting the memorandum or articles to include a provision exculpating the directors from liability for money *dama ges* in suits by the company – directly or indirectly – or by the shareholders, subject to exceptions for egregious misconduct, e.g., receipt of an improper personal benefit, active and deliberate dishonesty or commission of a crime.’
[565] Ulrich H supra op cit note 84 at 231. See also Keay A & Loughrey J supra op cit note at 361, wherein they state that [A]ccountability is seen as necessary to legitimise the greater power exercised by directors of public and large private companies, and promote good governance behaviour and market trust…Accountability is also important in small private owner-managed companies, and litigation is seen as a mechanism to promote such accountability….Conversely review could be problematic: it has been argued that holding directors liable for poor decisions could have adverse economic impacts by deterring entrepreneurial risk taking and discouraging able people from being directors.’
[566] Ulrich H supra op cit note 84 at 231.

determination of the propriety of the director's actions to ensure the proper use of corporate power.[567]

4.7.2. Relief by the Court: Discretionary Power to Grant Relief to Directors and Senior Managers

Section 77(9) of the Act grants the courts the power to grant directors relief from possible personal liability.[568] However, the extent of the court's discretionary power to provide judicial relief to directors and senior managers is unclear.[569] The question remains whether the existence of the court's discretionary power to grant judicial relief to a director or senior manager in terms of section 77(9) of the Act renders the protection through exemption clauses and exculpatory statutes unnecessary under the current legal enforcement framework.[570]

For the discussion of relief by the courts, it is necessary to have regard to section 248 of the 1973 Act to understand the court's statutory discretion to grant relief to a director or senior manager. Section 248 of the 1973 Act provides that the court may exercise its discretion to relieve directors from liability under particular circumstances. This provision reads as follows:

> '(1) If in any proceedings for negligence, default, breach of duty or breach of trust against any director, officer or auditor of a company it appears to the Court that the person concerned is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, the Court may relieve him, either wholly or partly, from his liability on such terms as the Court may think fit.
>
> (2) Any such director, officer or auditor who has reason to apprehend that any claim will be made against him in respect of any negligence, default, breach of duty

[567] Ulrich H supra op cit note 84 at 245 and 246.
[568] Cassim et al supra op cit note 32 at 779.
[569] Cassim et al supra op cit note 32 at 780.
[570] Mongalo T supra op cit note 10 at 153 -154. See also Bradstreet R supra op cit note 399 at 147 – 148.

> or breach of trust, may apply to the Court for relief, and the Court shall on any such application have the same powers to grant relief as are by subsection (1) conferred upon it concerning proceedings referred to in that subsection.'

There was some uncertainty regarding particular aspects of the relieving provisions contained in section 248 of the 1973 Act. First, whether directors who were involved in proceedings in terms of provisions such as section 424(1) of the 1973 Act could avail themselves of the potential relief offered by section 248 of the 1973 Act. Section 424(1) of the 1973 Act dealt with the personal liability for company debts of directors and other persons responsible for being knowingly involved in managing the business of the company fraudulently or recklessly.

However, it can be seen from the wording of section 248 of the 1973 Act that the court's judicial discretion provided for proceedings against directors which concerned 'negligence, default, breach of duty or breach of trust'. Directors' and senior managers' liability for intentional and reckless conduct is not the purpose of this research, as its focus is primarily on the relief that may be available to directors and senior managers from liability for breach of their duty of care, skill and diligence.

Second, it was uncertain whether relieving provisions contained in section 248 of the 1973 Act were applicable in respect of all proceedings by anyone against directors, or whether their application is limited to proceedings against directors specifically instituted by the company. The approach adopted in *Ex parte Lebowa Development Corporation Ltd*[571] by Stegmann J appeared to prefer the view that the relief was only available to directors in actions brought against them by the company and not third parties. In English Law, the courts were also of the same view that section 727 of the UK Companies Act, which was comparable to section 248 of the 1973 Act, meant that relief for directors was only available in respect of proceedings instituted against the director by the company and not in respect of third-party claims against the director.[572]

Third, a further problem regarding the application of section 248 of the 1973 Act was the apparent anomaly created by the fact that a person who acted 'negligently' could be relieved from liability if it could be shown that he acted 'reasonably'. Under normal circumstances, a

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[571] 1989 (3) SA 71 T 107.
[572] See *Customs & Excise Commissioners v Hedon Alpha Ltd* [1981] 2 All ER 697 (CA).

person is considered to have been negligent because he or she did not act reasonably.[573] The court in *Niagara Ltd v Langerman*[574] confirmed that a director wishes to avail himself of the relief offered in terms of s 248 of the 1973 Act had to prove on a balance of probabilities that he acted honestly, and reasonably and that he ought fairly to be excused. Henochsberg suggested that when a decision had to be made on whether relief should be granted in respect of negligence, the word 'reasonably' should be interpreted to mean 'understandably' in the circumstances.[575] Stegmann J in *Ex parte Lebowa Development Corporation Ltd*[576] *also* suggested that the degree of negligence involved should determine whether a person may be held to have acted 'reasonably'.

This problem was also considered in English Law and the courts had an opportunity to comment on the wording of section 727 of the UK Companies Act, which allowed the court to excuse a director who was guilty of negligence, provided that he or she acted reasonably. *In re D'Jan of London Ltd*[577], the court best put it in the following words:

> '[It] may be odd that a person found to have been guilty of negligence, which involves failing to take reasonable care, can ever satisfy the court that he acted reasonably. Nevertheless, the section contemplates that he may do so, and it follows that conduct may be reasonable for section 727 despite amounting to a lack of reasonable care at common law.'

Therefore, for purposes of section 248 of the 1973 Act and section 727 of the UK Companies Act, the anomaly persisted that while the reasonableness test is primarily an objective one for negligence liability, it contains a subjective element in the context of an application for relief.

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[573] The test for negligence was formulated in *Kruger v Coetzee* 1966 2 SA 428 (A) at 430, where it was stated that negligence is generally determined with reference to the objective standard of the reasonable person. The test was formulated as follows: For the purposes of liability culpa arises if – (a) a diligens paterfamilias in the position of the defendant – (i) would foresee the reasonable possibility of his conduct injuring another in his person or property and causing him patrimonial loss; and (ii) would take reasonable steps to guard against such occurrence; and (b) the defendant failed to take steps.

[574] 1913 WLD 188 202.

[575] Henochberg P supra op cit note 225 at 462.

[576] 989 (3) SA 71 (T).

[577] [1994] BCLC 561 (Ch).

Last, the greatest problem with section 248 of the 1973 Act was that the court's power to grant a director or officer relief was discretionary and not mandatory.[578] This was indicated by the use of phrases granting the court hearing the application for relief a wide and flexible discretion, such as that a director ought ‘fairly to be excused’, ‘having regard to all the circumstances...of the case’, at court’s sole discretion it ‘may relieve’ a director or officer from liability under these circumstances. Therefore, even if a director acted honestly and reasonably there was no guarantee that he or she would escape personal liability. According to Pasban, Campbell & Birds, they observed that:

> ‘A great deal will depend on the attitude of the trial judge towards the exercise of the discretion vested to him. If a case is brought before a judge who applies a wide and general interpretation of the concepts, the respondent will likely be given the relief, whereas if a case is proceeded by a judge who strictly interprets legal expressions, an application for the relief may likely be rejected.’[579]

The greatest deficiency of the court’s power to grant a director or officer judicial relief from liability for negligence or a breach of the duty of care and skill was that it was not statutorily secured but left in the court’s discretion. Therefore, directors and officers were not in a more favourable position to obtain relief from liability where the relief depended on the discretion of the courts. Under a legal enforcement framework which emphasises accountability over the protection of directors and senior managers the circumstances under which a court is under obligation to grant relief, which curtails the court’s discretion, works against directors and senior managers. The position under section 77(9) of the Act has not changed and the courts will likely be unwilling to go further in granting relief because the current legal enforcement framework is obsessed with accountability and the imposition of liability.

Section 77(9) of the Act provides that:

> ‘In any proceedings against a director, other than for wilful misconduct or wilful breach of trust, the court may relieve the director, either wholly or partly, from any liability set out in this section, on any terms the court considers just if it appears to the court that –

[578] A similar problem was noted about section 727 of the UK Companies Act see Pasban M et al ‘Section 727 and the Business Judgment Rule: A Comparative Analysis of Company Directors’ Duties and Liabilities in English and United States Law’ (1997) 6 *Journal of Transnational Law and Policy* 202 - 221 at 208.
[579] Ibid at 212.

(a) the director is or may be liable, but has acted honestly and reasonably; or

(b) having regard to all the circumstances of the case, including those concerned with the appointment of the director, it would be fair to excuse the director.

Mongalo points out the fact that under section 77(9) of the Act, policy makers have re-enacted the discretionary powers of the court to grant relief to a director or a senior manager. However, according to him, the difficulty regarding this approach is ‘that it makes the relief from liability a matter for judicial discretion’.[580] Such a crucial issue is capable of being addressed by the corporate constitution rather than being the subject of lengthy litigation processes at the directors’ or senior managers’ costs, which will deplete their financial resources and result in tarnishing their reputation.[581]

Mongalo argues that the existence of the discretionary power to grant judicial relief to directors and senior managers in terms of section 77(9) of the Act is not sufficient to make exculpatory statutes unnecessary. He warns that recent cases on director liability have endorsed the corporate law position of imposing personal liability on directors for contravening provisions of the Act. The lack of adequate protection for directors and senior managers is unfortunate, particularly for South Africa, which ‘still needs to transform the corporate leadership fraternity and significantly increase the number of those required to offer their services as directors’.[582]

It is thus submitted that the fact that the relief granted by the courts is discretionary justifies the conclusion that the protection afforded in terms of section 77(9) of the Act is inadequate. Probably, this would lead to the exact opposite result, with the discretion in the hands of the courts potentially affording directors and senior managers narrower protection than would have been available had the court been obliged to grant relief within the current legal enforcement framework which endorses the corporate law position of imposing personal liability on directors and senior managers for breaches of the duty of care, skill and diligence.

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[580] Mongalo T supra op cit note 10 at 154.
[581] Mongalo T supra op cit note 10 at 154.

[582] Mongalo T supra op cit note 10 at 154.

In Chapter 7, I offer some recommendations and amendments as regards section 78(2) of the Act which is aimed, in the main, at lifting the prohibition against exemption clauses for personal liability for directors and senior managers for breach of the duty of care, skill and diligence. An exculpatory statute will provide adequate protection to directors and senior managers that insulates them from liability resulting from bad decisions and the breach of the duty of care.

4.8 Conclusion

This Chapter has presented an overview of the continued prohibition against exemption clauses as a means of insulating and protecting directors and senior managers in South Africa from personal liability for breach of their duties. It was established that in the lead-up to the drafting of the Act, policy makers received a recommendation to amend section 247 of the 1973 Act and had an opportunity to revisit the appropriateness of the continued prohibition against exemption clauses.[583] The recommendation was disregarded and it raises a concern whether the current legal enforcement framework which prohibits exemption clauses will best serve to achieve the balance between providing directors and senior managers with the much-needed freedom to take calculated business risks without the continuous fear of personal liability, while not allowing unscrupulous directors and senior managers the opportunity to escape liability for a breach of their duties.[584]

The historical developments of the prohibition against the exemption of directors and officers were examined.[585] Initially, South Africa followed the approach adopted in English Law which dates back as far as 1925.[586] In the UK it was suggested that the practice of companies include in articles of associations provisions that exempted directors from liability for losses, other than losses for their wilful neglect and dishonesty, gave directors unjustified protection. The prohibition of the inclusion of exemption clauses in articles of associations or

[583] Mongalo T supra op cit note 10 at 154. He refers to the matter of *Hlumisa Investment Holdings (RF) and Another v Kirkinis and Others* ([2020] JOL 47567 (SCA)).

[584] See para 1 of this Chapter.
[585] See para 1 of this Chapter.
[586] See para 2 of this Chapter.

any agreement was not expected to cause any hardships on directors or it would make their position more onerous.[587]

The recommendations of the Lansdown Commission in 1931 regarding the prohibition of exemption clauses in South Africa were then examined.[588] The Lansdown Commission recommended the introduction of the prohibition of exemption clauses and for South Africa to follow the UK approach. The drafting of the Act provided an opportune moment for policy makers to revisit the position and whether the prohibition was still appropriate. In 2001 policy makers received a recommendation from the ABA to amend section 247 to allow companies to include in its articles of association provisions to exempt directors and officers from liability for their failure to perform their duties, but with the proviso that exculpation did not extend to include egregious misconduct.[589]

The prohibition as contained in section 70 of the Companies Act 1926 and section 247 of the 1973the Act was discussed. It was shown that sections 70 and 247, were unclear regarding the extent of the prohibition against exemption clauses.[590]

The recommendations emanating from the King Reports as regards the codification of the director's duties and the inclusion of a statutory business judgment rule were then examined.[591] King, I noted serious concerns over corporate scandals and the need for effective board accountability. However, the system of corporate government should not be made too onerous that it stifles the enterprise and a proper balance needs to be achieved between the freedom to manage the enterprise and accountability.[592] It was noted that directors and senior managers had onerous duties and that section 247 of the Act should be amended to provide for the indemnification of directors and officers.[593]

The guidelines provided by the Department of Trade and Industry were then considered. The Policy Paper rejected the ABA's recommendation for the inclusion of exemption clauses as a means of protecting directors.[594] It further implied that there was no need to exculpate or indemnify directors as South Africa is not a litigious society.[595]

[587] See para 2.1 of this Chapter.
[588] See para 2.1 of this Chapter.
[589] See para 2.2 of this Chapter.
[590] See para 3.1 to 3.3 of this Chapter.
[591] See para 4 of this Chapter.
[592] See para 4.1 of this Chapter.
[593] See para 4.1 of this Chapter.
[594] See para 4.2 of this Chapter.
[595] See para 4.2 of this Chapter.

The Companies Bill 2007, restated and preserved the prohibition against the exemption of directors and senior managers in clause 78. The prohibition negated any provision in a company's Memorandum of Incorporation or any agreement that purports to exempt a director or senior manager from liability or duty owed to the company.[596] The chapter then discussed the prohibition as contained in section 78(2) of the Act. First, some arguments for and against prohibition were examined.[597]

The question was posed whether the re-enacted discretionary power to grant judicial relief to directors and senior managers in section 77(9) of the Act renders exculpatory statutes unnecessary to provide sufficient protection to directors and senior managers from personal liability for breaches of the duty of care.[598] It is my view that the relief contained in section 77(9) of the Act does not achieve the required balance sufficient to protect directors and senior managers, and it was recommended that the legislature introduce provisions in section 78(2) of the Act that lifts the prohibition against exemption clauses when a breach of the duty of care, skill and diligence is involved.

The importance of providing honest directors and senior managers with adequate relief against personal liability cannot be denied. The implications of the continued prohibition against exemption clauses in the current legal enforcement framework mean that directors and senior managers in South Africa are at a greater risk of being unable to protect personal assets against liability claims for monetary damages and thus at a competitive disadvantage when compared with director and senior managers of companies whose jurisdiction provide for exculpatory statutes.

The importance of providing directors and senior managers with adequate relief from liability under suitable circumstances was emphasised in this Chapter. It was shown that the existing measures, in the current legal enforcement framework, are inadequate for providing directors and senior managers with the required degree of relief from liability. In Chapter 5, some important comparisons will be made between the approach to the exemption of directors, and several recommendations will be made in an attempt to improve the model and approach to the protection of directors and senior managers in South Africa.

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[596] See para 4.3 of this Chapter.
[597] See para 4.4.2.1 and 4.4.2.2 of this Chapter.
[598] See para 4.5 of this Chapter.

CHAPTER 5

INTERNATIONAL BENCHMARKS AND TRENDS IN THE EVOLUTION OF THE STANDARDS OF CARE, THE BUSINESS JUDGMENT RULE AND THE EXEMPTION OF DIRECTORS AND SENIOR MANAGERS FROM LIABILITY

5.1 Introduction

In this Chapter, a comparative analysis of the approach to the protection of directors and senior managers adopted in the United Kingdom and the United States is undertaken, with a view primarily to exposing the lack of adequate protection of directors and senior managers in jurisdictions which do not permit the inclusion of exculpatory statutes, such as South Africa.[599] The thesis considers both judicial and legislative corporate mechanisms available to protect or insulate directors and senior managers from personal liability for breaches of the duty of care, and it reviews the mechanisms' value and whether or not they provide measured protection

[599] Subsection 78(2) of the Act prohibits the inclusion of exculpation clauses in a company's Memorandum of Incorporation or any agreement exempting a director or senior manager from personal liability or a duty owed to the company. See Cassim et al supra op cit note 32 at 773.

under the current enforcement framework.[600] This Chapter will show that the judicial and legislative corporate mechanisms adopted in the United Kingdom, and by extension South Africa, that are not complemented by exculpatory statutes, which are imperative to insulating directors and senior managers from personal liability for breaches of their duties to ensure that they are not a competitive disadvantage when compared with directors and senior managers in whose jurisdiction the legislative corporate mechanism makes provision for exculpatory statutes.[601]

A fundamental difference between the United Kingdom and the United States corporate laws is the attitude towards the protection of directors and senior managers for breach of their duties. Slaughter notes that most States in the United States permit indemnification and insurance as methods to mitigate the financial disincentive to corporate service by insulating directors and officers from the financial impact that results from personal liability incurred while acting in a corporate capacity.[602] However, a combination of 'shrinking insurance coverage and increasing liability exposure' threatened incumbent directors and officers as well as the traditional system of corporate government which necessitated statutory responses to deal with the crisis aimed at mitigating the financial impact of personal liability.[603] Most States of the United States permit indemnification, insurance and exculpation in a broad range of circumstances.[604] However, this is in sharp contrast to English law which provides for general prohibitions on the exemption and indemnification of a director from liability or against liability that would otherwise attach to a director or officer in connection with any negligence,

[600] Bekink M supra op cit note 6 at 91, she states that '[I]n South Africa, the risk of litigation is increased owning to the…. increased focus on good corporate governance…the stringency of the Johannesburg Securities Exchange listing requirements; and the enactment of the new Companies Act of 2008. However, it is precisely in the current financial climate that directors need to be able to respond to competitive and dynamic markets without the fear of being sued for taking calculated risks. A central part of company law is thus concerned with striking a balance between constraining potential abuse by directors of their powers and granting them enough freedom to gain from a strong centralised management. D&O liability insurance may therefore not only be instrumental in encouraging talented individuals to serve as directors, but to do so without being overly conservative in their management of a company.'

[601] Mongalo T supra op cit note 10 at 141.

[602] Slaughter S supra op cit note 57 at 181.

[603] Slaughter S supra op cit note 57 at 182.

[604] See para 5.3.4 where the impact of the Model Business Act is discussed. The Model Act has been, in whole or substantial part, adopted by 36 jurisdictions in the United States. Therefore, to a greater or lesser degree, these states are affected by section 2.02(b)(4) of the Model Act, which permits exculpation clauses. Section 2.02(b)(4) of the Model Act provides that: '[t]he articles of incorporation may set forth…a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or by any failure to take any action, as a director…' The Model Act has been described as 'a freestanding general corporation statute that can be enacted substantially in its entirety by a state legislature…' – See Mongalo T supra op cit note 10 at 146.

default, breach of trust, or breach of duty about the company, with limited and specified exceptions in the case of indemnification relating to insurance.[605]

The analysis of the judicial and statutory corporate enforcement framework indicates that the difference between the jurisdictions reflects not only divergent attitudes towards the rule of personal liability for directors and senior managers but also different circumstances.[606] A fine balance needs to be maintained between the dual objectives of regulating the activities and conduct of directors and senior managers which are the need to protect shareholders and the company against mismanagement through the imposition of personal liability, and the need to encourage directors and senior managers to take good faith risk when exercising their business judgments.[607] The differences between the United Kingdom and the United States also reflect different circumstances. That said, it may be that directors and senior managers in the United States are the subject of more legal actions than in the United Kingdom. Indemnification and insurance are therefore thought to be more appropriate for the protection of directors and senior managers. The chapter and thesis specifically demonstrate that the failure of corporate statutory mechanisms in explicitly granting exculpatory statutes as a means of protecting directors and senior managers against the threat of personal liability attaching to them for the breach of the duty of care reflects a non-proactive approach which is a threat to directors and senior managers and the traditional corporate governance system.

In this Chapter, a comparative analysis of the judicial and statutory corporate enforcement mechanisms applicable to directors and senior managers in the United Kingdom is undertaken by:

(a) Analysing the duty of care, skill and diligence;

(b) Highlighting the nature of the general prohibition of indemnification and exemption from liability for directors and senior managers for breach of their duty of care, skill and diligence under English law; and

(c) Drawing attention to the comparative analysis of the liability of directors and senior managers and the permissible scope exemption by a company for breach

[605] S Mortimore *Company Directors: Duties, Liabilities, and Remedies* 2008 Oxford University Press at 447.
[606] Ramsay I 'Liability of Directors for Breach of the Duty and the Scope of Indemnification and Insurance' (1987) 5 *Comp & Soc L* 129 – 156 at 141.
[607] Johnston J supra op cit note 145 at 1993.

of the duty of care, skill and diligence under United States law, with particular reference to the State of Delaware.

(d) Concluding the viability of introducing exculpatory statutes in the corporate enforcement framework as an appropriate measure to protect directors and senior managers from breaches of the duty of care, skill and diligence.

Concerning the United States, the significant developments that led to the introduction of exculpatory statutes to protect directors and senior managers from the threat of personal liability are analysed, including the seminal decision of *Smith v Van Gorkom*.[608] The corporate statutes permitting exemption clauses, distinct relevant features of the statutes form the basis for the comparative analysis. The main point of the comparative analysis with regard to the dual objectives of regulating directors and senior managers is to demonstrate how the inclusion of exculpatory statutes for breach of the duty of care, skill and diligence achieves a balanced solution to the problem of director and senior manager liability without amounting to overprotection.[609] The analysis in this regard zeroes in on the pre-eminent state from a corporate law perspective, being the state of Delaware.

The Chapter concludes that while the general criticism against exculpatory statutes – that they defeat the object of deterrence and compliance with the law, is valid. The deficiency in an enforcement framework lacking in the complementary substantive protection of exemption clauses cannot be ignored and is equally valid and deserving of consideration.[610]

This Chapter begins briefly with justification for the choice of comparative jurisdictions and then by tracing the traditional or common law standards of care and skill in the United Kingdom, consideration is given to the incremental development of the modern standards of the duty of care, skill and diligence through the case law and section 174 of the Companies Act 2006.[611]

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[608] 488 A.2d 858 (1985). See para 5.3.

[609] It is submitted that this view is reinforced and grounded in the object of section 5(2) of the Act, which enjoins the courts to consider foreign law, to the extent appropriate, in interpreting or applying the Act. Section 5(2) of the Act provides that '[t]o the extent appropriate, a court interpreting or applying this Act may consider foreign company law.'

[610] See para 5.4.

[611] See para 5.1.1.

5.1.1. Justification for the choice of comparative jurisdictions

The reasons for comparing the South African legal enforcement framework under corporate law applicable to directors and senior managers with those of the United Kingdom and the United States, and the reasons for identifying the particular statutory provisions within the United Kingdom's corporate statutes dealing with the accountability of directors and within the United States exculpatory statutes for purposes of the comparative analysis, are briefly highlighted hereunder.

The South African corporate law reform coincided with similar developments in related jurisdictions. A comparison will be made between the positions in the United Kingdom.[612] Both the South African and the United Kingdom corporate legal enforcement frameworks have increased the standards of care for directors and senior managers and, in turn, accountability for breaches of the duty of care, where the rules and principles are now embedded in legislation, as well as self-regulating codes.[613] Despite this, the approach to the protection of directors and senior managers still prohibits the use of exculpatory provisions as a means to protect directors from the threat of disastrous personal financial liability for breach of the duty of care, skill and diligence.[614]

The United States has, in light of the increased potential for personal liability for directors and senior managers, opted to alter its corporate statutes legislatively to make provisions that allow corporations to include exemption clauses in their charters of incorporation to relieve directors and senior managers from liability for breach of the duty of care, skill and diligence.[615] The United Kingdom and South Africa have instead opted to retain

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612 Mongalo T supra op cit note 371 at 7 - 9, wherein he states that '[J]ust like South Africa has, through the Companies Act of 2008, seen the wisdom of an objective standard in so far as the duty of care & diligence is concerned, the United Kingdom had, even before the 2006 Companies Act, also appreciated that a director who failed to completely to participate in his company's affairs would be exposing himself to the risk of being held liable for a breach of the duty of care….while the ultimate test for the duty of care, skill & diligence in South Africa clearly seems to be based on…section 214 of the UK Insolvency Act, 1986, the objective test for care and diligence is also reflective of the position in the states of the US that follow the Model Act.' See para 5.2.1 and 5.1.2.

613 Mongalo T supra op cit note 371 at 7.

614 Bekink M supra op cit note 6 at 98, states that '…[t]he Companies Act of 2008 renders void any provision (in any agreement, the memorandum of incorporation, or rules of any resolution taken by the company) whether express or implied, that purports to relieve a director either directly or indirectly of her duties under ss 75 and 76; or of a liability under s 77; or that negates, limits or restricts any legal consequence arising from an act or omission that constitutes wilful misconduct or wilful breach of trust.'

615 See Appendices: Table 1 - List of states in the US that have adopted the Model Business Corporations Act – 36 states have enacted the Model Business Corporations Act into local law. The Model Business Corporation

the general prohibition against exemption clauses and allow the protection of directors and senior managers within limited exceptions through indemnification and liability insurance. The different approaches, i.e. of limited protection of directors and senior managers through indemnification and liability, of the United Kingdom and South Africa respectively, and the United States model which makes for a complementary approach for the protection of directors and senior managers through exculpatory statutes, indemnification and liability insurance will be compared to indicate the preferred one.

The law regarding directors' duties reveals significant similarities in the United Kingdom, Delaware and South Africa – each jurisdiction is considered to be part of the Commonwealth legal system, and each jurisdiction has duties designed to address the dual problems of 'shirking' and 'sharking' by directors and senior managers.[616]

Secondly, the standard for breach of the duty of care under the modern United Kingdom and Delaware courts has risen considerably, and directors are no longer just being held liable for 'gross negligence'.[617]

In addition to sharing common legal traditions, the United Kingdom and the United States have much in common with South Africa, in that they all share similar sophisticated economic, financial and market systems. The United States and the United Kingdom deal with 'similar problems resulting from economic and social conditions which are largely the same. Both are based on the same principles of law and equity derived from a common heritage'.[618] Both are also listed as South Africa's major trading partners[619] and some South African companies also have a United States or United Kingdom listing, thereby being subjected to the regulatory regimes of those countries in some way.[620]

Act deals, among other things, with directors' standards of care and makes provision for the adoption of exculpation clauses.

[616] Orts E 'Shirking and Sharking: A Legal Theory of the Firm' (1998) 16 *Yale Law & Policy Review* 265 – 329 at 267.

[617] Mongalo T supra op cit note 371 at 15, where he states that '…[t]he current Companies Act of South Africa has steered clearly far away from adopting the Delaware standard and experience will show that policy makers in this country took a wise decision as not doing so would have clearly dumbed down the standard for the duty of care. It is argued that South Africa is on a trajectory path that is conducive to improved corporate governance standards, although its standard of the duty of care is relatively higher than that of Delaware. This standard for the duty of care is not necessarily inimical to much-needed economic development.'

[618] Gower L 'Some Contrast Between British and American Corporate Law' (1956) 69 Harv. L. Rev 1369 – 1402 at 1370.

[619] https://wits.worldbank.org/CountryProfile/en/Country/ZAF/Year/LTST/TradeFlow/EXPIMP/Partner/by-country - date accessed 28 February 2024.

[620] Investec is a dual-listed entity in South Africa and the United Kingdom. Harmony Gold is an example of a company that is listed on the JSE and the NASDAQ.

5.2 The United Kingdom Duty of Care, Skill and Diligence

5.2.1. Statutory Statement of the Duty of Care, Skill and Development

A somewhat confusing picture is presented by UK law developments regarding the standards of the duty of care, skill and diligence under UK jurisprudence. Notable judicial pronouncements made from the middle of the 20th century indicate the incremental development of the standards of the duty of care, skill and diligence. This was confirmed by the codification of the duty of care in section 174 of the Companies Act 2006. The codification is largely viewed as a transfer of evolving modern-day standards of care, skill and diligence from case law into a legislative scheme. A key aspect of the company law reform process leading to the enactment of the Companies Act 2006 was the policy drive towards a statutory statement of duties for directors.[621] It was confirmed by the Company Law Review Steering Group (CLRSG), established in 1998 by the UK Department of Trade and Industry to review UK corporate law between 1998 and 2006 that a statutory statement of the duty of care, skill and diligence was the desire to improve its accessibility. However, a different picture has emerged and there is debate under English law whether section 174, within the entire scheme of the statutory statement of directors' duties under UK law, has merely restated in statute the position of the standards of the duties in the case law as they existed before the enactment of the Act.[622] This demonstrates that the interpretation of the duty of care, skill and diligence is, ever since its development, multi-faceted as it has been questioned whether it has become more stringent and if this development is beneficial.[623]

In the Explanatory Notes to the Act, it was expressly stated that the new law was modelled on the standard for wrongful trading section 214 of the UK Insolvency Act 1986. The hypothetical director thus sets the lowest acceptable standard but the actual director’s skill, experience, expertise, knowledge and attributes can raise that particular threshold. In the Lords Grand Committee, Lord Goldsmith stated that ‘… the standard of care which a director owes is enormously important… it is now accepted that the duty of care… is accurately stated in Section 214(4) of the Insolvency Act 1986… Under the clause, you take into account both the

[621] Herne D ‘Directors' Duties, Dry Ink and the Accessibility Agenda’ (2012) 114 *L.Q.R* 114 – 139 at 114.
[622] Ibid at 116.
[623] Zwingwe T ‘Have Directors' Duties of Care and Skill Become More Stringent? What has Driven this Development? Is this Development Beneficial? An Analysis of the Duty of Care in the UK in Comparison to the German Duty of Care’ (2010) Unpublished LLM Dissertation at 6.

general knowledge, skills and experience that may be reasonably expected of a person carrying out those functions and the general knowledge, skills and experience that that director has. It is a cumulative requirement… I want to emphasise the point that it is not making a change from what is already the common law.'[624]

Finch remarked that the common law gave directors 'remarkable freedom to run companies incompetently', and he stated that directors would only be held accountable for gross negligence.[625] There was an expectation that more rigorous duties would be developed with more attention being paid to the issue of accountability in the development of the duty of care in the United Kingdom.[626]

The perception developed that managerial incompetence could cause massive corporate losses, constituting a greater threat to society. In the United Kingdom, this perception and recognition were reinforced by major corporate failures and the global financial crisis in 2008.[627] The leading case on the duty of care in the United Kingdom was the 1925 decision, *In re City Equitable Fire Insurance Co.*[628] in which the court formulated the standard of negligence subjectively, under which a director 'need not exhibit a greater degree of skill than may reasonably be expected from a person of his knowledge and experience'.[629] This meant that the formulation of the standard insulated directors who were ignorant and inexperienced from liability for breaches of the duty of care.[630]

Over the years the formulation of the duty of care was criticised as being 'remarkably low', 'wholly inadequate', and being based on 'legacies of outmoded economic and social philosophies from another age'.[631] It would take another 70 years for the courts to change the benchmark for the duty of care through several decisions which represented a shift from the lenient subjective test. In 1990 the decisions of *In Re D'Jan of London*[632] and *Norman v Theodore Goddard*[633] expressed the view that the subjective standard was no longer

[624] Hansard, 6 February 2006, column 284.
[625] Finch V 'Company Directors: Who Cares About Skill and Care?' (1992) 55 *Mod L Rev* 179 – 214 at 179.
[626] Hill G and Conaglen M 'Directors' Duties and Legal Safe Harbours: A Comparative Analysis' Chapter in D Smith and A Gold Research Handbook on Fiduciary Law (2018) Edward Elgar at 23.
[627] Ibid at 24.
[628] [1925] Ch 407 at 428.
[629] Ibid at 428.
[630] Hill G & Conaglen M supra op cit note 630 at 24.
[631] Hill G & Conaglen M supra op cit note 630 at 24.
[632] [1993] BCC 646.
[633] [1992] BCC 14.

inappropriate and introduced the objective test for directors' conduct, which has been incorporated into section 174 of the United Kingdom Companies Act of 2006.

The directors' duty to exercise reasonable care, skill and diligence was codified in Section 174 of the United Kingdom Companies Act provides that:

'(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 reasonably diligent person with –

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director concerning the company, and

(b) the general knowledge, skill and experience that the director has.

Under the common law, the standard of care, skill and diligence expected of directors in the United Kingdom was initially not very high. However, over and through case law there was a gradual move towards the application of a more objective test. Under section 174 the test whether a director has complied with the duty of care, skill and diligence in any particular case requires an assessment of the director's conduct which is both subjective and objective. The case law discussed hereunder shows how the courts interpret and apply the duty of care under section 174. Courts interpret section 174 as requiring the adoption of a combined objective/subjective standard of judgment when reviewing whether a director's conduct in the circumstances complied with the expected standard. The discussion below further shows that there is a continued prohibition against exemption clauses in the Companies Act 2006, and explains why the continued prohibition against exemption was deliberately retained. The reasons why the United Kingdom opted to retain the continued prohibition against exemption clauses will be compared to the United States' arguments to include/exclude exculpatory statutes as a means to insulate directors from personal liability for the breach of the duty of care.

5.2.2. Notable Judicial Pronouncements on the Duty of Care, Skill and Diligence

Historically, it was considered under the common law that directors would only be liable for a breach of the duty of care, skill and diligence if guilty of 'gross negligence'. The standard of care expected of a director was not very high and this was confirmed in earlier decisions such as *Turquand v Marshall*[634], *Overend & Gurney Co v Gibb*[635], *Re Cardiff Saving Banks*[636], and *Re National Bank of Wales Ltd*[637], where the court confirmed that in the absence of 'of gross negligence', a mere error of judgment was not enough to render directors liable for breach of their duty of care, skill and diligence. In *Turquand v Marshall*, where the directors approved a loan to a fellow director who subsequently passed away insolvent, the court stated that: 'Whatever may have been the amount lent to anybody, however ridiculous and absurd their conduct might seem, it was the misfortune of the company that they chose such unwise directors; but as long as they kept within the powers in their deed, the Court could not interfere with the discretion exercised by them.'[638] In *Overend & Gurney Co v Gibb*[639], the court formulated the question as follows: 'Whether if [the directors] did not exceed their powers they were cognisant of circumstances of such a character, so plain, so manifest, and so simple of appreciation, that no men with the ordinary degree of prudence, acting on their behalf, would have entered into such a transaction as they entered into? Was there crassa negligentia on their part…?'[640]

This position was again confirmed in *Lagunas Nitrate Co v Lagunas Syndicate*[641] that the rules governing the standard of care and skill demanded very little from directors and the court stated the position as follows: 'If directors act within their powers if they act with such care as is reasonable to be expected of them, having regard to their knowledge and experience, and if they act honestly for the benefit of the company they represent, they discharge both their equitable as well as their legal duty to the company.'[642] The court found it difficult to define the amount of care that had to be displayed by a director and stated that: 'But it is plain that directors are not liable for all the mistakes they may make, although if they had taken more care they might have avoided them…Their negligence must be not the omission to take all possible care; it must be much more blameable than that: it must be in a business sense culpable or gross. I do not know how better to describe it.'[643]

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634 [1869] LR 4 Ch App 376.
635 [1872] LR 5 HL 480.
636 [1892] 2 Ch 100.
637 [1899] 2 Ch 629.
638 [1869] LR 4 Ch App 376 at 386.
639 (1872) LR 5 HL 480.
640 [1899] 2 Ch 392, 422, CA.
641 [1899] 2 Ch 392 (CA).
642 [1899] 2 Ch 392 (CA) at 435.
643 Ibid at 437.

In the well-known decision in *In re Brazillian Rubber Plantation and Estates Limited*[644], the court, through Nelville J, considered the extent of directors' duty of care to the company and explained that:

> 'So long as they act honestly, they cannot be made responsible for damages unless guilty of gross negligence. There is admittedly a want of precision in this statement of a director's liability. In truth, one cannot say whether a man has been guilty of negligence, gross or otherwise, unless one can determine what is the extent of the duty which he is alleged to have neglected. A director's duty has been laid down as requiring him to act with such care as is reasonable to be expected of him, having regard to his knowledge and experience. He is, I think, not bound to bring any special qualification to his office. He may undertake the management of a rubber company in complete ignorance of everything with rubber without incurring responsibility for the mistakes which may result from such ignorance, while if he is acquainted with the rubber business, he must give the company the advantage of his knowledge when transacting the company's business. He is not, I think, bound to take any definite part in the conduct of the company's business, but as far as he does undertake it, he must use reasonable care in its dispatch. Such reasonable care must, I think, be measured by the care an ordinary man might be expected to take in the same circumstances on his behalf. He is, I think, not responsible for damages occasioned by errors of judgment.'[645]

In 1925, Romer J *In re Equitable Fire Insurance Co Ltd*[646] concurred with the view expressed in *In re Brazillian Rubber Plantation and Estates Limited*[647] that if a director acted honestly he ought not to be held liable. Romer J went on to find that a director is not bound to give continuous attention to the affairs of the company. His duties are intermittent to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed.'[648] The court went on to state that directors were not guilty of negligence, but merely of a lack of sound commercial judgment.[649] It is suggested that Romer J used a subjective/objective standard test which set a minimal objective standard of care and skill.[650] However, the concern remained that the limitation of the subjective test was that it

[644] [1911] 1 Ch 425.
[645] [1911] 1 Ch 425 at 437.
[646] [1925] 1 Ch 407 CA.
[647] [1911] 1 Ch 425.
[648] Ibid at 427.
[649] Ibid at 427.
[650] Bekinink M supra op cit note 3 at 98.

exonerated honest but incompetent directors.[651] Lastly, Romer J confirmed that having regard to the demands of the business and in the absence of grounds for suspicion, a director was justified in trusting and relying on other officials of the company to perform their duties honestly.[652]

The decision in *In re Equitable Fire Insurance Co Ltd*[653] represents a departure from the traditional subjective approach which was ascribed to the existence of the practice to include service contracts between directors and companies and the court's reliance on section 214 of the United Kingdom Insolvency Act, 1986 in decisions that affected directors duties.[654] The courts were willing to apply section 214 in matters relating to the director's duty of care, skill and diligence even though it referred to wrongful trading cases.[655]

In 1989, a clear change in the way in which directors' duty of care and skill was perceived was signaled in the case of *Dorchester Finance Co Ltd v Stebbing*[656] where the court found a director, who was also chairman of the board, guilty of gross negligence while the other two non-executive directors were found guilty only of negligence. The court rejected the contention on behalf of the defendants that for the defendants that only directors guilty of gross negligence were in breach of their duty of care.

This set the stage for Hoffman LJ in the case of *Norman v Theodore Goddard* and *Re D'Jan of London Ltd*[657] to develop the use of an objective and subjective test and the court emphasised that directors are required to participate actively in the company affairs of the company with the court also finding that the expected standard of director's actions is even higher for directors that have specialized or professional skills. Hoffman LJ made the following statement regarding the duty of care owed by a director at common law: 'In my view, the duty of care owed by a director at common law is accurately stated in section 214(4) of the

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[651] Bekinink M supra op cit note 3 at 98.
[652] [1925] 1 Ch 407 CA at 430.
[653] [1925] 1 Ch 407 CA.

[654] Bekinink M supra op cit note 3 at 99. Section 214(4) of the United Kingdom Insolvency Act, 1986 provided that a director could face personal liability for wrongful trading if '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 reasonable be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that the director has'.
[655] See *Norman v Theodore Goddard* [1991] BCLC 1028 (CLDC) where the court applied its discretion afforded by section 727 of the United Kingdom Companies Act, 1985 to base its interpretation of the common law duty of care on section 214(4) of the Insolvency Act, 1986.
[656] [1989] BCLC 498.
[657] [1991] BCLC 1028 (CLDC).

Insolvency Act 1986. It is the conduct of – a reasonably diligent person having both – (a) the general knowledge, skill and experience that may be reasonably expected of a person carrying out the same functions as carried out by that director to the company, and (b) the general knowledge, skill and experience that that director has.'[658] Hoffman J in *Bishopsgate Investment Management Ltd v Maxwell (No 2)*[659] would go on to express in an obiter judgment that the law and the test applied to the standard of the duty of care expected of directors was evolving in response to changes in public attitudes to corporate governance.

The test to determine whether a director applied the necessary standard of skill when managing a company became more stringent and was based on the test formulated in section 214 of the Insolvency Act, of 1986. The test also became relevant in disqualification applications in terms of section 6 of the United Kingdom Company Directors Disqualification Act, 1996. Therefore, the court will apply a test with objective and subjective elements to determine liability or if a disqualification order should be awarded. Similarly, the position in South Africa appears to be the same in that the court in the matter of *Organisation Undoing Tax Abuse NPC and Another v Myeni and Another,*[660] where an application was brought to declare a non-executive former chairperson a delinquent director, confirmed that an objective and subjective test must be applied in assessing a director's gross negligence as required by section 76(3)(c) of the Act. The court stated that objectively a director's conduct must be weighed against the standards expected of a reasonable director in her position and that subjectively a director's conduct must also be measured against the skills, qualifications and experience she possesses. It was the court's view that more could be expected of an experienced director who was on the South African Airways board for more than nine years and who held herself as a 'corporate governance expert'. In South Africa, the formulation and application of the dual objective and subjective standard to the director's separate duty of skill has been criticised because it has been complicated by an inelegant drafting of section 76(3)(c) of the Act.[661] It has been argued that the continued use of 'skill together with care and diligence in connection with an objective standard in s 76(3)(c)(i), the legislature intentionally or mistakenly made the duty of the director to exercise skill subject to an objective standard.'[662] The implication of elevating the director's duty of skill to an objective standard means that it

[658] Re D'Jan of London Ltd [1994] 1 BCLC 561 at 563.
[659] [1994] 1 All ER 261, 264b CA.
[660] (15996/2007) [2019] ZAGPPHC 957 at 9.
[661] Mongalo T supra op cit note 10 at 151.
[662] Mongalo T supra op cit note 10 at 151.

is no longer sufficient for directors to bring to the performance of their functions the degree of skill that they possess. Directors and senior managers are therefore under a continuing duty to acquire and maintain sufficient knowledge and understanding of the company's business to enable them to sufficiently discharge their duties.[663] Professor Mongalo correctly points out the absurdity of subjecting the director's duty to exercise skill to an objective standard because the law, both in South Africa and the United Kingdom, does not require a director to possess any 'special skill or acumen in the execution of his or her corporate service' and creates a risk for directors and senior managers to be 'routinely sued for failure to exercise an objective of skill is heightened and the generous provisions make this risk even more elevated'.[664]

Mortimore confirms that it is not easy to discern the basis for this development of the standard of skill from the authorities dealing with this issue.[665] He states that Hoffman J in *Norman v Theodore Goddard*[666] did not hear an argument on this point but was willing to assume that an objective test was relevant in determining the standard of skill required of directors should be determined objectively nor did he elaborate why he held such a view.[667]

In re Barings plc[668] is an important English decision that dealt with the degree of a director's duty of skill. This case concerned disqualification orders sought against three of the company's former directors. In the facts of the case, a single trader carried out unauthorised activities in Singapore, which resulted in major losses to the company and subsequently a collapse of the company due to the lack of supervision and monitoring of the trader concerned. The court held that the directors did not comply with the objective standard appropriate for directors with their status and experience. Parker J held that '[d]irectors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors'.[669] He, furthermore, stated that 'It is a truism that if a manager does not properly understand the business which he is seeking to manage, he will be unable to make informed management decisions to it.'[670]

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663 Mortimore S supra op cit note 609 at 295 – 296.
664 Mongalo T supra op cit note 10 at 151.
665 Mortimore S supra op cit note 609 at 294.
666 [1994] BCLC 1028 at 1030.
667 Mortimore S supra op cit note 609 at 294.
668 [1999] 1 BCLC 433.
669 Ibid at 536–537.
670 Ibid at 439.

The decision to require the standard of skill to be ascertained about an objective standard or criteria was endorsed by the Law Commission which expressed the view that the movement in the case law to a dual subjective/objective test was a 'remarkable example of the modernisation of the law by judges, facilitated of course by the changes in the insolvency legislation made by Parliament'.[671] Parker J *In re Barings plc*[672] expressed his three-limbed formulation of directors' separate duty of skill as follows:

> 'i) directors have, both collectively and individually, a continuing duty to acquire and maintain sufficient knowledge and understanding of the company's business to enable them to discharge their duties as directors. ii) whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions. iii) no rule of universal application can be formulated as to the duty referred to in ii above. The extent of the duty, and the question whether it has been discharged must depend on the facts of each particular case, including the director's role in the management of the company.'[673]

The CLRSG, subsequently stated that '…the community as a whole suffers if companies are run with less than objective standards of competence and it is appropriate to impose a mandatory standard'.[674] This approach has been correctly criticised as creating an expectation of both executive and non-executive directors and in the case of South African senior managers, to 'demonstrate comparable objective exercise of skill in the exercise of directorial duties, then this heightened level of skill expected of directors make the threat of personal litigation against directors an even more serious disincentive to corporate service…'[675] It is suggested that the correct and logical interpretation is to subject only the care and diligence to an objective standard under section 76(3)(c)(i) of the Act and only skill to be subjected to a subjective standard under section 76(3)(c)(ii) of the Act.[676] The court in

[671] Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties (Consultation Paper No 153, 1998 at para 13.19.
[672] [1999] 1 BCLC 433.
[673] [1999] 1 BCLC 436.
[674] CLR: Developing the Framework (March 2000) at para 3.68.
[675] Mongalo T supra op cit note 10 at 151.
[676] Mongalo T supra op cit note 10 at 152.

Organisation Undoing Tax Abuse NPC and Another v Myeni and Another[677] failed to make a distinction between the two sets of duties being 'skill' and 'care and diligence' and the two standards that should attach to each. The approach in the United Kingdom's, and by extension South Africa's, enforcement framework creates an unsustainable position that places directors at heightened risk which was described by Riley as follows 'An objective standard, however, would place on a director the risk that, given the person she is, her best would simply be not be good enough.'[678]

5.2.3. Exculpatory Clauses Under United Kingdom Law: How Exculpatory Clauses Interact with the Duty of Care, Skill and Diligence and the Business Judgement Rule

In the lead-up to the company law review in the United Kingdom, policy makers had to consider whether to include a statutory business judgment rule in the United Kingdom's corporate law. However, historically in the United Kingdom, the courts have been reluctant to second-guess commercial decisions made by directors in good faith which they consider to be in the best commercial interests of the company. In contrast, the business judgment rule is a core feature of Delaware corporate law.[679] The Law Commission considered whether the introduction of a statutory statement of the duty of care would create a need for a statutory business judgment to ensure the non-interference by the courts in commercial decisions made in good faith by directors.[680] The Law Commission concluded that it would not be necessary to incorporate a statutory business judgment rule and that it would be difficult to precisely formulate the scope and extent of the rule without narrowing the principle or being too rigid.[681] The CLRSG also agreed that a statutory business judgment rule was unnecessary and noted

[677] (15996/2007) [2019] ZAGPPHC 957 at 108, the court without properly expanding how the test was applied merely summed up the position as follows 'If both an objective and subjective test is applied, one can safely conclude that she did not act as a reasonable director in light of her vast experience as a director.'
[678] (15996/2007) [2019] ZAGPPHC 957 at 108, the court without properly expanding how the test was applied merely summed up the position as follows 'If both an objective and subjective test is applied, one can safely conclude that she did not act as a reasonable director in light of her vast experience as a director.'
[678] Riley C 'The Company Director's Duty of Care and Skill: The Case for an Onerous but Subjective Duty' (1999) 62 *The Modern Law Review* 697-724 at 700.

[679] See *Howard Smith v Ampol Petroleum* [1974] 1 All ER 1126 at 835; *Devlin v Slough Estates Ltd* [1983] BCLC 497 503-504; and *Birdi v Specsavers Optical Group Ltd* [2015] EWHC 2870 (Ch) para 246.
[680] Hill G & Conaglen M supra op cit note 630 at 27.
[681] Law Commission, Company Directors: Regulating Conflicts of interests and Formulating a Statement of Duties (Consultation Paper No 153, 1998) at paras 15.31 and 15.41.

that the courts historically had shown a proper reluctance to enter into the merits of commercial decisions.[682]

A further reason why a formal business judgment rule was deemed not to be necessary in the Companies Act, 2006 was that there has been remarkably little litigation in the United Kingdom by shareholders or any substantial private enforcement actions against public company directors even in the aftermath of the global financial crisis.[683] The United Kingdom makes provision for derivative actions in section 260 of the Companies Act 2006. However, it is generally accepted that this section will in all probability not lead to a notable increase in shareholder actions as policy makers introduced procedural hurdles for bringing a derivative claim.[684] The United Kingdom Company Law Reform: Status Report was of the view that these measures were necessary to address concerns that the law should not make it too easy for shareholders to bring frivolous claims against directors and they serve to limit the scope for shareholders to bring legal actions against directors without good cause.[685]

In contrast in South Africa, section 165 of the Act introduces the new statutory derivative action that has significantly widened the categories of persons that have legal standing and the right to sue in the name of the company against wrongdoers who are in control of the company.[686] The United Kingdom Companies 2006 Act limits the institution of a derivative claim only to shareholders of the company.[687] South African legislation does not provide any limit and does not specify the causes of action that may be the subject of derivative proceedings. In addition, section 165(1) of the Act provides for a wide cause of action that the statutory derivative action may be initiated to protect the legal interests of a company a great scope for applicants to institute a derivative claim. According to Cassim, section 165 of the Act has introduced a new 'streamlined statutory derivative action' and that 'the procedural barriers and hindrances, and the problematic concepts of fraud on the minority, wrongdoer control and

[682] Law Commission, Company Directors: Regulating Conflicts of interests and Formulating a Statement of Duties (Report No 261,1999) at paras 5.28 -5.29.
[683] CLR: Developing the Framework (March 2000) at para 3.69.
[684] Hill G & Conaglen M supra op cit note 630 at 27.
[685] United Kingdom Company Law Reform: Status Report August 2006 at 4.
[686] Ibid at 4.
[687] Under the common law and section 266 of the 1973 Act the right to sue was only available to shareholders of the company whereas section 165(2) of the Act extends the right to sue to: '2(a) a shareholder or a person entitled to be registered as a shareholder of the company or of a related company; b) a director or prescribed officer; c) a representative trade union of the employees of the company or any other representative of employees of the company; and d) a person who has been granted leave by a court to initiate proceedings.

the ratifiability principle, which constituted hostile deterrents to the protection of minority shareholders are all jettisoned.'[688]

In addition, the circumstances in South Africa and the United Kingdom are different regarding personal liability litigation against directors and senior managers. In recent cases, South African directors have been the subject of personal liability claims. The recent cases involving personal liability litigation against directors in South Africa reveal a trend highlighting the heightened risks and likelihood of lawsuits against directors and senior managers.[689] Some of the cases involving personal liability litigation against directors include the high profile cases of *Hlumisa Investment Holdings (RF) Ltd and another v Kirkinis and Others,*[690] *Organisation Undoing Tax Abuse NPC and Another v Myeni and Another*[691] and *De Bruyn v Steinhoff International Holdings N.V. and Others*[692]. In the latter case, the applicant brought an application seeking authorisation to represent three classes of shareholders in a class action suit. The application was the first shareholder class action that had been brought for certification before the South African courts under the Act. This shows that the standing rules for bringing personal liability actions against directors and senior managers have been immensely relaxed by the Act and that means that directors and senior managers are not immune to actions that could result in personal liability.[693]

In light of the increased focus on accountability and the heightened likelihood of lawsuits against directors and managers under the United Kingdom's, and by extension the South African, approach the question that has to be considered is how the legal safe harbours such as the business judgment rule and exculpatory clauses interact with the duty of care and whether this legal enforcement framework model exposes or insulates directors and senior managers from the likelihood of personal liability when sued. At this juncture, it is important

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[688] MF Cassim unpublished PhD Thesis 'The Statutory Derivative Action Under the Companies Act of 2008: Guidelines for the Exercise of the Judicial Discretion' (2014) at 8.
[689] Mongalo T supra op cit note 10 at 148.
[690] [2020] JOL 47567 (SCA).
[691] (15996/2007) [2019] ZAGPPHC 957.
[692] (29290/2018) [2020] ZAGPJHC 145; 2022 (1) SA 442 (GJ) (26 June 2020).
[693] See section 157(1) of the Act which provides that 'When, in terms of this Act, an application can be made to, or a matter can be brought before, a court, the Companies Tribunal, the Panel or the Commission, the right to make the application or bring the matter may be exercised by a person- (a) directly contemplated in the particular provision of this Act: (b) acting on behalf of a person contemplated in paragraph (a), who cannot act in their own name; (c) acting as a member of, or in the interest of a group or class of affected persons, or an association acting in the interest of it members; or (d) acting in the public interest, with leave of the court.' See also Mongalo T supra op cit note 10 at 148.

to enquire what measures (if any) under the United Kingdom model exist for the exculpation or eliminating director liability.

In the United Kingdom before the 1929 Companies Act, it was generally accepted that the courts gave effect to provisions in articles that effectively exempted directors and officers of the company from liability to it, provided that they were not guilty of fraud or ‘willful neglect or default’.[694] Section 152 of the 1929 Act brought into effect provisions recommended by the Greene Committee that recommended a prohibition of provisions in the articles exempting and indemnifying directors. Subsequent statutory provisions have provided that clauses for exemption or indemnity are void. Section 310 of the Companies Act 1985, which was the successor to section 205 of the Companies Act 1948, provided that any provision which purports to exempt a director against any liability which would otherwise attach to him in respect of any negligence, default or breach of duty or breach of trust of which he may be guilty in relation to the company, was void.

There was considerable discussion on the precise scope of the provisions that fell into the ambit of section 310 of the Companies Act 1985.[695] The issue related to the application of the section because Table A of the model form of the articles contained provisions which appeared to modify and partly allow the exclusion of directors' duties.[696] This created a paradox between the conflicting provisions of the section and Article A.[697] The question was whether, (and if so) to what extent, articles adopted by companies which do not exactly follow the Table A articles, are valid. This problem was considered in *Movitex Ltd v Bulfield*[698] where the court held that the articles were valid and did not infringe on the provisions of the Act. However, the Motivex case dealt with the analysis of corporate contracts in which directors were interested. The court was of the view that it would be absurd to think that the directors’ duty of care, skill and diligence was capable of being modified through the articles.[699] Vinelott J concluded in *Movitex* that section 310 and exclusions by articles such as article 85 of Table A cannot be reconciled without producing undesirable results.

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[694] *In re Brazillian Rubber Plantation and Estates Limited* [1911] 1 Ch 425; *Re City of London Insurance Co* Ltd (1925) 41 TLR 521 and *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407.
[695] Sealy L ‘Company Directors' "Duties" and Exempting Articles’ (1987) 2 *The Cambridge Law Journal* 217 – 219 at 217.
[696] Ibid at 218.
[697] Ibid at 219.
[698] (1986) 2 BCC 99 at 403.
[699] Ibid at 403.

Section 232 of the United Kingdom Companies Act 2006 now contains a general prohibition on exemption and indemnification of directors concerning their negligence, default, breach of duty, or breach of trust about the company, subject to certain exceptions on indemnification.[700] Section 232 of the 2006 Act largely restates and preserves the previous position which was contained in section 310 of the Companies Act 1985 that prohibited exemption clauses. Section 232 provides that:

> ‘(1) Any provision that purports to exempt a director of a company (to any extent) from any liability that would otherwise attach to him in connection with any negligence, default, breach of duty or breach of trust to the company is void.
>
> (2) Any provision by which a company directly or indirectly provides an indemnity (to any extent) for a director of a company, or an associated company, against any liability attaching to him in connection with any negligence, default, breach of duty or breach of trust concerning the company of which he is a director is void, except as permitted by-
>
> (a) section 233 (provision of insurance),
>
> (b) section 234 (qualifying third-party indemnity provisions), or
>
> (c) section 235 (qualifying pension scheme indemnity provision).
>
> (3) This section applies to any provision, whether contained in a company’s article or any contract with the company or otherwise…’

Section 232(1) of the 2006 Act has cleared the debate as to whether the articles of a company can exempt a director from certain duties. The use of the term ‘to any extent’ means that the prohibition is a blanket prohibition against exculpatory clauses. Hill insists that even though section 232(2) lists some exceptions to the statutory prohibitions on exemption or indemnification of directors for liability these tend to be narrower than the safe harbours under the United States and in particular Delaware statutory law.[701] It is argued that the United States and those states that have followed the prominent example of the state of Delaware have adequately addressed the extent of liability of directors for breach of the duty of care, which represents the best model that makes provision for exculpatory statutes.[702] The availability and

[700] Mortimore S supra op cit note 609 at 448.
[701] Hill G & Conaglen M supra op cit note 630 at 33.
[702] Ramsay I supra op cit note 610 at 141.

reliance on insurance or indemnification is inadequate to mitigate the financial disincentive to corporate service because of the heightened risk of personal liability.[703] It can be argued that because the United Kingdom model and enforcement framework, which South Africa has followed, only provides for statutory insurance and indemnification of directors and senior managers under limited exceptions as the only safe harbours exposes directors and senior managers to personal liability for breaches of the duty of care, skill and diligence and pose a financial disincentive to corporate service in both jurisdictions that could have been properly mitigated through exculpatory statues. The heightened risk of personal financial liability for directors and senior managers is also made more pronounced by the possibility of delinquency orders being sought against directors and senior managers in terms of section 6 of the United Kingdom Company Directors Disqualification Act, 1996 and section 162 of the Act, respectively.[704]

5.2.4. Reasons Why the United Kingdom Opted to Retain the General Prohibition Against Exemption Clauses

The principle underlying the prohibition of exemption clauses protecting directors and senior managers from liability for negligence, default, breach of duty, and breach of trust was explained by Attorney General, Lord Goldsmith who stated that:

> '…the starting point for our reform package was a principle…that companies should be prohibited from exempting directors from, or indemnifying them against, liability for negligence, default, breach of duty or breach of trust concerning the company. However, the reform package also recognised that companies should be permitted to indemnify directors in respect of third-party claims in most circumstances…There are four main possible exceptions to indemnification: criminal penalties; penalties imposed by regularity bodies; costs incurred by the director in defending criminal proceedings

[703] Ibid at 141.
[704] With regards to the South African position see *Gihwala and Others v Grancy Property Ltd and Others* (20760/14) [2016] ZASCA 35; [2016] 2 All SA 649 (SCA); 2017 (2) SA 337 (SCA) 35, *Organisation Undoing Tax Abuse NPC and Another v Myeni and Another* (15996/2007) [2019] ZAGPPHC 957 and *Sanlam Capital Markets (Pty) Ltd v Mettle Manco (Pty) Ltd and Others* (12/07159) [2014] ZAGPJHC 134.

in which he is convicted; and costs incurred by the director in defending civil proceedings brought by the company in which final judgment is given against him.'[705]

Lord Goldsmith confirms the point of departure and approach in the United Kingdom that considered the use of exculpation clauses as providing overprotection to directors which view was expressed by the Greene Committee.[706] The Greene Committee considered the increasing or common use of exculpatory clauses was scathing in its assessment of these clauses, stating that: 'We consider that this type of article gives quite unjustifiable protection to directors. Under it, a director may with impunity be guilty of the grossest negligence provided that he does not consciously do anything which he recognises to be improper'.[707] It is important to note that the Green Committee's report was issued in 1926 and the recommended reform that prohibits and invalidates any provision exempting directors from liability for breach of duty, including the duty of care, was passed in 1928.[708] Arguably, the underpinning reasons for the continued prohibition against exemption clauses have not been revisited or reviewed since 1926. This raises the question of whether such reasons are still valid and appropriate under modern corporate laws.

It is submitted that the real weakness in the United Kingdom's model or enforcement framework lies in the model's failure to find an appropriate balance between two equally important policy objectives of accountability and the protection of directors and senior managers, which points to a fatal flaw whether increasing the amount of 'skill', 'care and diligence' required of directors and senior managers will create a disincentive for suitably qualified persons to serve as directors and senior managers because of the heightened risk of personal financial liability. Ramsay argues that a proper evaluation of the rules governing liability must be conducted and the question must be asked whether incentives are created for directors to take the appropriate amount of care i.e., 'care decision', and whether incentives are created for people to participate as directors at appropriate level i.e., 'activity-level decision'.[709] He affirms the view expressed by Johnston that a middle ground needs to be sought between '…the need for punishing faithless fiduciaries against the need to protect aggressive managers who are willing to take good faith risks in the search for profits…we must seek the middle

[705] Hansard, Lord Grand Committee, 9 February 2006 at 364.
[706] Greene Report supra op cit note 46 at 35.
[707] Greene Report supra op cit note 46 at 37.
[708] The Companies Act 1928.
[709] Ramsay I supra op cit note 610 at 144.

ground between encouraging fiduciaries to violate their trust and discouraging them from serving at all.'[710]

The strongest argument that could be advanced to minimise the liability of directors and senior managers for breach of the duty of care, skill and diligence is not only that substantial risk may inhibit directors and senior managers from taking good faith risks aimed at maximising profits but that '…it can be doubted whether the courts are in the best position to evaluate the merits of business decisions made by directors.'[711] The argument is premised on the proposition that it may be easier for courts to assess breaches of the duty of loyalty than the duty of care violations because the enquiry with regards to the latter requires the court to conclude that the behaviour of the director or senior manager concerned did not meet the required standard, which decision necessitates the court to know prevailing business practices and behaviour.[712] It is not suggested that the court cannot evaluate the process by which a decision was made to ensure that it was made on an informed basis and in good faith but rather that the courts may '…lack the expertise to evaluate the actual merits of a business judgment in a duty of care violations case…'[713] The validity of this argument is underscored by the fact that in both jurisdictions the 'informal business judgment rule' in the United Kingdom and the 'statutory business judgment rule' in South Africa offer very little protection to directors and senior managers against personal liability for breaches of the duty of care, skill and diligence. In Australia, the statutory business judgement rule has been described as an 'alien graft on Anglo Australian corporate jurisprudence of no real assistance to directors',[714] 'largely symbolic'[715], and mere 'window dressing'.[716] It can be expected that the business judgment rule will not be of much assistance to directors and senior officers under the current model and enforcement framework and they remain exposed to liability for errors of judgment in the absence of exculpatory statutes.[717]

Another reason that has been suggested for the continued prohibition against exemption clauses in the United Kingdom is that companies in the United Kingdom developed from

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[710] Ramsay I supra op cit note 610 at 144.
[711] Ramsay I supra op cit note 610 at 144.
[712] Santow G 'Codification of Directors' Duties' (1999) 73 *AUSTL. L.J.* 336 – 350 at 337.
[713] Bird J 'Duty of Care and the CLERP Reforms' (1999) 17 *CSLJ* 141 – 159 at 151.
[714] Young N 'Has Directors' Liability Gone Too Far or Not Far Enough? A Review of the Standard of Conduct Required for Directors under Sections 180–184 of the Corporations Act' (2008) 26 *Company and Securities LJ* 216 – 234 at 222. The business judgment rule was incorporated into Australian corporate law through section 180 of the Australian Corporations Act 2001.
[715] Hill G & Conaglen M supra op cit note 630 at 31.
[716] Hill G & Conaglen M supra op cit note 630 at 31.
[717] Hill G & Conaglen M supra op cit note 630 at 31 - 32.

unincorporated joint stock companies which had strong contractual elements, whereas United States corporations were originally quasi-public entities subject to state control.[718] As a result of the divergent origins, United States corporations required explicit statutory authorisation for the inclusion of exculpatory statutes in the company's charter, whereas companies in the United Kingdom could freely amend articles of association to include exculpatory clauses, without any specific authorisation. The inclusion of exculpatory clauses was justified in the United Kingdom under both contractual and general fiduciary principles before the legislature intervened and prohibited the use of exculpatory clauses.[719]

In conclusion, some of the reasons proffered for the continued prohibition against exculpatory clauses are stronger than others. Taking into consideration the heightened risk of personal financial liability for directors and senior managers under the current statutory formulation of the duty of care, skill and skill together with the lack of protection under the business judgment rule, it may be argued that statutory exculpatory clauses should be considered. It was, however, clear throughout the company law review process, that the relevance of exculpatory clauses did not receive much attention as policy makers were content to retain and restate the previous position, and that there was no indication whether the Greene Committee's views expressed in 1926 were still appropriate.[720] There was nothing to suggest that the inclusion of exculpatory clauses would have resulted in the overprotection of directors and senior managers. The research indicates that no strong argument was made for the continued prohibition of exculpatory clauses.[721]

5.3 Legal Developments in the United States of Delaware and the Enactment of Exculpatory Statutes

According to Ramsay, corporate governance and the scope of directors' duties have been the subject of extensive debate in the United States particularly in the manner in which large

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[718] Greene Report supra op cit note 46 at 37.
[719] Ramsay I supra op cit note 610 at 136.
[720] Dooley P 'Two Models of Corporate Governance' (1992) 47 *BUS. LAW* 461 – 527 at 469. See Delaware General Corporation Law section 141(a) provides that 'the business and affairs of every corporation organised under this chapter shall be managed by or under the direction provided in this chapter or in this certificate of incorporation.'
[721] It is submitted that subsection 78(2) of the Act should be amended accordingly. See Mongalo T supra op cit note 10 at 141. See also para 7.3.

corporations are being managed by directors.[722] It has been recognised that directors' authority and their duties create tension in corporate law. It has been accepted that at the 'heart' of corporate authority lies with the board of directors, who have the authority to manage the corporation.[723] However, in carrying out their managerial roles directors and officers are charged with duties to the corporation and its shareholders. Clark identified fiduciary duties, which include the duty of care, as a key component in holding directors and officers accountable, and he states that:

> 'Most corporate law is concerned with the array of substantive rules and procedural devices that are aimed at controlling managerial slack and diversion while preserving adequate discretion to carry out business operations efficiently. Put in other words, the law displays a constant tension, and a constant striving for a good balance, between the fiduciary duties of care and loyalty on the one hand and the business judgment on the other…Seen in this light, the study of corporate law is a study of the legal system's attempts to control managerial discretion in an important class of large, complex, formal organizations….The central problem of corporate law [is] the optimal control of managerial discretion…Corporate law's major conceptual contribution to the solution of the problem (the fiduciary principle), the major substantive rules it deploys to implement that concept, and its distinctive set of enforcement mechanisms…should be of great interest as a source of more general reflections about the allocation and control of power in highly organized societies.'[724]

The tension between directors' statutory authority to manage the business affairs of the corporation and accountability has been characterised as the defining tension in corporate law.[725] It has been argued that a strict accountability regime would inevitably reduce 'the efficiency of corporate decision-making'.[726] Whereas deference to the board's authority would necessarily involve a risk of 'opportunism or even plain carelessness'.[727] The importance of

[722] Ramsay I supra op cit note 610 at 136.
[723] Dooley P supra op cit note561 at 469. See Delaware General Corporation Law section 141(a) provides that 'the business and affairs of every corporation organised under this chapter shall be managed by or under the direction provided in this chapter or in this certificate of incorporation.'
[724] B Clark *Corporate Law* 2ed (1986) Little, Brown at xxiii.
[725] Veasey E 'The Defining Tension in Corporate Governance in America' (1997) 52 *Bus. Law.* 393 – 406 at 403.
[726] Bainbridge S 'The Business Judgment Rule as Abstention Doctrine' (2004) 53 *Vand. L. Rev* 83 – 130 at 129.
[727] Ibid at 129.

choosing an appropriate balance between authority and accountability has been described as ‘the central problem of business judgment jurisprudence.’[728]

An unmistakably broad question of the degree to which business participants ought to be free to limit or eliminate ‘the fiduciary and other duties of those who have the ultimate power to manage the organization’ has been aptly described as among ‘the most complex questions’ in corporate law.[729] This section examines the development of director and senior manager liability exculpation under United States statutes, and in particular under the Delaware General Corporation Law and Model Business Corporation Act and explores the extent of contractual freedom that shareholders have to exempt directors and senior managers from liabilities for the breach of duty of care in the state of Delaware.[730] The Delaware model represents a balanced approach that provides a middle-ground approach concerning the due care liability of directors and senior managers. It is argued that the United States model represents an appropriate balance for directors’ liability exculpation for duty of care violations that South Africa could adopt to provide measured protection to directors and senior managers. Based on experience garnered from the United States, and in particular the state of Delaware guidelines are suggested for the approach for reform in South Africa. It is submitted that the real weakness in section 78 of the Act lies in that it does not permit greater insulation to directors and senior managers from exposure to monetary liability for duty of care breaches in sections 78(2) and (4) to (6) of the Act, which contains a fatal flaw that renders the protective measured defective and calls for legislative amendment. Pending such amendment, proposals will be suggested for the proper approach to balancing the underpinning policy of accountability and protection of directors and senior managers in South Africa, in the meantime, to address the troublesome provisions of the Act in line with the Delaware approach or model.[731] These proposals are supported by both reasoned argument and original research on experience in the state of Delaware.

An obvious starting point is examining the journey of the corporate directors and senior managers’ duty of care under Delaware law, the business judgment rule, and the relationship

[728] Ibid at 129.
[729] Havenaga M supra op cit note 2 at 311, wherein she states that the office of company director is ‘one of the most complex fiduciary offices’.
[730] Mongalo T supra op cit note 371 at 3, notes that ‘….[a]lthough over half of the states in the U.S. have adopted the Model Business Corporations Act…. Substantially in its entirety as their general corporation statute, the state of Delaware, which is unofficially regarded as the national source of corporation law, has not adopted the Model Act as its general corporation statute. Particularly in the area of directors’ standards of conduct and liability, Delaware still relies on the common law and has not enacted for that.’
[731] See Chapter 7.

between these two. The state of Delaware has long been considered the preeminent jurisdiction of business incorporation in the United States, and its judges have been described as sitting at 'the centre of the corporate law universe'.[732] The persuasive role Delaware law plays in the protection of directors and senior managers jurisprudence, and the unique role of Delaware courts in shaping the duty of care cannot be overlooked.[733] An explanation for the divergence of the standards of conduct and review is considered together with the standards of care and review in decision-making and oversight contexts. A brief overview of the standard of care under the Principles of Corporate Governance and the Business Corporation Act will be examined, as well as the business judgment rule. Lastly, the chain of events that occurred in the wake of the landmark corporate law case of *Smith v Van Gorkom*[734] and the legislative response as contained in section 102(b)(7) of the Delaware General Corporation Law will be discussed. It is concluded that policy makers in the state of Delaware were correct in enacting statutory provisions to insulate directors and senior managers from monetary liability for breaches of the duty of care.[735]

5.3.1. The Duty of Care in the State of Delaware: The Difference Between a Standard of Care and a Standard of Review

The Model Business Corporation Act[736] provides that standards of conduct are distinct from standards of review. Eisenberg explains that standards of conduct include conduct that is required of directors and aspirations for what is expected of directors.[737] Whereas, standards of review, govern whether directors will be held liable or a transaction set aside as a result of a particular action or inaction.[738] What is clear is that the standard of review does not perfectly coexist with the standard of conduct, as the duty of care imposes a strict standard of care on corporate directors but the applicable standards of review for the performance of this duty are lenient.[739]

[732] Bainbridge S supra op cit note 730 at 120.
[733] Bainbridge S supra op cit note 730 at 121.
[734] 488 A.2d 858 (1985).
[735] Sharfman B 'The Enduring Legacy of Smith v Van Gorkom' (2008) 33 *Del.J.Corp.L.* 287 – 310 at 290.
[736] MODEL BUS. CORP. ACT (MBCA) §§ 8.30-31 (2002).
[737] Eisenberg M 'The Divergence of Standards of Conduct and Standards of Review in Corporate Law' (1993) 62 *Fordham L. Rev.* 437 – 468 at 462.
[738] Ibid at 468.
[739] Ibid at 465.

Eisenberg has stated that a strict standard of review that imposes liability on directors and senior managers might discourage directors from taking risks and induce them to be over-cautious in an attempt to avoid litigation.[740] He argues that the law should not discourage directors and senior managers from making 'bold but desirable decisions'[741], as such a posture would 'defeat one of the very purposes for which the corporation exists'.[742] He also notes that protecting directors and senior managers from excessive liability is necessary to attract competent individuals to serve as directors.[743] It is argued that lax standards of review give directors greater freedom to make risky decisions without fear of personal liability as it is accepted that business decisions are virtually always made with less than perfect information and thus decision makers are required to assess and assume some degree of risk.[744]

According to Eisenberg, the law seeks to send directors and senior managers a two-part message that their '…legal duty is to act with due care. At the same time, [it is] to give [them] a certain amount of running room so that …[they]… are not unduly risk-averse or otherwise preoccupied with liability.'[745] Therefore, although directors and senior managers are required to act per their conduct rules i.e. a standard of conduct, lenient standards of review ought to give directors and senior managers a certain margin which is essential to managing complex and large corporations.[746] He points out that, standards of conduct are neither meaningless nor merely aspirational but are intended to control behaviour and the rules have a real bite.[747]

5.3.2. The Standard of Care: Decision Making and Oversight

Lubben and Darnell point out that before 1985 the duty of care led 'a normal, humble existence in Delaware law' and the business judgment rule protected shareholders against extreme cases of managerial incompetence.[748] They conclude that this standard was changed by the *Smith v*

[740] Ibid at 462.
[741] Ibid at 465.
[742] Ibid at 445.
[743] Ibid at 445.
[744] Ibid at 445.
[745] Ibid at 448.
[746] Allen W, Jacobs J & Strine E 'Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem' (2002) 96 *Northwestern University Law Review* 449 – 446 at 454.
[747] Eisenberg M supra op cit note 575 at 456.
[748] Lubben S & Darnell A 'Delaware's Duty of Care' (2006) 31 *Delaware Journal of Corporate Law* 589-630 at 589. See also Eisenberg M supra op cit note 741 at 444, wherein he states in the context of decision making that '….[i]n the case of business decisions it may often be difficult for factfinders to distinguish between bad decisions

Van Gorkom[749] decision and the classical duty of care no longer exists in Delaware law. The courts have long recognised 'the inherent tension in corporate law between discretion and accountability, and this tension is especially acute in the duty of care context.'[750]

Initially, American law was largely silent on the standards to be adhered to by directors and senior managers in the performance of their duties. The courts in the US followed the British rule of 'gratuitous mandatories' as at this stage directors served as such without remuneration and could only be liable for 'want of care' in cases involving near fraud.[751] In the early twentieth century, courts were abandoning the notion of directors as 'gratuitous mandatories' and replacing it with the notion of directors as corporate fiduciaries.[752] Later the court's view began to change and there was a shift from an agency analogy to a trust analogy, and a corresponding shift to a higher expectation of care on the part of directors.[753] Delaware embraced a formulation of the standard of care that directors could be held liable for failure to exercise the level of care expected from 'a hypothetical, reasonable director—that is, the standard became negligence.'[754]

Earlier Delaware cases were often not clear as to whether the state followed the earlier agency theory of director care or the newer New York trust-law theory.[755] However in 1939, the court in *Guth v Loft* [756] dealt explicitly with the duties and obligations owed to the shareholders by the directors of a corporation and held the court that while the directors were not trustees, they stood 'in a fiduciary relation to the corporation'. It is important to note that in Delaware the fiduciary duties of directors are generally subdivided into the duty of care and the duty of loyalty, including good faith.[757] The duty of care in the United States forms part of a director's fiduciary duties, whereas in South Africa where the duty of care is traditionally a duty distinct from the fiduciary duties of a director.[758]

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and proper decisions that turn out badly. Business judgments are necessarily made on the basis of incomplete information and in the face of obvious risks, so that typically a range of decisions is reasonable.'

749 488 A.2d 858 (1985).

750 Lubben S & Darnell A supra op cit note 752 at 594.

751 Lubben S & Darnell A supra op cit note 752 at 595.

752 Lubben S & Darnell A supra op cit note 752 at 595.

753 Lubben S & Darnell A supra op cit note 752 at 596.

754 Lubben S & Darnell A supra op cit note 752 at 596.

755 Lubben S & Darnell A supra op cit note 752 at 596.

756 Guth v Loft 23 Del. Ch 255, 5A (2d) 503 (Del. Ch 1939).

757 See Smith v Van Gorkom 488 A.2d 858, 872 (Del. 1984) where the court clarified that good faith was 'described colloquially as part of a 'triad' of fiduciary duties that includes the duties of care and loyalty'.

758 The duty of good faith is dealt with in section 76(3)(a) & (b) of the Act 71 of 2008. Whereas section 76(3)(c) includes the director's duty of care, skill and diligence.

In the period leading up to the *Smith v Van Gorkom*[759] decision, several cases in Delaware courts blurred the interpretation of the director's duty of care. In 1963 the Supreme Court in the matter of *Graham v. Allis-Chalmers Mfg. Co*[760] explained that directors must 'use that amount of care which ordinarily careful and prudent men would use in similar circumstances.' This decision placed Delaware in line with the majority of jurisdictions that treated the duty of care as a standard negligence that was limited by the business judgment rule.[761] However, some prior Delaware decisions had accepted gross negligence as the standard of care.[762] The confusion was largely attributed to the competing theories of duty—trust and agency and persisted even after the *Smith v Van Gorkom* decision.[763]

There are currently two well-known formulations of the duty of care in the United States. The latest being the American Law Institute's Principles of Corporate Governance: Analysis and Recommendations (1994). This is based on the earlier Revised Model Business Corporation Act 1984.

Section 4.01 of the ALI Principles of Corporate Governance presents the duty of care as closely linked to some fiduciary duties in the following manner:

> 'A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinary prudent person would reasonably be expected to exercise in a like position and under similar circumstances.'[764]

Before the ALI's came into effect the American Bar Association's Committee on Corporate Law had formulated a proposed reversion of the Model Business Corporations Act in 1974 that provided that a director shall perform his duties: 'in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances and in

[759] 488 A.2d 858 (1985).
[760] 188 A.2d 125, 130 (Del. 1963).
[761] Lubben S & Darnell A supra op cit note 752 at 598.
[762] Lubben S & Darnell A supra op cit note 752 at 599.
[763] Lubben S & Darnell A supra op cit note 752 at 600.
[764] This section was based on s 8.30 (a) of the Model Act which provides as follows:―(a) A director shall discharge his duties as a director…(1) in good faith; (2) with the care an ordinary prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation'.

a manner he reasonably believes to be in the best interest of the corporation.'[765] The American Bar Association's Committee commented on the proposed provision as follows:

> 'The phrase 'in a like position' recognises that the 'care' under consideration is that which would be used by the 'ordinarily prudent person' if he were a director of the particular corporation. The combined phrase 'in a like position…under similar circumstances' is intended both to recognize that
>
> (a) the nature and extent of responsibilities will vary, depending upon such factors as the size, complexity, urgency and location of activities carried on by the particular corporation,
>
> (b) decisions must be made on the basis of information known to the directors without benefit of hindsight, and
>
> (c) the special background, qualifications, and management responsibilities of a particular director may be relevant in evaluating his compliance with the standard of care.'[766]

It is important to note that in the United States and in particular the state of Delaware that 'skill' is not specifically required on the part of a director because it is believed that 'skill, in the sense of technical competence as opposed to ordinary care, has never been a requisite for the corporate director.'[767]

Cassidy is of the view that the tests for the standard of care in both the ALI Principles of Corporate Governance and the Model Act contain both elements of subjectivity and objectivity.[768] She argues that the 'ordinary prudent person' test in both formulations leads to an objective test in the greater scheme of things.[769] The objectivity of the test from both formulations is reinforced by the requirement that the conduct be that of a 'prudent person…in a like position and under similar circumstances.'[770] Similarly, just like the duty of care in South Africa, the United States' duty of care takes into account the circumstances within which the directorial function is performed and how the power conferred is exercised.

[765] American Bar Association Model Business Corporation Act Annotated (3rd ed) 1986 at 926.
[766] Ibid at 929.
[767] E Broddsky and M Adamski *Law of Corporate Officers and Directors* (2011) West at para 2:04.
[768] Cassidy J –supra op cit note 363 at 387.
[769] Cassidy J supra op cit note at 387.
[770] Cassidy J supra op cit note at 387.

According to Eisenberg liability will be imposed on a director or senior manager ‘only if there is a clear variance between the conduct required by law and actual director conduct’.[771] He has identified a few main aspects of the duty of care in the state of Delaware which breaks down into four aspects which have an emphasis on care and diligence, namely:

‘(1) The duty of directors to reasonably monitor or oversee the conduct of the corporation's business, and, as a corollary, to take reasonable steps to keep abreast of the information that flows to the board as a result of monitoring procedures and techniques.

(2) The duty of inquiry-that is, the duty to follow up reasonably on information that has been acquired and should raise cause for concern.

(3) The duty to employ a reasonable decision making process.

(4) The duty to make reasonable decisions the duty to monitor; the duty to inquire, the duty to be informed; and the duty to make reasonable decisions.’[772]

In the decision-making context, directors and senior managers are required to employ a reasonable decision-making process and to make reasonable decisions which means that directors and senior managers are required to be adequately informed on the subject matter of a decision and to make a reasonable decision upon considering all relevant information.[773] In the oversight context, the duty of care requires that directors and senior managers reasonably monitor the conduct of the corporation’s business affairs.[774] It is also a requirement that directors and senior managers should have at least a rudimentary understanding of the business of the corporation.[775] In addition, directors and senior managers are under a continuing obligation to maintain an awareness of significant developments and to consider any material and adverse developments that come to their attention.[776] The courts interpret the standards of the duty of care and diligence in conjunction with the business judgment rule, whereby the courts ‘will give directors wide latitude in the management of the corporation’s affairs as long as they reasonably exercise an honest, unbiased judgement’.[777]

[771] Eisenberg M supra op cit note 741 at 456.
[772] Eisenberg M ‘The Duty of Care of Care of Directors and Officers’ (1990) 51 *U. Pitt. L. Rev.* 945 – 972 at 948.
[773] Ibid at 952.
[774] Ibid at 951 – 952.
[775] Ibid at 951.
[776] Ibid at 952.
[777] W Knepper Liability of Corporate Officers and Directors (1978) 3rd ed Lexis Nexis California at 20.

5.3.3. The Standard of Review: The Business Judgment Rule and Decision Making

The business judgment rule was developed in the United States alongside the duty of care and is firmly entrenched in the United States common law.[778] The rule can be traced back as far as 1829.[779] The business judgment rule was developed 'because of a desire to protect honest directors and officers from risks inherent in hindsight reviews of their unsuccessful decisions, and because of the desire to refrain from stifling innovation and venturesome business activity.'[780] The business judgment rule has not been codified in the state of Delaware because it is accepted that the rule has already been well-developed and established by case law. The rule aims to provide a safe harbour for directors and senior managers by restraining judicial control over board decisions.[781]

The United States has two major formulations of the business judgment rule, the Delaware business judgment rule which was formally adopted in the case of *Aronson v Lewis*[782] where the court described the rule as a presumption; and the ALI-business judgment rule[783] which declares the business judgment rule a safe harbour. Under the *Aronson* standard, the business judgement rule is 'a presumption that in making a decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company.'[784] In defining the relationship between the duty of care and the business judgement rule the Supreme Court in *Aronson v Lewis*[785] refuted the criticism that Delaware courts failed to enforce the duty of care and the court clarified the misconception that the business judgment rule immunised directors and senior managers from the duty of care by stating that:

> '[T]o invoke the [business judgement] rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably

[778] Kennedy-Good S & Coetzee L supra op cit note 376 at 64.
[779] Kennedy-Good S & Coetzee L supra op cit note 376 at 64.
[780] American Law Institute Principles of Corporate Governance and Structure: Restatement and Recommendations (1982), Tentative Draft No 1 at 147.s
[781] Nietsch M 'Corporate Illegal Conduct and Directors' Liability: An Approach to Personal Accountability for Violations of Corporate Legal Compliance' (2018) 18 *Journal of Corporate Law Studies* 151 – 184 at 180.
[782] A2d 805, 812 (Del. 1984).
[783] The American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (Proposed Final Draft, 31 March 1992) s 4.01 (c).
[784] Aronson, 473 A.2.d at 812.
[785] A2d 805, 812 (Del. 1984).

available to them. Having become so informed, they must then act with the requisite care in the discharge of their duties'[786]

Some commentators interpreted the *Aronson* standard of care to include two distinct components, procedural and substantive.[787] The procedural element of the duty of care requires directors and senior managers to 'inform themselves, prior to making a business decision, of all material information reasonably available to them.'[788] Whereas the substantive element requires that directors and senior managers 'having become so informed, they must then act with the requisite care in the discharge of their duties.'[789] However, there was confusion regarding what was meant by substantive care and how it differed from procedural care. However, the court *In re Caremark Int'l Inc. derivative Litig.*[790] stated that if the courts were to review the substantive quality of a decision for its reasonableness, then the business judgment rule would have no utility. The court observed that: 'To employ a different rule – one that permitted an 'objective' evaluation of the [substance of a] decision – would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interest.'[791]

The Delaware Supreme Court's subsequent analysis of the business judgment rule in *Van Gorkom* muddied the waters even more and was met with heavy criticism and it was described as being 'misguided'.[792] The decision was said to have pierced the business judgment and imposed personal liability on independent outside directors of Trans Union Corporation because the court thought they had not been careful enough in approving a cash-out merger.[793] Herzel and Kazt stated that in *Van Gorkom*, the directors were found liable for something that not only failed to produce a disaster but was in fact a success because the shareholders received a premium of $17 over the market price.[794] In addition, it has been argued that the decision failed to appreciate that the courts cannot evaluate adequately the decision of directors, such a task is best left to the market for directors, and more importantly that the imposition of

[786] Aronson, 473 A.2.d at 812.
[787] Johnson L 'The Modest Business Judgment Rule' (2000) 55 *Bus. Law.* 625 – 652 at 627.
[788] Aronson, 473 A.2.d at 812.
[789] Aronson, 473 A.2.d at 812.
[790] 698 A.2d 959 (Del. Ch.1996) at 967.
[791] Ibid at 967.
[792] Herzel L & Katz L 'Smith v Van Gorkom: The Business of Judging Business Judgment' (1986) 41 *The Business Lawyer* 1187-1193 at 1188.
[793] Manning B supra op cit note 550 at 1.
[794] Herzel L and Katz L supra op cit note 796 at 1187.

additional personal liability will result in directors being too cautious in their business decisions and that this may consequently render such directors ineffective.[795]

The Delaware court's application of the director's and senior manager's duty of care and the business judgment rule is of particular importance to South Africa. It is noteworthy that the South African business judgment rule is based on the United States model, which views the rule as a presumption in favour of the board and a safe harbour restraining judicial control over board decisions. Consequently, useful lessons may be gleaned from the experience and decisions of the Delaware court, as the business judgment rule has yet to be judicially tested since its introduction in the Act. This view is reinforced by section 5(2) of the Act, which enjoins the courts to consider foreign law, to the extent appropriate, in interpreting or applying the Act.

In the early to mid-1980s, there was an outbreak of hostile takeovers in the US and, in response, the Delaware court, which was traditionally sympathetic to corporate directors expanded the obligations of directors significantly to protect the best interests of the corporation and its shareholders.[796] The cases examined hereunder show that the court is appearing to change its approach by restricting the limits of the protection offered by the business judgment rule and it is expected that some of these decisions will influence the discourse on the interpretation and application of director's and senior manager's duty of care vis-à-vis the business judgment rule in South Africa.[797]

In *Unocal Corp v Mesa Petroleum Corp.*[798] the court held that directors addressing a takeover bid have an 'enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.'[799] The court had to determine whether the board's decision to resist a hostile takeover by using defensive measures to benefit certain shareholders and some directors was reasonable in relation to the threat posed. The Delaware Supreme Court formulated a new, improved standard of review and stated that directors must satisfy the court that they acted in good faith, after a reasonable investigation, and are under a clear duty to protect the corporation.[800]

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[795] Herzel L and Katz L supra op cit note 796 at 1187.
[796] Jones E supra op cit note 274 at 327.
[797] Jones E supra op cit note 274 at 327.
[798] 493 A.2d 946 (Del. 1985) 946.
[799] Ibid at 946.
[800] Ibid at 947.

In *re Walt Disney Co Derivative Litigation,*[801] the plaintiffs brought a derivative action against the directors of the company alleging the breach of the board's duty of care in the employment of Michael Ovitz, a close friend of CEO Michael Eisner, as its president and chief operating officer and the subsequent approval of his severance package worth $140m within 12 months. In the Delaware Court of Chancery, the plaintiff's claims were dismissed because it found that the plaintiffs had failed to demonstrate the CEO's interest in the personal employment of a close friend. On appeal the Delaware Supreme Court allowed the plaintiffs to amend their pleadings to include the allegation that the facts raised a reasonable doubt that the board's decision enjoyed the protection of the business judgment rule. It was found that the friendship between Eisner and Ovitz, and the fact that Ovitz's employment was negotiated between the two of them raised questions about Eisner and the board's independence. The court was also critical of the fact that it only took the board no more than 10 minutes to approve Ovitz's employment contract and that the minutes of the decision were contained in one and a half pages.

In *Texlon Corp v Meyerson*[802] it was alleged that the directors had breached their fiduciary duty by allowing the chairman of the board to take an opportunity that was open to the company to develop a product within the company's line of business, and then sell the technology back to the company. It was alleged that the chairman dominated the board to such an extent that it could not be said that the transaction was approved by independent directors. On appeal, the Supreme Court held that there were not enough facts to decide whether or not the directors were independent and a stricter test for director independence was applied.

In *Krasner v Moffat,*[803] two companies with several communal board members entered into merger negotiations with each company having set a special committee of independent directors to assess the transaction. The shareholders of company A alleged that their directors had breached their fiduciary duties by approving the transaction because the shareholders of company B received a greater percentage interest in the merged entity. The court held that if a party challenging the board's decision is able to prove that those involved in the decision-making process lacked independence or otherwise breached any of their fiduciary duties, the

[801] 825 2nd 275 (Del Ch,2003).
[802] 802 A 2nd 257 (Del 2002).
[803] 826 A 2nd 277 (Del 2003).

presumption of the business judgment rule will have been rebutted and the court will apply the entire fairness standard.[804]

Since the decision in *Smith v Van Gorkom*, it could be argued that the Delaware court's approach there is a sharp departure from the position that existed before the Van Gorkom case[805] and the court has enhanced scrutiny for directors and senior managers in decision making.[806] Jones has observed that 'a common thread weaves through Delaware's recent opinions. The courts express a new reluctance to credit defendants' arguments which are premised on the assertion that the directors charged with making the challenged decision were independent.'[807] One commentator has argued that the *Van Gorkom* judgment effectively 'stripped corporate directors and officers of the protective cloak formerly provided by the business judgment rule, rendering them liable for the tort of gross negligence for the violation of their duties under the rule.'[808] The decision sent 'shockwaves' through the corporate establishment which resulted in a shrinking pool of available directors and senior managers and the limited availability and high cost of liability insurance.[809] Reacting to the concerns raised by *Smith v Van Gorkom* which confronted directors and senior managers with a very real possibility that courts would second guess the care with which they made corporate decisions and the resulting personal financial risk, the Delaware legislature quickly enacted section 102(b)(7) of the Delaware General Corporation Law to shield directors and senior managers from liability for breach of care.

It has been demonstrated that Delaware courts are prepared to disabuse directors and senior managers of the safe harbour effect of the business judgment rule even if they have complied with the requirements of making an informed decision after following a clear deliberative process. In the matter of *R Tornetta v E Musk*[810] the Delaware Court of Chancery was asked by a shareholder of Tesla Motors Inc to rescind a board decision to pay the CEO Mr Elon Musk a $56 billion pay package. The court in its opinion by McCormick C accepted that '…[A] board of directors decision how much to pay a company's chief executive officer is the quintessential business determination subject to great judicial deference. But Delaware law recognizes unique risks inherent in a corporation's transactions with its controlling stockholder.

[804] Ibid at 287.
[805] Jones RM supra op cit note 274 at 644.
[806] Jones RM supra op cit note 274 at 661.
[807] Jones RM supra op cit note 274 at 661.
[808] Howell L supra op cit note 440 at 559.
[809] Ibid at 654.
[810] (31 January 2024) C.A. No. 2018-0408 – KSJM.

Given those risks, under Delaware law, the presumptive standard of review for controlled-controller transactions is entire fairness.'[811] It is submitted that the court overlooked the process that the board of directors took in arriving at the decision: '…the duration of the process (nine months) and the number of board meetings (ten) as evidence that the process was thorough and extensive.'[812] It is clear that the board of directors had followed a process, but the court was not convinced that the size of the compensation sum was 'right' and considered it to be 'unfathomable'.[813]

The court noted Musk's 'superstar' effect and influence on the board of directors and that he effectively controlled this particular transaction.[814] The board had the onus to prove that the compensation was fair. It is important to note that no damages were claimed. However, the board had to defend its decision to grant the CEO a $56 billion pay package.[815] The testimony led on behalf of the board was that the process followed was extensive and long in that it involved several relevant persons. The court was not convinced that substantively the directors could show that this pay package was fair. The court went on to describe the package as 'unfathomable' and unfair to shareholders.[816] The decision was rescinded by the court as it agreed with the plaintiff.

The court stressed the fairness standard because Musk was considered to be a controller.[817] The decision has a bearing on the business judgment rule as a standard of review in the state of Delaware because the court, on grounds of fairness, denied the board of directors' judicial deference, even though the board had technically complied with the requirements of the business judgment rule. This means that if the board had implemented the decision (and there had been no proactive action by one of the shareholders to stop the implementation of the decision), the board could have been personally liable to the company and its shareholders for any losses and damages suffered as a result of the decision.

The case highlighted the dangers of the board of directors having too much faith in 'Superstar CEO's' because of how they affect the dynamics of the board, especially when they are potentially conflicted in a decision affecting their interests. It is argued that the decision is in all probability correct and accords with previous Delaware decisions where the court is

[811] Ibid at 1.
[812] Ibid at 5.
[813] Ibid at 180.
[814] Ibid at 2.
[815] Ibid at 2.
[816] Ibid at 5.
[817] Ibid at 104.

prepared to override the principle of judicial deference to the board's commercial decision, where fairness or where, in its view, the process followed was too superficial. As stated, the business judgment rule in South Africa, as contained in section 76(4) of the Act, is a defence and not a standard of review. However, in all probability is likely that the courts in South Africa will be constrained to follow this example and trend of enforcing directors' duties and rules more strictly under the current enforcement framework applicable to directors and senior managers because of its persuasive value. The measure of the protection afforded to directors and senior managers under the business judgment rule stands to be watered down further if South African courts follow this approach.

5.3.4. The Midpoint Collision: Smith v. Van Gorkom and its Effects

Smith v Van Gorkom[818] is arguably the most famous Delaware case in the history of corporate law and the area of the duty of care required by directors and senior managers.[819] The Delaware Supreme Court held that, despite the absence of bad faith, fraud, illegality, or self-dealing on the part of the directors were not protected by the business judgment rule because the court found that they had adequately failed to adequately inform themselves of the decision to approve the sale of the company. The court's decision, effectively exposed directors and senior managers to catastrophic liability which meant that their personal assets were exposed to seizure to satisfy monetary damages for the breach of the duty of care.[820] The Delaware policy makers swiftly responded by enacting section 102(b)(7) of the Delaware General Corporation Law. Section 102(b)(7) Delaware General Corporation Law permits certificates of incorporation or the charter to contain a provision that exculpates directors and senior managers from liability for monetary damages for a breach of the duty of care. Delaware became the first United States state to provide authorisation for the inclusion of exculpatory clauses in corporate charters permitting companies to exclude director and senior manager liability for good faith breaches of the duty of care, even where that breach involved gross negligence.[821] It is argued that section 102(b)(7) of the Delaware General Corporation Law plugged the *Smith v Van Gorkom* liability gap and exculpatory clauses are now a familiar part of the United States

[818] 488 A.2d 858 (Del.1985).
[819] Ramsay I supra op cit note 610 at 138.
[820] Mongalo T supra op cit note 10 at 151.
[821] Hill G & Conaglen M supra op cit note 630 at 31.

corporate law landscape with many states providing authorisation for exculpatory statutes and with almost every Delaware incorporated company amending their charter provisions to include such a provision.[822]

In *Van Gorkom*,[823] the facts briefly were that shareholders of Trans Union Corporation (‘TU’) sought rescission of a cash-out merger of TU to another entity. In the alternative, the shareholders claimed damages against members of the board of directors. A critical question was whether the board of directors had acted in an informed manner and was thus entitled to the protection of the business judgment rule in approving the cash-out merger. A related question was whether the shareholder's vote approving the cash-out merger ought to be set aside on grounds that the shareholders had not been properly informed. A central figure in the transaction was Mr. van Gorkom, who was the time was TU’s chairman and chief executive officer. It would appear that TU had been having problems with generating sufficient taxable income to offset large investment credits. One of the options that were considered, as a possible solution, was a leveraged buy-out of TU by another entity. The chief financial officer of TU had done a limited study and assessment of the value of the company’s stock and what would be necessary to service the debt. Van Gorkom without the knowledge of the board or senior management found a buyer. Van Gorkom called a special meeting of TU’s board. Before the meeting only a few board members were advised of the purpose of the meeting. This meeting included senior management. In the meeting Van Gorkom revealed the terms of the offer, reference was made to a further study, but it was not produced in the form of a report for the board to consider. Senior management was not in favour of the proposal, and they were concerned with the timing of the transaction. The transaction was approved by the board after a twenty (20) minute oral presentation by Van Gorkom. The motivation by Van Gorkom was devoid of the methodology used to arrive at the price of the stock of TU. After TU entered into the transaction senior management revolted against the decision. The board of directors went on to present the transaction for approval to the shareholders of TU. The court found that the board of directors had not made an informed decision on the transaction, and pertinent questions regarding the transactions were not raised. The court also stated that the information disclosed to the shareholders by the board on the transaction was insufficient for them to make an informed decision and therefore set aside the shareholders’ approval.

[822] Hill G & Conaglen M supra op cit note 630 at 19.
[823] 488 A2d 858 (1985).

The Supreme Court found the directors of TU personally liable for breach of their fiduciary duty of care.[824] The court stated that the directors had failed to reach an informed business judgement in a grossly negligent manner by failing 'to inform themselves of all information reasonably available to them'.[825] The directors were considered to have been grossly negligent because they did not make an inquiry regarding the intrinsic value of the company or regarding the adequacy of the $55 per share price, they did not review the merger agreement or any written summary of it, and they approved the merger within two hours relying on Van Gorkom's twenty-minute oral presentation.[826] They were found to be in breach of their duty of care for not making an informed business decision and therefore could not rely on the business judgment rule as a defence.[827] The court held that: 'Under the business judgment rule there is no protection for directors who have made an unintelligent or unadvised judgment.'[828]

The decision alerted the corporate directors that the business judgment rule was no longer an impenetrable shield and to the dangers inherent in careless investigations, particularly because, as Lee describes it, 'The Delaware Supreme Court appeared to go out of its way to use this case as a vehicle to revitalize the dormant duty of care doctrine.'[829] The finding which revived the dormant duty of care paved the way for directors and senior managers to be exposed to catastrophic personal liability for monetary damages for the lack of due care even if they acted in good faith and had no conflict of interest.[830]

In response to *Smith v Van Gorkom*, the perception of increased liability threat for directors and senior managers led to dramatic changes in the insurance market.[831] Directors' and Officers' liability insurers withdrew from the market completely or dramatically altered

[824] *Smith v Van Gorkom* 488 A.2d (Del. 1985) 876, 893. The courts' two findings were that '[W]e hold that the directors of Trans Union breached their fiduciary duties to their stockholders (1) by their failure to inform themselves of all information reasonably available to them and relevant to their decision to recommend the Pritzker merger; and (2) by their failure to disclose all material information such as a reasonable stockholder would consider important in deciding whether to approve the Pritzker offer.' – at 893. The majority decision went on to find that 'We conclude that Trans Union's Board was grossly negligent in that it failed to act with informed reasonable deliberation in agreeing to the Pritzker merger proposal…' The dissenting judgment, which was considered to be correct, made a distinction between inside and outside directors. They were also of the view that 'Directors of this caliber are not ordinarily taken in by a "fast shuffle"'. I am in agreement with the findings of the dissenting judgment as it takes into consideration the real-time pressures and incomplete information that directors have to often make – see Eisenberg M supra op cit note 741 at 444.
[825] *Smith v Van Gorkom* 488 A.2d (Del. 1985) at 879.
[826] *Smith v Van Gorkom* 488 A.2d (Del. 1985) at 877.
[827] See discussion on the business judgment rule at para 5.3.3.
[828] *Smith v Van Gorkom* 488 A.2d (Del. 1985) at 872.
[829] Lee T 'Limiting Corporate Director's Liability: Delaware's Section 102(b)(7) and the Erosion of the Director's Duty of Care' (1988) 136 *U. PA. L.* 239 – 280 at 249.
[830] Manning B supra op cit note 550 at 3.
[831] Eisenberg M supra op cit note 741 at 400.

their policies to decrease the availability and scope of coverage and/or increased the premiums and the amounts deductible under existing policies.[832] The declining availability of directors' and officers' liability insurance increased the likelihood of director and senior manager liability exposure even more, and the shortage of directors' and officers' liability insurance placed directors and senior managers in an unduly risky position.[833] In addition, there was an increase in the number of shareholder derivative actions and takeover claims, and Delaware courts became more willing to scrutinise director decisions by limiting the protection afforded by the business judgment rule.[834] The fear of personal liability became widespread and many incumbent directors resigned or refused to extend their directorship.[835] Sensing a potential corporate flight from Delaware, the state legislature enacted section 102(b)(7) of the Delaware General Corporation Law,[836] allowing directors to be released from liability for all breaches of the duty of care by allowing corporations to include a provision in their certificates of incorporation eliminating or limiting the personal liability of a director.[837]

Section 102(b)(7) of the Delaware General Corporation Law is an enabling provision that permits shareholders of a corporation to include provisions in their certificate of incorporation limiting or eliminating directors' liability for monetary damages for breach of the duty of care, but this excludes liability for (i) any breach of loyalty, (ii) acts or omissions not in good faith or which involve intentional misconduct or a known violation of law, (iii) unlawful payment of dividends or unlawful stock purchases or redemptions, and (iv)

[832] Eisenberg M supra op cit note 741 at 400 - 401.
[833] Eisenberg M supra op cit note 741 at 401.
[834] Jones R supra op cit note 274 at 644.
[835] The ABA remarked that the Smith v Van Gorkom 488 A.2d (Del. 1985) decision resulted in a severely constricted market for directors' and officers' liability insurance, that prompted many directors of United States companies to resign and/or refuse to stand for re-election – ABA South Africa Report, 2001 supra op cit note 12 at 21.
[836] Delaware General Corporation Law Del. Code Ann. tit. 8, § 102(b)(7), 2001.
[837] Section 102(b) provides: 'In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters: … (to indicate there is an unquoted section in between) (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with s 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.'

transactions from which a director or senior manager has derived an improper benefit.[838] Whitehead argues that the protectionist legislation that Delaware adopted in response to the increased risk faced by directors takes a middle ground between protecting directors and protecting shareholders.[839]

In the United States, all American jurisdictions except the District of Columbia have either a 'charter-option' or 'self-implementing' statutes that provide for the exculpation of directors (and in some instances senior managers) with some form of protection from personal liability for breach of the duty of care.[840] A significant number of states have followed the Delaware approach and adopted exculpatory statutes along the lines of section 2.02(b)(4) of the Model Business Corporations Act which provides that: '[t]he articles of incorporation may set forth…a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or the failure to take any action, as a director.' Some of these states include Alabama, Arizona, Arkansas, Connecticut, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Kentucky, Maine, Massachusetts, Mississippi, Montana, Nebraska, New Hampshire, North Carolina, Oregon, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. In addition, an overwhelming majority of Delaware corporations amended their certificates of incorporation to include exculpatory clauses shortly after the enactment of section 102(b)(7). A study commissioned in the year 2000 revealed that every Delaware corporation in a sample of one hundred 'Fortune 500' companies has adopted exculpatory provisions in their incorporating charters.[841] non-Delaware corporations have also adopted exculpatory in their charters of incorporation.[842] It is generally accepted that exculpation has become a default rule governing the due care liability of directors and senior managers in Delaware.[843]

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[838] Whitehead L 'Corporate Directors - An Endangered Species? A More Reasonable Standard for Director and Officer Liability in Illinois' (1987) 3 *U. Ill. L. Rev.* 495 – 521 at 507.
[839] Ibid at 508.
[840] Honabach D 'Smith v Van Gorkom: Managerial Liability and Exculpatory Clauses – A Proposal to Fill the Gap of the Missing Officer Protection' (2006) 45 Washburn L.J. 307 – 342 at 313. See also Vaaler B '2.02(b) or not 2.02 (B)(4): That is the Question' (2011) 74 *Law & Contemp. Probs.* 79 – 93 at 82 where two statutory approaches have been observed: the charter-option approach, first embodied by section 102(b)(7) of the DGCL, and self-executing statutes eliminating or limiting personal liability for money damages, with certain exceptions.
[841] L Hamermesh 'Why I do not Teach Van Gorkom' (2000) 34 GA. L. Rev. 478 – 503 at 497 – 499.
[842] Ibid at 497 – 500.
[843] It has been stated that 'exculpation provisions [virtually] became standard features in Delaware certificates of incorporation s stockholders of hundreds of existing corporations approved the addition of exculpation clauses in the certificate of incorporation and such provisions became routine in new incorporations.' – B Vaaler '2.02(b) or not 2.02 (B)(4): That is the Question' (2011) 74 Law & Contemp. Probs. 79 – 93 at 82.

The impact of exculpatory statutes is that, where the business judgment rule is not available, directors and senior managers will be protected from liability by an exculpatory charter provision provided that their actions do not fall within one of the exceptions contained in section 102(b)(7) or section 2.02(b)(4) of the Model Business Corporations Act. With effect from 1 August 2022, the state of Delaware amended its General Corporation Law to specifically permit the certificate of incorporation of a Delaware corporation to provide for the exculpation of officers or senior managers from liability to the corporation or its stockholders for money damages for breach of fiduciary duty as an officer or senior manager of the corporation.[844] However, directors and senior managers remain personally liable 'for wrongful conduct going beyond duty of care violations'.[845]

It is important to note that section 102(b)(7) permits only limitation or elimination of liability for the monetary damages arising out of a breach of the duty of care, not the duty of care itself.[846] An example of a charter provision is set forth below:

> 'No director or officer of the Company shall be liable to the Company or its stockholders for monetary damages for breach of fiduciary duty as a director or officer, as applicable, except to the extent such an exemption from liability or limitation thereof is not permitted under the Delaware General Corporation Law (the "DGCL") as presently in effect or as the same may hereafter be amended. No amendment to or repeal of this provision shall apply to or have any effect on the liability or alleged liability of any director or officer of the Company for or with respect to any acts or omissions of such director or officer occurring prior to such amendment or repeal.'[847]
>
> In addition, the enabling statute provides that the section applies to a corporation if shareholders approve a charter amendment to include an exculpatory provision. It has been suggested that he democratic nature of section 102(b)(7) is very appealing and in

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[844] Up to this point, only seven states afforded exculpatory protections to corporate officers and senior managers. These included: Louisiana, Maryland, Nevada, New Hampshire, New Jersey, Utah, and Virginia.
[845] *Arnold v Society for Sav. Bancorp, Inc*. 678 A.2d at 541 -542.
[846] In *Emerald Partners v Berlin* 787 A.2d at 92 the court states that '[A] section 102(b)(7) provision does not operate to defeat the validity of a plaintiff's claim on the merits, "it can operate to defeat the plaintiff's ability to recover monetary damages". See also Disney 907 A.2d at 572 where the court confirmed that '[S]ection 102(b)(7) does not eliminate the duty of care that is properly imposed on directors. Directors continue to be charged under Delaware law with a duty of care in the decision-making process and in their oversight responsibilities. The duty of care continues to have vitality in remedial contexts as opposed to actions for personal monetary damages against directors as individuals.'
[847] https://corpgov.law.harvard.edu/2022/08/04/delaware-approves-permitting-exculpation-of-officers-from-personal-liability/ - accessed on 23 January 2024.

Arnold v Society for Sav. Bancorp, Inc.[848] the court described the shareholder's election as follows:

> 'While it is often thought to be axiomatic that a wrong must have a correlative remedy, this is not always the case. The Stockholders of [the corporation] voted to enact the charter provision which now limits the recovery against directors. Thus, the absence of a remedy for monetary damages is directly attributable to the decision of the stockholder of [corporation] to enact the character provision authorized by 8 Del.C. s 102(b)(7) exempting directors from liability.'[849]

A charter provision duly authorised in terms of section 102(b)(7) constitutes an affirmative defence which must be positively raised by defendant directors and senior managers seeking exculpation under the relevant provision in the charter.[850] A director or senior manager needs to properly invoke section 102(7)(b) in an action for 'any claims for money damages against directors that are based solely on alleged breaches of the board's duty of care',[851] and a failure to assert the protection under an exculpatory provision constitutes a waiver on the part of the director or senior manager.

5.3.5. Evaluation

The scope of protection of exculpatory provisions is broader than just the decision-making context. Section 102(b)(7) is applicable in the oversight and monitoring context. Therefore, directors and senior managers are protected from monetary liability for duty of care breaches due to their inaction or passivity, including their failure to monitor the corporation. In contrast, the business judgment rule applies only if a director or senior manager has made a decision or judgment, and it provides no protection for failure to act or take any action. This would deal with the limitation of the protection available to directors and senior managers under the business judgment in section 76(4) of the Act.[852]

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[848] 678 A.2d at 541 -542

[849] Ibid at 542.

[850] In *Malpiede v Townson* 780 A.2d 1075 at 1095, the court described exculpatory clauses as 'a defence to raise and argue the applicability of the bar a Section 102(b)(7) charter provision to a due care claim…'

[851] Ibid 1095.

[852] Lombard S supra op cit note 252 at 617 states that '[I]t should furthermore be noted that the business judgment rule only applies in respect of actions taken or decisions made by directors. Refraining from doing anything would thus not entitle directors to the protection afforded by the business judgement rule, unless it was

It has been argued that the rationale supporting section 102(b)(7) is that it allows corporations to attract qualified persons to serve as corporate directors and senior managers and to encourage them to make risky, good-faith business decisions without fear of personal liability.[853] The concern is that the risk of personal financial liability arising from a breach of due care may deter many qualified and talented persons from serving on corporate boards and lead to over-cautiousness by those who do serve on boards. Therefore, shareholders include exculpatory provisions in corporate charters to ensure that directors and senior managers focus on business ventures and profitability rather than being worried or preoccupied with due care liability threatening their personal wealth.[854]

Nevertheless, the desirability of exculpatory statutes has been questioned and some commentators were critical of the enactment of section 102(b)(7).[855] In some instances, some commentators called for federal intervention in corporation laws to address what was perceived as Delaware's pro-management corporate policy.[856] The enactment of section 102(b)(7) was said to only serve to further Delaware's pro-management policy and to attract many corporations to incorporate in that state a practice which is referred to pandering to the to the desires of managers at the expense of shareholders.[857] However, Moodie argues that director liability statutes are an important consideration for corporations when choosing a state of domicile.[858] He argues that the answer to the question of why Delaware is dominant ranges from 'its friendliness towards managers, the stability and depth of its corporate law, quality of its specialized corporate judiciary, the lack of interest groups to compete with managers and shareholders, the indeterminacy of its legal doctrine, and networks effect of well-established corporate law'.[859] He points out that one of the things 'that lead states – and particularly Delaware – to be successful in the market for corporate charters…[is] the role of statutes limiting liability'.[860] Over time Delaware was handsomely rewarded when it innovated to

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a positive decision, meeting all the standards of decision-making under the business judgment rule, to do nothing.'

853 See *Prod. Res. Group L.L.C. v NET Group Inc.* 863 A.2d 772 (Del. Ch. 2004) at 793, where the court stated that exculpatory provisions encourage capable persons to serve as directors of corporations by providing them with freedom to make risky, good faith business decisions without fear of personal liability.

854 Ibid at 793.

855 Blank S 'Delaware Amendment Relaxes Directors' Liability' (1987) 44 *Wash. & Lee L. Rev.*111 – 134 at

856 Ibid at 128.

857 Ibid at 112. See also Carney J and Shepherd B 'The Mystery of Delaware Law's Continuing Success' (2008) Emory Law and Economics Research Paper No. 07-17, Available at SSRN: https://ssrn.com/abstract=999477 or http://dx.doi.org/10.2139/ssrn.999477 1 - 94 at 1.

858 Moodie G 'Forty Years of Charter Competition: A Race to Protect Directors from Liability?' (Harvard Law Sch. John M. Olin Ctr. for Law, Econ., and Bus. Fellows' Discussion Paper No. 1, 2004) 1 – 40 at 1.

859 Ibid at 1 – 2.

860 Ibid at 2.

protect directors and a key aspect of this race has been its attitude to protect from liability.[861] Therefore, it can be argued that a jurisdiction's capacity to attract corporations and by extension talented individuals to serve on the board of directors and senior managers is largely dependent on the protection available to directors and senior managers from personal financial liability for breaches of the duty of care. This consideration is also particularly important for the South African position as one of the objects of section 7(g) of the Act is to ‘create optimum conditions for the aggregation of capital for productive purposes, and for the investment of that capital in enterprises and the spreading economic risk’. The lack of adequate protection of directors and senior managers under the current enforcement framework is at odds with the object of creating ‘optimum conditions’ rendering South Africa a less desirable destination for incorporation than jurisdictions that permit exculpatory statutes to insulate directors and senior managers from personal financial liability for breaches of the duty of care.

In addition, the *Smith v Van Gorkom* decision serves as a cautionary tale of the limitations of the business judgment rule and the inadequacy of indemnification and liability insurance. Slaughter noted that in Delaware the decision led to a severe constriction of the market for liability insurance and to a disincentive for corporate service which effectively meant that indemnification and liability insurance proved to be inadequate and unavailable to mitigate the risk to directors and senior managers for liability for breach of care violations.[862] Mongalo argues that South African directors and senior managers are ‘…at a competitive disadvantage when compared with directors and senior managers of companies formed under the laws of jurisdictions with exculpatory statutes.’[863] The Delaware solution allowing shareholders to waive their right to sue directors and senior managers from liability for breach of the duty of care appears to be ‘the most effective, efficient and popular method’[864] that can delicately balance the imperative of accountability and protect directors and senior managers from the threat of personal financial liability for breach of care violations that South African can follow.[865]

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[861] Ibid at 2.
[862] Slaughter S supra op cit note 57 at 181. See Chapter 6 wherein the argument is made regarding the inadequacy of extended indemnification and liability as an appropriate solution to protecting directors and senior managers from personal liability for duty of care violations under the current enforcement framework.
[863] Mongalo T supra op cit note 10 at 141.
[864] Whitehead L supra op cit note 840 at 512.
[865] See Chapter 7 where the proposal on amendments to section 78(2) of the Act.

5.4 Conclusion

In this Chapter, it has been shown that United Kingdom in the lead up to its company law reform policy makers glossed over the appropriate balance that needed to be struck between two equally important policy considerations of accountability and the protection of directors and senior managers from personal liability for breach of duty of care violations.[866] The United Kingdom's model or enforcement framework increases the risk of personal liability for directors and senior managers because of the heightened standard of 'skill', and 'care and diligence' without providing sufficient protection which creates a disincentive for corporate service.[867] In addition, the protection available under the business judgment is severely limited because of its construction.

It was also shown that there is little evidence, if any, that suggests that the inclusion of exculpatory clauses in the protection of directors and senior managers from personal liability for breach of duty care will lead to overprotection. The continued prohibition of exculpatory clauses under the current enforcement framework represents a fatal flaw given the heightened risk that directors and senior managers are exposed to should their good faith risk-taking prove unsuccessful in hindsight.[868] The deliberate unwillingness or inability of the legal system to properly balance the tension between accountability and protection begs the question of whether the current framework adequately maintains a middle ground between 'punishing faithless directors against the need to protect aggressive managers who are willing to take good faith risks in the search for profits…'[869] renders the consideration of any interests other than those of shareholders effectively nugatory.

The decision in *Smith v Van Gorkom* alerted the business community to the limitations of the protection afforded by the business judgment rule to directors and senior managers for breach of care violations.[870] The legacy of this decision was that it resulted in a severely constricted market for directors' and officers' liability insurance, which in turn prompted directors to resign or refuse to be re-elected which created a crisis in the state of Delaware.[871]

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[866] See para 5.2.
[867] See para 5.2.3 and 5.2.4.
[868] See para 5.2.4.
[869] Spisto M supra op cit note 104 at 61.
[870] See para 5.3.5.
[871] Slaughter S supra op cit note 57 at 181 - 182.

This Chapter also revealed that, reacting to the concerns raised by *Smith v Van Gorkom*, the Delaware legislature swiftly enacted section 102(b)(7) of the Delaware General Corporation Law. This section allows directors to be absolved of liability for breaches of the duty of care. Most corporations incorporated in Delaware took advantage of the new statute, amending or adopting exculpatory provisions providing directors and senior managers with meaningful protection from personal financial liability for breaches of the duty of care. The prevalence and importance of exculpatory statutes have been emphasised by the fact that they have been extended or enacted by 36 jurisdictions in the United States, except the District of Columbia, mainly through the Model Business Corporations Act and exculpation has virtually become a standard rule governing the due care liability of directors and senior managers.[872]

It was therefore not far-fetched for one commentator to conclude that the legislative response adopted by the state of Delaware to solve to the problem of increasing managerial susceptibility to personal liability for breach of the duty of care by permitting shareholders the option to waive their right to sue directors and senior managers 'appears to be the most effective, efficient and popular method for corporations to protect their officers and directors from the threat of personal liability in derivative actions'.[873] Although the business judgment rule has not been tested in South Africa, as it is relatively new, directors and senior managers are at risk of being found personally liable for business judgments taken in good faith that prove unsuccessful in hindsight.[874] The risk is further increased by the objective standard being applied to the separate duty of 'skill' in section 76(3)(c)(ii) of the Act which elevates the director's or senior manager's duty of skill to an objective standard making it no longer sufficient for directors or senior manager to bring to the performance of their functions the degree of skill that they actually possess, but rather that directors and senior managers are now under a continuing duty to acquire and maintain sufficient knowledge and understanding of the company's business to enable them to sufficiently discharge their duties under the current enforcement framework.[875]

[872] See Appendices: Table 1 - List of states in the US that have adopted the Model Business Corporations Act – 36 states have enacted the Model Business Corporations Act into local law.
[873] Whitehead L supra op cit note 8 at 512.
[874] Jones E supra op cit note 271 at 445.
[875] See para 5.2.2.

CHAPTER 6

THE SCOPE OF INDEMNIFICATION AND LIABILITY INSURANCE FOR DIRECTORS AND SENIOR MANAGERS UNDER SUBSECTIONS 78(4) – (7) OF THE ACT

6.1 Introduction

This Chapter demonstrates that the protection available to directors and senior managers under subsections 78(4) – (7) of the Act, permitting indemnification and liability insurance as possible methods companies can rely on to limit the extent to which their directors and senior managers are exposed to personal liability for negligence or default in the performance of their duties, remains inadequate to insulate them from the threat of serious financial liability for breaches of the duty of care, in the absence of exculpatory provisions.[876] It argued that the viability of indemnification and liability insurance as a means to strike an appropriate balance between holding directors and senior managers accountable and protecting them from liability for breach of the duty of care under subsections 78(4) to (7) of the Act should be of serious concern to corporations and those in managerial positions.[877] In other words, the specified

[876] Cassim et al supra op cit note 32 at 772.
[877] Mongalo T supra op cit note 10 at 149 -150.

exceptions permissible in the case of indemnification and liability insurance as methods to limit the extent of exposure to personal liability of directors and senior managers do not render the inclusion of exculpatory clauses unnecessary under the current legal enforcement framework. The extent and scope of the protection available to directors and senior managers through indemnification and liability insurance is significantly watered down because of several factors which include, amongst other things, the discretionary language used in subsections 78(4) to (7) of the Act, the cyclical nature of the insurance market, and the limitation of the policy terms and coverage.

There is a growing awareness that any regulation of the activities of the companies and their directors and senior managers must serve the dual objective of both the need to protect shareholders against mismanagement through the threat of personal liability and the need to encourage directors and senior managers to take good faith risks when exercising their business judgment.[878] In addition, the current legal enforcement framework has increased the standard expected of directors and senior managers for the discharge of the duty of care, skill and diligence under section 76(3)(c)(ii) of the Act.[879] Finally, the extension of legal standing to bring claims for breaches of duty of care violations and other personal liability litigation against directors and senior managers under the Act has further increased directors' and senior managers' potential exposure to legal suits and liability.[880] These developments in the current enforcement framework have exposed directors and senior managers to the real possibility of being held liable for monetary damages and defence costs that are in far excess of what has been experienced historically in South Africa.[881] Whether or not the legal suits brought against directors or senior managers have any merit to them, the costs of defending them will be enormous, and it is unlikely that individual directors and senior managers have the resources to cover such legal costs or adverse judgements that could run into millions.

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[878] Ramsay I supra op cit note 610 at 129. See also Cassim et al supra op cit note 32 at 772.

[879] Concerning the required degree of ‘skill’ as a separate aspect of the duty of care, a very subjective yardstick was used. Under the common law, directors were not expected to possess any particular degree of business acumen, experience or even some proficiency concerning the company’s area of business. All that was expected of them in terms of their duty to display the necessary degree of skill was that they must exercise the care that may reasonably be expected of a person with their specific knowledge and experience – see Fisheries Development Corporation of SA Ltd v Jorgensen at 166.

[880] Cassim et al supra op cit note 32 at 772, where Cassim observes that the Act provides a more effective means of enforcing the duties of directors and senior managers and a more effective derivative action in terms of section 165 of the Act. Accordingly, the remark is that the need for protective measures for directors and senior managers is perceived to be magnified under the current enforcement framework.

[881] Horney J supra op cit note 13 at 63.

The current legal enforcement framework applicable to directors and senior managers, which prohibits the inclusion of exculpatory clauses as a means of further protection, leads to a characteristic set of problems and yields a serious concern for corporations and their directors and senior managers, which are not properly countered through indemnification rights and liability insurance. The question has been posed whether the protection can be enhanced through expanded indemnification rights and liability insurance to the extent that they are capable of filling the gap and answering the liability problem for directors and senior managers for breach of duty of care violations, rather than exculpation, as a natural response to mitigate the risk faced by directors and senior managers.[882] It is demonstrated that the South African alternatives to exculpation are not appropriately expansive to address the dilemma of directors' and senior managers' personal liability for managerial decisions.[883] The problem of increasing managerial susceptibility to personal liability for breach of the duty of care requires that South Africa should find the middle ground between encouraging directors and senior managers to violate their trust and discouraging them from serving at all.[884] In other words, methods must be developed for the protection of directors and senior managers and senior managers against personal liability for breach of care violations because while indemnification and liability insurance still achieve the object of deterrence as shareholders retain their right to sue directors and senior managers, unlike exculpation, the inadequacy of these measures result in a potentially serious disincentive for corporate service especially in jurisdictions such as South Africa where directors and senior managers are subject to increased standards of care, skill and diligence which is further aggravated by the relaxed legal standing for bringing personal director litigation.[885]

In addition, an assessment of the viability of non-statutory responses/options such as 'captive insurance' reveals that the effectiveness of such methods is largely dependent on the financial means and foresight of the company concerned, which means that directors and senior managers have no legal basis for insisting on this form of protection as part of their service contract.[886] The fact that directors and senior managers have no legal right to insist on

[882] Mongalo T supra op cit note 10 at 150.
[883] Mongalo T supra op cit note 10 at 150.
[884] Spisto M supra op cit note 104 at 61.
[885] Mongalo T supra op cit note 10 at 150.
[886] Subsection 78(4) – (7) of the Act does not oblige a company to make provisions for indemnification or liability insurance for its directors and senior managers through captive insurance or otherwise. See Cassim et al supra op cit note 32 at 776, wherein it is stated that '[S]ection 78(4) does not go as far as s 124(5) of the Canada Business Corporations Act 1985, which imposes a mandatory statutory duty on a company to indemnify a director in respect of costs, charges and expenses reasonably incurred in the defence of any legal proceedings.'

exemption, indemnification, liability insurance and the adoption of risk mitigation measures such as captive insurance for claims alleging breach of duty of care suits highlights the inadequacy of the protection under the current enforcement framework.[887] It is expected that this lack of adequate protection via the bouquet of methods available to South African directors and senior managers will serve as a financial disincentive to corporate service, this argument also takes into consideration the inadequacy of the business judgment rule and judicial relief as the possible solution to the liability problem for breach of the duty of care which have been observed under the current legal enforcement framework.

This Chapter will not deal with the underlying substantive liabilities of directors and senior managers, as this has been dealt with in Chapter 3.[888] Rather, it will concentrate on the more legal and practical subject of the extent of indemnification and liability insurance as methods of protecting directors and senior managers against personal liability for duty of care violations under subsections 78(4) – (7) of the Act.[889]

[887] South African policy makers have not followed the Canadian approach under section 124(5) of the Canada Business Corporations Act, 1985 and made it compulsory for a company to indemnify its directors or senior managers in legal proceedings arising out of their service to the corporation. Section 124(5) of the provides that '[(5)] Despite subsection (1), an individual referred to in that subsection is entitled to indemnity from the corporation in respect of all costs, charges and expenses reasonably incurred by the individual in connection with the defence of any civil, criminal, administrative, investigative or other proceeding to which the individual is subject because of the individual's association with the corporation or other entity as described in subsection (1), if the individual seeking indemnity: (a) was not judged by the court or other competent authority to have committed any fault or omitted to do anything that the individual ought to have done; and (b) fulfils the conditions set out in subsection (3).' See also section 8.52 of the US Business Model Corporations Act which provides that '[A] corporation shall indemnify a director who was wholly successful, on the merits or otherwise, in the defense of any proceeding to which he was a party because he was a director of the corporation against reasonable expenses incurred by him in connection with the proceeding.'

[888] Under the common law, a director who was negligent in managing the affairs of the company was liable to incur delictual liability based on the general principles of the lex Aqualia. See Chapter 3 para 3.1.

[889] Cassim et al supra op cit note 32 at 775, wherein is states that '[S]ubject to the…exceptions of s 78(6) and to any contrary provisions of the company's Memorandum of Incorporation, s 78(5) permits the indemnification of any liability incurred by a director. This means there is now a considerably wider scope for the indemnification of the directors (and prescribed officers) of a company. It seems that a company may now indemnify a director in respect of liability arising from the negligence of that director.'

6.2 Indemnification of Directors and Senior Managers by the Company

6.2.1. History of Indemnification of Directors and Senior Managers in South Africa

A company cannot act on its own behalf, and its corporate actions have to be carried out through its representatives, also referred to as its 'organs'.[890] Lord Thurlow observed that a company 'had no soul to be damned and no body to be kicked'.[891] In terms of section 66(1) of the Act, the board of directors, one of the organs, is authorised and entrusted to manage the affairs of the company.[892] A director's and senior manager's common law duties include their obligations as a fiduciary. The term 'fiduciary' is applied to a large number of persons in diverse capacities, including commercial relationships.[893] The relationship between a company and a director of that company is an example of a commercial fiduciary relationship. However, the precise nature of the legal relationship between the company and a director and senior manager remains a controversial question.[894] A director or a senior manager can be seen as an agent because the director or senior manager does not act on his or her own behalf, but on behalf of the company. A director or senior manager can also be regarded as a trustee, since he does not own company assets, but controls them and exercises powers for the company's and not for his own benefit.[895] However, the relationship between a director or senior manager and a company remains unique. It is suggested that categorising directors as agents or trustees is intended to prove the existence of a fiduciary relationship rather than to equate directors with those particular positions.[896]

Johnson has observed that the recognised principle in the common law of agency is that a principal under a duty to indemnify an agent for damages the agent is required to pay to a third party on account of authorised performance by the agent for an act constituting a delict or breach of contract.[897] However, there appears to be serious gaps in the protection of directors and senior managers under common law and whether directors and senior managers should be

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[890] Havenga M supra op sit note 111 at 40.
[891] The quote is attributed to Edward, the first Baron Thurlow (1731-1806) and has been used in this chapter in the context of corporate responsibility. See Coffee J Jr. '"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment' (1981) 79 *MICH. L. REV*. 386-459 at 386.
[892] Cassim et al supra op cit note 32 at 538.
[893] Cassim et al supra op cit note 32 at 684. See also Havenga M supra op cit note 2 at 311.
[894] Cassim et al supra op cit note 32 at 552.
[895] Cassim et al supra op cit note 32 at 522.
[896] Havenga M supra op cit note 317 at 369.
[897] Johnston J supra op cit note 145 at 1994.

treated as 'agents' of the corporation.[898] He remarks that the extent of the law of directors' and senior managers' indemnification as a branch of the law of agency and 'the protection afforded to directors was doubtful, particularly in the case of a derivative action brought for the benefit of the corporate 'principal' against the director-'agent''.[899] In South Africa, it is recognised that directors and senior managers can incur personal civil liability for their role in corporate faults and defaults under the Act,[900] under specific legislation such as environmental law,[901] and also in terms of general delictual principles.[902] The extent to which a director may seek to be indemnified from liability for loss resulting from breach of all possible duties owed by a director to his company was not as clear as it would first seem under South African law.

Section 70, sext of the 1926 Companies Act, was introduced by Act 23 of the 1939 Act and stated that:

> 'Any provision, whether contained in the articles of a company or in any other contract with the company, and whether express or implied, which purports to exempt any director or officer or the auditor of the company from any liability which would otherwise attach to him in respect to 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 and such liability, is void.'

Section 70, sext of the 1926 Companies Act expressly prohibited both the exemption and indemnification of directors from any liability which would otherwise attach to him or her in respect to any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company. Essentially the same wording as contained in section 70sext in the Companies Act 46 of 1926 was carried over to section 247(1) of the 1973 Act which restated the prohibition against the exemption or indemnification of directors and officers against liability through private arrangements between themselves and the company, which

[898] Johnston J supra op cit note 145 at 1994.
[899] Johnston J supra op cit note 145 at 1994.
[900] For example, see section 77 of the Act.
[901]In terms of section 28(8) of the National Environmental Management Act, No. 107 of 1998 provides for the imputation of strict liability to a director or senior manager, where '…the offence in question resulted from the failure of the director member or partner to take all reasonable steps that were necessary under the circumstances to prevent the commission of the offence.' This means that criminal and/or civil proceedings may be instituted against a director or senior manager of a company for the recovery of costs and/or damages incurred for the rehabilitation of the environment or for failing to prevent environmental degradation caused by his/her firm.
[902] Van der Linde K supra op cit note 318 at 439.

would otherwise attach to them in respect of negligence, default, breach of duty or breach of trust. Section 247(1) states that:

> '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.'

An important proviso was added to s 247(1) by section 12 of Act 35 of 1998 to make an express provision for a company to take out insurance on behalf of its directors and officers. The proviso somewhat equated the provision of liability insurance to directors and officers as 'indemnification'. It is submitted that these are two separate concepts and the reference to the provision of liability insurance as indemnification created unnecessary confusion between the two concepts.[903] The amendment section 247(1) provided that:

> '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 which he may be guilty of in relation to the company or indemnify him from 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*.'
>
> (Own emphasis.)

There was some uncertainty as to the effect of this amendment on the position of directors and officers. It was suggested that the purpose of amendments permitting the purchase

[903] This was clarified in the Act. Subsection 78(4) – (6) of the Act deals with indemnification a concept that deals with the advancement of costs or amounts to a director or senior management by the company for defending legal proceedings or any liability 'in any proceedings arising out of the director's service to the company'. Whereas, a company may purchase insurance from an insurer to protect a director or senior manager from liability or expenses in terms of subsection 78(7) of the Act. See also Cassim et al supra op cit note 32 at 772 where he observed that companies have relied on certain methods in the past to limit the extent to which their directors were exposed to personal liability which included 'indemnities' which protected them from loss of as a result of some default and by effecting payments for directors' liability insurance which meant that the director would be indemnified by the insurer from any liability arising out his or her service to the company.

of insurance by the company on behalf of its directors and officers, was to protect the company.[904] It was uncertain, however, whether directors are protected in terms of the amendment to section 247(1) of the 1973 Act.

Some commentators argued that the rendered meaningless and directors' common-law duties, should it be accepted that liability insurance policies also serve to protect directors.[905] It was suggested that the only purpose of the amendment to section 247(1) is to protect the company and not its directors and officers.[906] It was also suggested that a director or officer will not be able to escape liability through the application of normal principles of insurance law, with specific reference to the principle of subrogation, in terms of which the insurance company should be able to recover the compensation paid by the company from the director or officer concerned.[907] This rather surprising proposition was been rejected and it was accepted that the correct interpretation was that directors and officers would stand to benefit very little, if at all, from insurance taken out by the company. The proviso specifically to allowed companies to purchase insurance to protect its directors and officers from all liability to compensate their company for losses caused to it as a consequence of their wrongdoing, provided they can obtain the necessary insurance cover.[908]

Subsection 78(4) to (6) Act has gone some way in clarifying the matter regarding the extent to which a director or senior manager could be indemnified by the company. Subsection 78(4) to (6) of the Act states that:

> '(4) Except to the extent that a company's Memorandum of Incorporation provides otherwise, the company-
>
> (a) may advance expenses to a director to defend litigation in any proceedings arising out of the director's service to the company; and
>
> (b) may directly or indirectly indemnify a director for expenses contemplated in paragraph (a), irrespective of whether it has advanced those expenses, if the proceedings-

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[904] Botha D & Jooste R 'A Critique of the Recommendations in the King Report Regarding a Director's Duty of Care and Skill' 1997 *SALJ* 65 – 67 at 66.
[905] Cilliers CH & Benade ML Corporate Law 3rd ed (2000) Butterworths, Durban, 2000 at para 10.56.
[906] Ibid at para 10.57.
[907] Ibid at para 10.57.
[908] Blackman et al Commentary on the Companies Act (2012 Juta).

(i) are abandoned or exculpate the director; or

(ii) arise in respect of any liability for which the company may indemnify the director, in terms of subsections (5) and (6).

(5) Except to the extent that the Memorandum of Incorporation of a company provides otherwise, a company may indemnify a director in respect of any liability arising other than as contemplated in subsection (6).

(6) A company may not indemnify a director in respect of-

(a) any liability arising-

(i) in terms of section 77(3)(a), (b) or (c); or

(ii) from wilful misconduct or wilful breach of trust on the part of the director; or

(b) any fine contemplated in subsection (3).'

It is important to note that for purposes of section 78 of the Act the term 'director' includes an 'alternate director', 'prescribed officer', a 'board committee member', 'or an audit committee member'.[909] Therefore, it is irrelevant if the concerned person is a part of the company's board of directors which means that senior managers of a company are also included in the application of section 78 of the Act.[910]

The important question of the extent to which a director or senior manager may seek to be indemnified by the company is dealt with more fully in paragraphs: 6.2.2 Instances where Indemnification is Prohibited in terms of Subsection 78(6) of the Act, 6.2.3 Instances When Indemnification is Permissible, and 6.2.4 The Operation of Indemnification: Advancement and Indemnification to Defend Legal Proceeding below. It is submitted that the meaning of the words 'arising out of the director's service to the company' in subsection 78(4) of the Act dealing with instances where indemnification is permissible can be read broadly to include

[909] See subsection 78(1) of the Act.
[910] The term 'director' is used in the extended sense of the word to include those listed in section 78(1) of the Act. The implication of the extended definition of the term 'director' was discussed in Chapter 3 para 3.2. See also M Botha 'Are Senior Managerial Employees Prescribed Officers in Terms of the Companies Act 71 of 2008 and Are They Treated the Same as Executive Directors?' (2012) 4 TSAR 786 – 800 at 749 to 750 where he stated that 'It is clear that…some senior managerial employees are regarded as "prescribed officers". This would, for example, be the case where such a person is in a similar position to that of a principal executive officer if a senior managerial employee takes part in the management and direction of the company, he will therefore fall squarely within the definition of "prescribed officer". This will obviously place onerous duties on him. It must also be mentioned that not all senior managerial employees are regarded to be 'prescribed officers'.'

indemnification by a company for loss resulting from acts performed by a director or senior manager in relation to claims brought by third parties, such as creditors and that its operation is not limited to duties owed to the company.[911] However, even though the instances under which indemnification is now permissible have been relatively broadened under the current enforcement framework the protection available to directors and senior managers is significantly reduced by the discretionary word 'may advance' used in subsection 78(4) which does not oblige a company to indemnify a director or senior manager but leaves it at the discretion of the company whether to indemnify a director for liability and expenses incurred for losses arising out of acts performed in the service of the company. Furthermore, the fact that the company in terms of subsection 78(4)(b)(i) of the Act reserves the statutory right to claw back any expenses advanced to a director or senior managers to defend litigation in any legal proceedings that were not been abandoned and where the court's finding does not exonerate the director or senior manager serves to erode further any protection that may have been afforded to the director or senior manager by subsection 78(4)(a) of the Act thus exposing their personal assets for attachment to satisfy adverse costs orders against the director or senior manager concerned.[912]

6.2.2. Instances where Indemnification is Prohibited in terms of Subsection 78(6) of the Act

Subsection 78(6) of the Act lists instances where a company is prohibited from indemnifying a director or senior manager.[913] Subsection 78(6) of Act the states that a company may not indemnify a director or senior manager in respect of the following:

(a) any liability arising in terms of section 77(3)(a), (b) or (c) of the Act, which relates to litigation where it is alleged that a director or senior manager knowingly acted without authority on behalf of the company; acquiescing in the fraudulent or reckless conduct of the company's business and contrary to

[911] Subsection 78(4) of the Act requires that the proceedings should arise from the directors' or senior managers' service to the company, which would include their dealings with third parties, such as creditors, bringing an action citing the director or senior manager as a defendant. This thesis is not concerned with the question of whether directors or senior managers owe a duty of care or fiduciary duties to third parties such as creditors. This question and debate fall outside the scope of this focus of this research.

[912] Cassim et al supra op cit note 32 at 775.

[913] Cassim et al supra op cit note 32 at 774, wherein the instances are listed when indemnity is prohibited in terms of subsection 78(6) of the Act.

section 22 of the Act; and knowingly being party to conduct calculated to defraud a creditor, employee or shareholder or for another fraudulent purpose.[914] Section 1 of the Act defines 'knowing', 'knowingly' or 'knows' to mean '…that the person either – (a) had actual knowledge of the matter; or (b) was in a position in which the person reasonably ought to have – (i) had actual knowledge; (ii) investigated the matter to the extent that would have provided the person with actual knowledge; or (iii) taken other measures which, if taken, would reasonably be expected to have provided the person with actual knowledge of the matter'.[915] It is argued that this definition will probably cause much confusion because of its broad nature and because it may blur the distinction between actual knowledge, deemed knowledge, and gross negligence because of the concerned director's or senior manager's failure to exercise reasonable care to become informed in a particular matter.[916]

(b) liability for wilful misconduct or wilful breach of trust on the part of the director or senior manager concerned.[917] It is generally accepted that conduct that is egregious should be incapable of indemnification.

(c) any fine contemplated in subsection 78(3) of the Act which provides that a company may not directly or indirectly pay any fine that may be imposed on a director or senior manager of the company, or on a director or senior manager of a related company, as a consequence of that director or senior manager

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914 Subsection 78(6)(a)(i) read together with subsection 77(3)(a), (b) and (c) of the Act.

915 Section 1 of the Act.

916 Bekink M supra op cit note 6 at 99 to 100, wherein she remarks that '[T]he Companies Act…distinguishes between an indemnification that may not be granted lawfully and one that may be granted lawfully. In terms of subs 78(6), an indemnity may not be granted to a director in respect of any liabilities arising in terms of subs 77(3)(a),(b),(c), or from wilful misconduct or a wilful breach of trust. The 'wrongful acts' contemplated in these provisions include, apart from wilful misconduct or breach of trust, a lack of authority, recklessness, gross negligence, fraudulent or insolvent trading, or defrauding of a stockholder. All three of these subsections require that the director should have acted knowingly to be held liable. The Act itself, unlike its predecessor, defines 'knowing' in Ch 1 to mean that the person acting in relation to a particular matter either 'had actual knowledge of that matter' or was in a position in which the person reasonably ought to have had actual knowledge…. It accordingly places an obligation on directors to be actively involved in matters affecting the company and to take measures to allow them to have actual knowledge of such matters. For non-executive directors, this could prove problematic…. This could lead to the situation where a company may not be able to indemnify a director in the event that she negligently failed to have actual knowledge.'

917 Subsection 78(6)(a)(ii) of the Act. See also Cassim supra op cit note 32 at 777 – where he states that 'this provision is perfectly sensible, because there is no good reason why a company should pay for the wilful misconduct or a miscreant director.'

having been convicted of an offence, unless the conviction was based on strictly liability.[918]

6.2.3. Instances When Indemnification is Permissible for Legal Expenses to Defend Legal Proceedings and for Liability (Damages)– Subsections 78(4) and (5) of the Act

Subsections 78(4) and (5) of the Act permit, but do not oblige, a company to have a provision in the company's Memorandum of Incorporation which provides for an indemnity of a director or senior manager for both the liability of the director or senior manager and the costs of defending the action.[919] Nothing in subsections 78(4) and (5) of the Act precludes the granting of indemnity to a director or senior manager through a provision in a contract, provided that the provisions of such a contract are not in conflict with the company's Memorandum of Incorporation. It is also possible for the company to grant indemnification on an ad hoc basis through a decision or resolution of the board of the company. However, such a decision will be subject to the company's Memorandum of Incorporation and the requirement that the board discharges its duties in terms of section 76 of the Act in paying the indemnity.[920] Gower and Davies state that 'Under an indemnity provision the company promises that the director will not bet out of pocket in relation to a claim made against him or her (whether by way of a judgement against the director, a settlement of the litigation or by or by the incurring of legal costs), so that, to the extent of that indemnity, the cost of the director's breach of duty is borne directly by the company'.[921]

However, Gower and Davies are of the view that directors and senior managers may prefer liability insurance over a promise of indemnity by the company because as they point out the company's promise may be empty or not worth very much if the company is very close to insolvency.[922] It is important to note that for purposes of subsections 78(4) and (5) of the Act that a company may promise an indemnity to a director or senior manager against liability

[918] Subsection 78(6)(b) read together with subsection 78(3) of the Act.
[919] Cassim et al supra op cit note 32 at 775.
[920] Bekink M supra op cit note 6 at 101, wherein she states that '…[i]t should be observed that the conditions of such indemnification and advance of expenses are at the discretion of the company as the Act specifically states that a company 'may' indemnify a director or 'may' advance expenses in any proceedings (see s 78(4) and (5) and it is therefore not obliged to do so.'
[921] Davies P and Gower S supra note 99 at 594.
[922] Davies P and Gower S supra note 99 at 594.

and costs incurred in an action 'to defend litigation in any proceeding arising out of the director's service to the company'[923] and for 'any liability'.[924] It seems clear that subsection 78(4) and (5) of the Act do not operate to prohibit indemnification in relation to claims brought by third parties, such as creditors or liability and costs incurred by a director or senior manager in an action brought by the company. The use of the words 'arising out of the director's service to the company' and 'any liability' render the scope broadly to include instances where a director or senior manager is sued by the company for a breach of the duty or by a third party, such as a creditor, subject to the limitation that the company may not provide indemnity for the listed categories in subsection 78(6) of the Act.

A serious point of concern is that the indemnification under subsections 78(4) and (5) of the Act is not a right that is statutorily guaranteed or available to directors and senior managers. Subsections 78(4) and (5) state that a company 'may' advance legal costs to a director or senior manager or 'may indemnify a director in respect of any liability arising…'. Bekink observes two main problems with the extent and scope of indemnification permissible under subsections 78(4) and (5).[925] First, in the event that a director or senior officer is not successful with his or her defence, the director or senior manager will be out of pocket for the legal expenses advanced by the company in terms of subsection 78(4) of the Act.[926] In addition, Cassim observes that legal costs to defend litigation include the fees of legal counsel which involves substantial amounts of money.[927] Second, the conditions of indemnification or advancement are at the discretion of the company as subsection 78(4) and (5) expressly state that a company 'may indemnify' or 'may advance expenses' to a director or senior manager.[928] She argues that because the company is not obliged to indemnify a director or senior manager this places them in a position of grave disadvantage as they will not be able to demand indemnification or advancement of expense, especially in the case of public companies as directors and senior managers may incur extensive liability for losses sustained by the company or towards third parties.[929]

In contrast, the Canadian and United States approach, indemnification under South African law, merely authorises, subject to the company's Memorandum of Incorporation to

[923] Subsection 78(4) of the Act.
[924] Subsection 78(5) of the Act.
[925] Bekink M supra op cit note 6 at 101.
[926] Bekink M supra op cit note 6 at 91.
[927] Cassim et al supra op cit note 32 at 775.
[928] Bekink M supra op cit note 6 at 101.
[929] Bekink M supra op cit note 6 at 101.

indemnify a director or senior managers for expenses incurred in successfully defending legal proceedings instituted against him or her or if the legal proceedings are abandoned.[930] Whereas, section 124(5) of the Canada Business Corporations Act 1985, imposes a statutory duty on a company to indemnify a director or senior manager for costs, charges and expenses reasonably incurred in the defence of any legal proceedings, provided that the director or senior manager acted honestly and in good faith with the view to the best interest of the company.[931] Similarly, section 8.52 of the United State Business Model Act provides for a mandatory obligation for the company to indemnify directors and senior managers for reasonable legal expenses incurred in successfully defending legal proceedings instituted against a director of the company.[932]

It is argued that a statutory right to indemnification for legal costs incurred by a director or senior manager in defending legal proceedings would have provided directors and senior managers with legal certainty concerning their exact legal position.[933] In addition, the effectiveness of the protection is eroded by the fact that the company reserves the right to reimbursement if the defence is unsuccessful or where the proceedings are not abandoned.[934]

6.2.4. Evaluation of Indemnification: Advancement and Indemnification to Defend Legal Proceeding

In the United Kingdom, it was suggested that if the company promised an indemnity against liability or costs incurred in an action brought by the company for a breach of a duty such a complete indemnity would come close to an exemption from liability, and thus defeating the purpose of the prohibition contained in section 232(1) of the United Kingdom Companies Act

[930] Subsection 78(4)(i) and (ii) of the Act.

[931] Section 124(5) of the Canada Business Corporations Act 1985 provides that the 'Right to indemnity
(5) Despite subsection (1), an individual referred to in that subsection is entitled to indemnity from the corporation in respect of all costs, charges and expenses reasonably incurred by the individual in connection with the defence of any civil, criminal, administrative, investigative or other proceeding to which the individual is subject because of the individual's association with the corporation or other entity as described in subsection (1), if the individual seeking indemnity(a) was not judged by the court or other competent authority to have committed any fault or omitted to do anything that the individual ought to have done; and
(b) fulfils the conditions set out in subsection (3).

[932] Section 8.52 of the United States Model Business Corporation Act provides that mandatory indemnification is required for a 'director who was wholly successful, on the merits or otherwise, in defense of any proceeding to which he was a party because he was a director of the corporation.'

[933] Bekink M supra op cit note 6 at 100.

[934] See subsection 78(4)(ii) and Bekink M supra op cit note 3 at 101.

2006.[935] This criticism overlooks the fact that a director or senior manager could only be indemnified by the company for legal expenses advanced in terms of an indemnity provision if their defence against a suit brought by the corporation is successful or if it is abandoned.[936] However, it may be difficult to apply subsection 78(4)(b) of the Act to a case where the director or senior manager settles or compromises the legal proceedings against him or her before a final judgment is awarded in the matter.[937] It is unclear whether it can be said that the director or senior manager has succeeded in their defence because the merits of the matter would not have been adjudicated by a court. It must be noted that even though the company's ability to indemnify a director or senior manager in respect of liabilities in legal proceedings is controlled and restricted by subsections 78(4) and (5) of the Act, it is possible for a company to lend or loan the director or senior manager money to defend the legal proceedings against him or her, provided that the board complies with its duty of care, skill and diligence in terms of section 76(3) of the Act in approving such a loan.[938]

There is some debate about whether is appropriate to leave the decision to indemnify a director or senior manager at the discretion of the company and its board or if it should be required by statute that a company should indemnify a director or senior manager for reasonable costs and expenses in defending legal proceedings arising out of their service to the company.[939] In the United Kingdom policy makers justified the company's discretion with reference to the principle that ultimately it should be a matter for the board of a company to determine the conditions of employment of its directors and senior managers.[940] Self-regulation advocates that a company should have the freedom to decide whether or not to indemnify or purchase liability insurance to protect its directors and senior managers. In addition, it is fitting

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935 Mortimore S supra op cit note 609 at 474. Section 232(2) of the United Kingdom Companies Act 2006 specifically states that indemnity can be provided to a director 'against liability incurred by the person other than the company'. This type of indemnity is referred to as 'qualifying third party indemnity'. See also Mortimore S supra op cit note 609 at 453.

936 Subsection 78(4)(i) and (ii) of the Act.

937 The reason is that often settlements or compromises are subject to confidentiality clauses and are as a result of certain commercial and strategic considerations. A judgment by a court or tribunal would fully assess the facts and applicable legal principles to determine liability and the basis for any cause of action. In the absence of a ruling by a court and without the benefit of the settlement terms, how will the company assess the appropriateness of indemnity to the director or senior manager? It creates a conundrum which could have been avoided by obligating the company to indemnify the director or senior manager, save for those prohibited instances in subsection 78(5) of the Act.

938 The board of directors will have to apply its mind to the question of indemnity or the purchase of liability insurance, unless this issue is specifically dealt with in the Memorandum of Incorporation – subsection 78(4) of the Act.

939 Bekink M supra op cit note 6 at 101.

940 Policy makers were of the view that 'ultimately it [was] a matter of the board [of a company] to determine the conditions of employment of senior employees' – Hansard – Standing Committee A, 14 September 2004 – as quoted by Mortimore S supra op cit note 609 at 474.

for the company to determine in its article the specific conditions and circumstances under which its directors and senior managers should be indemnified by the company or whether liability insurance will be purchased by the company to protect its directors and senior managers.[941] It is argued that the rationale for permitting a company to indemnify and purchase liability insurance to protect its directors and senior managers is twofold. First, it strikes a balance between punishing faithless fiduciaries and protecting directors and senior managers from personal liability for good faith risk-taking. This was aptly explained in the United Kingdom White Paper: Company Law Reform 2005, where it was explained as follows:

> 'the law on director's liability needs to strike a balance: on the one hand, the law must be firm and robust to deal fairly with cases where something has gone wrong, as a result of either negligence or of dishonesty: on the other hand, Britain needs a diverse pool of high-quality individuals willing to assume the role of company director, and a willingness by directors to take informed and rational risks.'[942]

Second, a heightened risk of exposure to personal liability exacerbated by inadequate protection for good faith risk taking under the current enforcement framework should not be a disincentive for corporate service. It is argued that subsections 78(4) to (7) of the Act should be amended to make indemnification and liability insurance mandatory for companies to secure indemnification and liability insurance as a right for directors and senior managers because some measure of protection is better than nothing.[943] However, this protection would best be augmented with a relaxation of the prohibition against exemption clauses in subsection 78(2) of the Act for liability for breaches of the duty of care violations to serve the need for South Africa to retain 'a diverse pool' of suitably qualified directors and senior managers that will be encouraged to take good faith risks without the fear of personal financial ruin should their decisions prove unsuccessful with the benefit of hindsight.[944] It has also been argued that a statutory right to exemption, indemnity and liability insurance for breaches of the duty of care, skill and diligence will have various advantages for directors and senior managers which will include legal certainty, bargaining power, and provide a uniform approach which is in line with best practices relating to the protection of directors and senior managers in jurisdictions, such as the United States model and in particular the state of Delaware model, which permits both

[941] Bekink M supra op cit note 6 at 101.
[942] Chapter 3, (Enhancing Shareholder Engagement and a Long Term Investment Culture) at 23.
[943] See Chapter 7.
[944] Mongalo T supra op cit note 10 at 151.

exculpation, indemnification and liability insurance as comprehensive solution to the director liability problem.[945]

6.3 The Provision of Insurance: Directors' and Officers' Liability Insurance

Directors' and officers' liability insurance was first developed in the United States as a response to the liabilities faced by company directors because of increased governmental regulation and the proliferation of third-party and shareholder derivative suits.[946] As a reaction to the surge of claims against directors, it became necessary for business management groups to find sufficient protection against what was termed as 'the spiral exposure to liability'.[947] Corporations preferred directors' and officers' liability insurance as the cure to protect directors and officers from 'honest mistake' or 'shakedown shareholder suits' as an attempt to retain competent managers.[948] One commentator in describing the liability of directors and officers referred to them as 'sitting ducks' because of the increased focus and scrutiny that they had become subjected to and which necessitated the development of sustainable methods which secured their protection, hence the development and prominence of directors' and officers' liability insurance policies.[949]

In this section, the focus will be on the need for insurance, an examination of some key aspects of the terms of a directors' and officers' policy, and lastly, an evaluation of the extent and scope of protection available to directors and senior managers under a directors' and officers' policy as permitted in terms of subsection 78(7) of the Act, in the absence of exculpation clauses because of the blanket prohibition contained in subsection 78(2) of the Act. In addition, it will survey the potential liabilities that directors and senior managers face under the current enforcement framework with reference to the personal liability for breach of the duty of care violations in section 76(3) of the Act. It will also consider the greatest risk factors

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945 Mongalo T supra op cit note 10 at 141 and 151. See also Bekink M supra op cit note 6 at 102.
946 Greenberg J and Dean B 'Protecting the Corporate Executive: Director and Officer Liability Insurance Reevaluated' (1975) 58 Marq. L. Rev. 555 – 588 at 555.
947 Ibid at 555.
948 Ibid at 555.
949 Bishop J 'Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers' (1968) 77 *YALE L.J.* 1078 – 1982 at 1078.

that directors and senior managers deem to be a deterrence for corporate service in South Africa currently.

6.3.1. The Need for Insurance: Directors and Senior Managers Heightened Exposure for Liability for Breach of Care Violations

Ramsay observes that ‘One of the most troubling questions facing company directors is to what extent they may insure themselves (or what extent their companies may insure them) against liability for the various duties that they owe to the company’.[950] This question is also relevant for company directors and senior managers and their position needs to be reevaluated in light of the provisions of subsection 78(7) of the Act which permits certain forms of insurance to be purchased by the company against the liability of its directors and senior managers.[951] The Act has partially codified some director duties and others have been refined by the courts and form part of directors' and managers' common law duties.[952] In particular and for purposes of this research, the Act has partially codified the directors' duty of care, skill and diligence in section 76(3)(c) of the Act which provides that a director or senior manager ‘must exercise the power and perform the functions of director – 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’.[953]

A director or senior manager could potentially be held personally liable for a breach of the duty of care which may give rise to an action for damages against the director concerned in contract or delict. A directors’ and officers’ liability insurance policy operates to protect a director or senior manager against their civil and personal liability for damages and defence costs for the breach of the duty of care, skill and diligence. According to Slaughter ‘insurance has never totally protected directors against the risk of monetary liability’ which means that insurance is meant to provide some measure of protection but not eliminate the financial burden

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[950] Ramsay I supra op cit note 610 at 141.
[951] See Cassim et al supra op cit note 32 at 772. who acknowledges that the extent to which this method (i.e. liability insurance), among others, is valid and permissible has a direct effect on the effectiveness of directors and senior managers as fiduciaries and the statutory duty of care imposed on them.
[952] Fiduciary duties of directors fall outside the scope of this study.
[953] Section 76(3)(c) of the Act is applicable in the decision and oversight aspects of the duty of care, skill and diligence.

from a director or senior manager.[954] This is because directors are expected under the policy to pay an excess or contribution towards the loss from their own pocket and any portion above the available policy limits, which can be substantial amounts.[955] It is also important to point out that indemnification and liability insurance do not eliminate the director's or senior manager's duty of care, skill and diligence.[956] Davies observes that 'Under an indemnity arrangement the director remains in principle liable but the company picks up the financial consequences of that liability'.[957] The argument that the removal of potential liability through exemption clauses, indemnification and liability insurance frustrates the goal of deterrence overlooks the fact that directors and senior managers remain under a duty to act with the necessary care, skill and diligence but for the arrangement regarding the payment of damages and costs. It is important to point out that the duty of care, skill and diligence remains vitally important for directors and senior managers in the context of removal proceedings in term section 69 of the Act.[958]

It is clear that liability insurance only limits or eliminates the monetary damages impact on directors and senior managers, not the duty of care itself. However, certain remedies may be available to a shareholder such as bringing an application in terms of section 218(1) of the Act for relief declaring an agreement, resolution or provision void or voidable.[959] This is a non-financial remedy but represents another context in which shareholders can enforce the duty of care when they ask a court to stop or rescind a transaction that they consider to be suspect. In addition, a credible threat of personal liability remains and it was best explained as follows:

> 'Most directors—even the most responsible and diligent directors—will have some inhibition about openly questioning and criticizing the actions of [senior officers]. Importantly, the prospect of liability will often provide the justification (or excuse) for those kinds of conversations to occur within the boardroom's collegial setting. We can imagine a director saying something like, 'Of course we have the utmost faith in you, Sally, but the lawyers insist we ask you the following for the record. . . .' Thus, the

954 Slaughter S supra op cit note 57 at 188.
955 Slaughter S supra op cit note 57 at 188.
956 Davies P and Gower S supra note 99 at 589.
957 Davies P and Gower S supra note 99 at 592.
958 Mongalo supra op cit note 10 at 154.
959 Section 218(1) of the Act provides that 'Subject to any provision in this Act specifically declaring void an agreement, resolution or provision of an agreement, Memorandum of Incorporation, or rules of a company, nothing in this Act renders void any other agreement, resolution or provision of an agreement, Memorandum of Incorporation or rules of a company that is prohibited, voidable or that they may be declared unlawful in terms of this Act, unless a court has made a declaration to that effect regarding that agreement, resolution or provision.

symbolic existence of personal liability, even though its practical consequences may be mitigated by private-ordering arrangements such as indemnification and insurance, may play an important role in assisting the directors, aided by the corporation's lawyer, to fulfill their monitoring and oversight functions.'[960]

The need for the protection of directors and senior managers through directors' and officers' liability insurance is highlighted by the enormous scope of potential monetary liability for a due care breach, coupled with the fact-specific nature of the duty of care,[961] and the potential that this liability may have counter-effects on director behaviour. A breach of the duty of care exposes directors and senior managers to personal liability for the entire amount of damages to the company that results from flawed decision-making or oversight. For example, for a multi-billion Rand company listed on the Johannesburg Stock Exchange, a single mistake could result in a multi-million Rand damage award against directors and/or senior managers. This potential monetary liability may discourage competent people from serving on corporate boards and may reduce the efficiency of corporate decision-making. Further, personal liability for a due care breach raises serious fairness concerns, especially in light of the modest compensation that directors and senior managers receive for their service to the company. The liability that directors and senior managers could face for a due care breach or violations appears to be 'disproportionate in relation to the degree of wrongdoing.'[962] As one commentator aptly explained:

'The measure of damages is not directly related to an individual director's degree of culpability or the benefit received by the director...A director who lacked intent to harm the corporation or was unaware of the potential consequences of a failure to act is not the most blameworthy agent … for the corporation's losses.'

It is argued that it may be appropriate to provide directors and senior managers adequate—not absolute—protection from personal liability arising from personal liability.[963] through exemption clauses and directors' and officers' liability insurance as a means of striking

[960] Davis K Jr. 'Once More, the Business Judgment Rule' (2000) 20 *Wis. L. Rev.* 475 – 505 at 586.
[961] The duty of care in section 76(3)(c) of the Act imposes an objective/subjective requirement on directors and senior managers to discharge their duties with the necessary care, skill and diligence in decision-making and the oversight context. As previously pointed out the duty of 'skill' as a separate aspect of the duty of care has been elevated to an objective criterion which means a director or senior manager has a continuing duty to acquire and maintain sufficient knowledge and understanding of the company's business to enable them to sufficiently discharge their duties - see Chapter 5 at paragraph 5.2.2.
[962] Jones R 'Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance' (2006) 92 *IOWA L. REV.* 105 - 158 at 118.
[963] Slaughter S supra op cit note 57 at 190.

a balance between the competing policy interests to punish faithless directors and the reduction of the likelihood of director and senior manager resignations because of the increasing managerial susceptibility to personal liability for breach of the duty of care.[964]

6.3.2. The Permissible Scope and Extent of the Company's Right to Protect Directors and Officers Through the Purchase of Directors' and Officers' Policies in Terms of Subsections 78(7) of the Act

A company is permitted to purchase and maintain insurance on behalf of a director and senior manager of the company to protect them from against personal liability claims incurred in his or her capacity as a director or senior manager of the company in terms of subsection 78(7) of the Act.[965] In addition, a company may purchase insurance to protect itself against expenses of indemnification that it may advance to a director or senior manager in terms of subsection 78(4) and (5) of the Act. Subsection 78(7) of the Act provides that:

> 'Except to the extent that the Memorandum of Incorporation of a company provides otherwise, a company may purchase insurance to protect –
>
> (a) a director against any liability or expenses for which the company is permitted to indemnify a director in accordance with subsection (5); or
>
> (b) the company against any contingency including but not limited to –
>
> (i) any expenses –
>
> (aa) that the company is permitted to advance in accordance with subsection (4)(a); or
>
> (bb) for which the company is permitted to indemnify a director in accordance with subsection 4(b); or
>
> (cc) any liability for which the company is permitted to indemnify a director in accordance with subsection (5).

[964] Mongalo T supra op cit note 10 at 155 – 156.
[965] Cassim et al supra op cit note 32 at 778.

It is clear that subsection 78(7) of the Act only permits the purchase and maintenance of liability insurance against liability and expenses for which the company is permitted to indemnify a director or senior manager with are contained in subsection 78(6) of the Act.[966] The power to purchase and maintain liability insurance cover for its directors and managers was in doubt under section 247(1) of the Act until the passing of the proviso introduced by section 12 of Act 35 of 1998, which expressly made it possible for a company to purchase liability insurance for its directors and officers for liability in respect of any negligence, default, breach of duty, or breach of trust.[967]

It is argued that it is unfortunate that the permissible extent and scope of liability insurance in terms of subsection 78(7) of the Act is subject to and/or limited to the extent of the indemnification under subsection 78(5) of the Act. Thus, the protection available to directors and senior managers through liability insurance is in essence hamstrung with the same problems that are inherent to indemnification, which have already been listed.[968] This is largely due to the reason that the extent of protection for liability, costs and expenses expended under subsection 78(4) of the Act is subject to the proviso a director or senior manager is exonerated at the end of the matter or if the proceedings are abandoned or settled. It is conceivable that a company or its insurer may seek reimbursement of the defence costs advanced in terms of the policy should the director or senior manager be unsuccessful with their defence on the merits against a claim brought against him or her for the breach of the duty of care. This position is untenable because it would effectively strip a core component of the protection sought to be afforded to directors and senior managers under a directors' and officers' policy. In practice, insurers rarely invoke a right of recovery but the lack of clarity is unsettling.

It is to be noted that, subsections 78(7) of the Act explicitly refers to 'any liability or expenses' which encapsulates any damages and costs incurred by the director or senior manager should they be found guilty of breaching the duty of care. If this caveat were allowed to remain it is argued that it would obviate and frustrate the protection against liability for damages or costs under a directors' and officers' policy should they be found guilty of breaching the duty of care at the end of the matter. Policy response is not always confirmed upfront and insurers reserve the right to make a call on the merits of an action against a director or senior manager at any stage before or after a finding by a court. In certain instances, insurers

[966] Cassim et al supra op cit note 32 at 773 and 778.
[967] Cassim et al supra op cit note 32 at 773 and 778.
[968] See para 6.2.4.

may prefer to let the matter run its course and allow a court to make a finding on liability. The insurer could potentially recover defence costs advanced to a director or senior manager if their defence is not upheld by the court through this clawback, should the matter be not capable of early settlement. There is no logical reason why a director or senior manager whose matter is settled, and without adjudication of the merits, should be in a better position and be entitled to indemnification or cover for defence costs than when the court finds that the director or senior manager is guilty of mere negligence in instances where they have acted in good faith with a view of the best interest of the company.

In the matter of *Centriq Insurance Company Ltd v Oosthuizen and Another,*[969] the Supreme Court of Appeal had to deal with the interpretation of an insurance policy/contract which indemnified a financial adviser from liability for 'breach of duty in connection with [his] business by reason of any negligent act, error or omission'. The advisor had advised his client to invest in a property development scheme that had failed. The insurer denied liability relying on an exclusion in which certain situations indemnity did not apply. The court advocated for a commercially sensible interpretation instead of one that is insensible or at odds with the purpose of the contract/policy. The court also pointed out that insurance contracts have a 'risk-transferring purpose'.[970] It is argued that if a company or insurer has the right of recovery against a director or senior manager for costs or expenses advanced in defending an action where they have been found guilty of a breach of the duty of care would defeat the risk transfer purpose of a directors' and officers' liability insurance policy and result in an absurd commercial construction of the protection available to directors and senior managers under subsection 78(7) of the Act which is permitted through directors' and officers' policies. It would obviate the object of such insurance which is to protect directors and senior managers, among other things, from liability and costs for breach of the duty of care and negligence. The caveat requiring that directors and senior managers be successful in their defence or that the matter be settled or abandoned for them to be entitled to protection needlessly creates uncertainty, there should be none, about the extent of the protection permissible under directors' and officers' liability insurance under subsections 78(7) of the Act. The court opined that:

> 'The consequence of adopting a business-like or commercially sensible construction of an insurance policy is that the literal meaning of words read in their context may have

[969] (237/2018) [2019] ZASCA 11 (14 March 2019).
[970] Ibid at para 17.

to yield to a fair and sensible application where they are likely 'to produce an unrealistic and generally unanticipated result', which is at odds with the purpose of the policy. But a word of caution is warranted: courts are not entitled, simply because the policy appears to drive a hard bargain, to lean to a construction more favourable to an insured than the language of the contract, properly construed, permits. For, if that is what the insured contracted for that is what he is entitled to, and no more. It is not for the courts to construe exclusions in favour of the insured simply because it considers them to be unfair or unreasonable.'[971]

In addition, the formulation for the terms 'knowing', 'knowingly' or 'knows' under section 1 of the Act presents a unique problem for the application of the protection permissible under subsection 78(7) of the Act. Subsection 78(6)(a)(i) of the Act provides that a director or senior manager cannot be indemnified or cover be extended to him or her through an insurance policy for liability arising in terms of any liability arising in terms of section 77(3)(a), (b) or (c) of the Act, which as stated relates to litigation where it is alleged that a director or senior manager 'knowingly' acted without authority on behalf of the company; 'acquiescing' in the fraudulent or reckless conduct of the company's business and contrary to section 22 of the Act; and 'knowingly' being party to conduct calculated to defraud a creditor, employee or shareholder or for another fraudulent purpose.[972] Further, subsection 78(6)(a)(ii) of the Act prohibits indemnification or the provision of liability insurance for wilful misconduct or wilful breach of trust on the part of the director or senior manager concerned.[973] The 'wrongful acts' contemplated in subsection 77(3)(a), (b) and (c) including subsection 78(6)(a)(ii) of the Act all require that a director or senior manager must have acted with the necessary knowledge to be held liable. However, because of the extended meaning of the term 'knowing' actual knowledge is not the only requirement to establish liability but it is sufficient to prove that the director or senior manager 'was in a position in which the person reasonably ought to have had actual knowledge.'

The duty of care under section 76(3)(c) of the Act requires that directors and senior managers act with reasonable care, skill and diligence in performing tasks directing and

[971] Ibid at 9 para 21.
[972] Subsection 78(6)(a)(i) read together with subsection 77(3)(a), (b) and (c) of the Act.
[973] Subsection 78(6)(a)(ii) of the Act. See also Cassim et al supra op cit note 27 at 775 – where he states that 'this provision is perfectly sensible, because there is no good reason why a company should pay for the wilful misconduct or a miscreant director.'

monitoring the corporate affairs of the company.[974] In the oversight context, directors and senior managers are expected to monitor the corporate affairs of the company and to take appropriate action to intervene. Under subsection 76(3)(c)(ii) of the Act directors and senior managers are required to possess at least a rudimentary understanding of the business of a company. In addition, directors and senior managers are under a continuing obligation to keep informed of the business affairs of the company.[975] This authority and responsibility is conferred on the board of directors under section 66(1) of the Act. Bekink points out the problem for directors and senior managers, especially non-executive directors.[976] Section 76(3)(c)(ii) of the Act places an obligation on directors and senior managers to be actively informed in matters affecting the company and also to take reasonable measures that will enable them to gain knowledge of such matters relevant and affecting the business.[977] In *Howard v Herrigel and Another NNO*[978] the Appellate Division confirmed that for purposes of section 424 of the 1973 Act, it was not necessary to prove that a person [director or senior manager] had actual knowledge of the legal consequences of those facts sought to be held liable to establish liability on their part for the reckless trading of a company's business. This raises a pertinent question of how a directors' and officers' liability insurance policy will respond to claims brought against a director or senior manager in the context of the breach of their oversight function. Notionally, the policy should respond to cover the director or senior manager for damages and defence costs for a claim alleging breach of the duty of care for failing to exercise reasonable oversight. However, what about the requirement that a director or senior manager ought to have known or taken reasonable steps to have become duly informed about the affairs or a decision?[979] This potentially has the effect of elevating the inquiry from being about negligence into the realm of deemed knowledge. This may result in an unfortunate situation where a company or insurer may not be able to indemnify or cover a director or senior manager because, on the facts of the matter, he or she failed to take reasonable steps to be informed and not indemnifiable. After all, it falls foul of subsection 78(6) of the Act. It is argued that such a situation would fly in the face of the purpose of directors' and officers' liability insurance which is to protect directors and senior managers from liability for negligence conduct.[980] Bekink suggests that the courts will have to use their discretion on a

[974] Cassim et al supra op cit note 32 at 775.
[975] See Chapter 5 at paragraph 5.2.2 and the sources cited thereunder.
[976] Bekink M supra op cit note 6 at 100.
[977] Bekink M supra op cit note 6 at 101.
[978] 1991 (2) SA 660 (AD).
[979] Bekink M supra op cit note 6 at 101.
[980] Bekink M supra op cit note 6 at 101.

case-by-case basis to avoid absurdity.[981] This formulation of 'knowing' and linking it to the liability and protection of directors is undesirable because it leaves directors and senior managers with a lack of legal certainty regarding the extent and scope of the protection available under directors' and senior managers' policies for breach of care violations in the oversight context.[982]

6.3.3. The Policy: Key Terms, Wordings, Limitations and Exclusions

The nature of directors' and officers' liability insurance 'is a unique type of corporate insurance.[983] that may potentially cover three categories of claims.[984] First, Side A Cover provides that the insurer agrees to pay any loss suffered by an individual director or senior manager, for example, where the director or senior manager has breached his or her duty of care in approving a transaction that has failed, causing the company to suffer a loss. However, Side A cover is limited to claims in which the company is permitted to indemnify a director or senior manager in terms of subsections 78(7) and the terms of the policy.[985] Second, Side B cover offers reimbursement to the company itself for any sums paid by the company to a director or senior manager by way of indemnification in terms of subsections 78(4) and (5) of the Act.[986] Under Side B cover the company is the insured, and thus a director or senior manager cannot himself sue for indemnification under this policy.[987] Last, Side C cover protection is afforded to both the directors/senior managers and the company against its own personal liability in instances where the company faces primary or vicarious liability for the acts and defaults of its directors and senior managers.[988]

[981] Bekink M supra op cit note 6 at 101.
[982] Subsection 78(7) read together with subsection 76(3)(c)(ii) of the Act.
[983] Bekink M supra op cit note 6 at 89.
[984] Merkin R, Summer L and Hogdson P *Colinvaux's Law of Insurance* Thirteen Ed 2022 Sweet & Maxwell Croydon 1356 at para 21.253 -21.256.
[985] Ibid 1356 at 2.254.
[986] Ibid 1356 at 2.255.
[987] Ibid 1356 at 2.255.
[988] Ibid 1356 at 2.256. See also Bekink M supra op cit note 6 at 90.

6.3.3.1 The Insuring Clause

Directors' and Officers' liability insurance is an insurance product that is 'subject to fluctuations in price and to variations in the terms and conditions that insurers are prepared and permitted to offer'.[989] It is also important to point out that the competition for business between insurers, and the claims history/insurance history of the particular insured, may lead to materially differing terms from insured to insured from year to year.[990]

The wordings of directors' and officers' policies may vary, but in general terms, a directors' and officers' liability policy covers sums for which a director or senior manager becomes liable to pay by way of damages as a result of acting in the course of the business of a company.[991] The cover deals with three main areas: (a) the directors' or senior managers' own liability risk towards third parties e.g., shareholders suing by way of a derivative action or a third party such as a creditor;[992] (b) defence costs, expenses and charges incurred by a director or a senior manager in which the director himself is a party to the litigation proceedings;[993] (c) reimbursement of the company for any indemnities expended to a director or senior manager.[994]

An example of a typical insuring clause reads as follows:

> 'In consideration of the payment of the premium and subject to all terms, conditions and limitations of this Policy, the Insurer and the Insured and the Company agree as follows:
>
> 1.0 INSURING CLAUSES (What is covered by this Policy)
>
> 1.1 DIRECTORS & OFFICERS LIABILITY
>
> The Insurer shall pay on behalf of the Insured any Loss resulting from any Claim which is first made against the Insured during the Policy Period and notified to the Insurer in accordance with the terms of this Policy, except when and to the extent that the Company has indemnified the Insured.

[989] Mortimore S supra op cit note 609 at 475.
[990] Mortimore S supra op cit note 609 at 474.
[991] Merkin R, Summer L and Hogdson P supra op cit note 988 at 1361 para 21.270.
[992] Bekink M supra op cit note 6 at 89.
[993] This may include proceedings before a regulatory investigation by a public body such as parliament – see Mortimore S supra op cit note 609 at 475.
[994] Bekink M supra op cit note 6 at 89.

1.2 COMPANY REIMBURSEMENT LIABILITY

> The Insurer shall pay on behalf of the Company any Loss resulting from any Claim which is first made against an Insured during the Policy Period and notified to the Insurer in accordance with the terms of this Policy, but only when and to the extent that the Company has indemnified the Insured.'[995]

6.3.3.2 The Limit of Indemnity

A directors' and officers' liability insurance policy will provide cover up to a policy 'limit of indemnity' which is the maximum amount the insurer will be liable to pay under each policy.[996] The limit of indemnity available under one policy often represents a 'single pot' of money, subject to certain reinstatements if the policy allows it.[997] This means that once the limit, which applies to an aggregation or series of claims for a policy period, has been expended for damages and costs the limit of indemnity available will be exhausted.[998] The insurer's obligation to pay will arise after the excess has been paid by the insured.

The size of the limit of indemnity will be influenced by several factors which include the insurer's risk appetite, the insured's claim history and the rate of premium in the market – which in essence simple economics.[999] It will not be possible or practical to prescribe a minimum limit of indemnity that will adequately protect directors and senior managers because the question of the extent of cover required is risk-dependent and subject to market forces at play at any particular moment. It is suggested that a company consider the decision relating to the policy limit with a view to the nature, size and complexity of the company's business practices, as a potential guideline.[1000]

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[995] As may be seen from seen from this example (which was taken from W. R. Berkley Company a Lloyd's underwriter https://www.brokerdirect.co.uk/wp-content/uploads/2018/08/Directors-Officers-WRB_PolicyWording_V06_MAY18.pdf - accessed on 6 February 2024) it is clear that the cover makes for both areas of cover under one policy.
[996] Mortimore S supra op cit note 609 at 480.
[997] Mortimore S supra op cit note 609 at 480.
[998] Mortimore S supra op cit note 609 at 480.
[999] Mortimore S supra op cit note 609 at 480.
[1000] Mortimore S supra op cit note 609 at 480.

6.3.4. Directors' and Officers' Liability Insurance Market and its Triggers

As alluded to earlier, the insurance market, like any other, is also subject to cyclical patterns that have a bearing on the premium, wording, terms and availability of the cover.[1001] Underwriting cycles can be defined as:

> '…as repeating, regular periods of soft and hard markets. In a soft market, insurance coverage is readily available at "reasonable" prices, while a hard market is characterized by high prices and unavailability of coverage or limited coverage for potential policyholders. Historically, these cycles have averaged six years in length, although some literature questions whether this period has been lengthening.'[1002]

It is important to note that, insurance cycles result as a phenomenon due to certain internal and external forces that can partially be explained by rational responses to several different features of insurance markets and dynamic market developments, such as new entrants and changes in the regulatory environment.[1003] In the state of Delaware, *the Smith v Gorkom*[1004] decision had a profound impact on the insurance market for directors and officers in Delaware which led to a constriction of the market and mass resignation of directors because of a perception of increased liability and exposure of directors, which was termed an 'insurance crisis'.[1005] The Delaware Supreme Court's finding in *Smith v Gorkom*[1006] opened the business community to the harsh reality that directors and senior managers could face personal liability for catastrophic corporate damages for breach of the duty of care violations even though the directors concerned had met the requirements of the business judgement rule because their decision to sell the company at a specific share price was informed and in good faith. The court took issue with the limited time for consideration and the adequacy of the process followed by the board in approving the transaction declaring that they were 'grossly negligent' and liable

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[1001] Mortimore S supra op cit note 609 at 475. See also Baxter C supra op cit note 548 at 537, where he states that '…[a]ny discussion of market trends needs to be read with careful regard for its time and place, but it is unfortunately all too easy to read comment about the social value of insurance or the desirability of giving company directors peace of mind without gaining any clear idea as to who is being insured against what, or what it is exactly that needs to be insured against.' Chapters 1 and 3 were dedicated to understanding the definition of director and senior manager, directors' and senior managers' standards of care, skill and their liability.

[1002] Weiss M 'Underwriting Cycles: A Synthesis and Further Directions' (2007) 30 *Journal of Insurance Issues* 31–45 at 31.

[1003] Ibid at 32.

[1004] 488 A.2d 858 (1985).

[1005] Slaughter S supra op cit note 57 at 181.

[1006] 488 A.2d 858 (1985).

for damages in the order of $ 23m.[1007] It is argued that the *Smith v Van Gorkom* narrative is more than anecdotal evidence for the position that may eventuate for South African directors and senior managers should the courts follow the trend adopted in the state of Delaware regarding the application of the business judgment rule and it points to the potential harm that may result from a decision of a similar import, given the limitation of the business judgment rule, the continued prohibition against exemption clauses and the limitations in the scope and extent of protection available to directors and senior managers through indemnification and liability insurance. In addition, the potential solution to prevent a similar 'insurance crisis' from occurring is to amend subsection 78(2) of the Act to permit exemption clauses for directors and senior managers' personal liability for breach of care violations and ensure that the right to indemnification and liability insurance is statutorily required by affecting the necessary changes to subsections 78(4) to (7) of the Act.[1008]

It is argued that South African policy makers should recognise the dangers of this situation and make the necessary changes to subsections 78(2) and (4) to (7) of the Act.[1009] One commentator warned of the danger to directors and senior managers and stated that:

> '(O)ne of these days, some court …will read literally the judicial dicta,…on the directors duty of care….and will impose personal liability on some unlucky directors who had in fact done all that was expected of them and all they realistically could….[A] flood of consequences will follow – almost all bad. Lawsuits against directors will mushroom. Insurance rates for directors and officer will jump. Heavy litigation and related expenses will be imposed on companies, to the loss of shareholders and all concerned, and corporations will find it increasingly difficult to attract onto their boards men and women of achievement as liability risks and the work burden of directorship overwhelmingly outbalance the marginal benefits of directorship.
>
> ….[I]f there was ever a time in the nation's history when encouragement should be given to innovation, risk taking, and entrepreneurship, it is now. Of all times, this is the worst to move skill further to the creation of a cautious, prudent-man, trustee-like environment in the boardrooms of American business.'[1010]

[1007] Mongalo T supra op cit note 10 at 145.
[1008] See Chapter 7 on the specific proposed changes to provisions of section 78 of the Act.
[1009] Mongalo T supra op cit note 10 at 155.
[1010] Manning B 'The Business Judgment Rule and Director's Duty of Attention: Time for Reality' (1984) 39 Bus Law 1447 – 1500 at 1498.

The aftermath of the *Smith v van Gorkom* decision serves as a timely warning and points to the need to correctly predict the consequences to corporate South Africa should the courts decide to impose personal liability on directors and senior managers for breaches of the duty of care violations.[1011]

6.3.5. Select Aspects: Evaluation of the Adequacy of the Protection Available Under Subsection 78(7) of the Act

6.3.5.1 Reputation and Detracting Focus Because of Protracted Litigation

Mongalo argues that exculpation clauses are preferable for directors and senior managers, over indemnification and liability insurance, because they could limit the extent to which a director or senior manager is exposed to litigation.[1012] Exculpatory clauses have been described as a 'a defence to raise and argue the applicability of the bar… to a due care claim…' which can quickly and effectively dispose of action against a director or senior manager.[1013] According to Mongalo addressing the issue of directors and senior managers in the company's constitution is the best way of dealing with it than rather leaving it to the dictates of lengthy or protracted litigation that may drain the resources of the director or senior manager concerned and which proceedings have the potential to tarnish their good reputation in the business world.[1014]

Davis correctly observed that:

> 'The threat of liability and the director's interest in his or her professional stature no doubt interacts in other important ways. No high profile business or community leader wants to see his or her name in a court decision or newspaper as a defendant in a suit for sloppy performance as a director, even if the existence of indemnification or insurance assures that he or she faces no out-of-pocket loss.'[1015]

[1011] Mongalo supra op cit note 10 at 155.
[1012] Mongalo supra op cit note 10 at 150.
[1013] See Malpiede v Towson 780 A.2d at 1095.
[1014] Mongalo supra op cit note 10 at 154.
[1015] Davis K Jr. supra op cit note 964 at 587.

While exculpation is the ultimate ideal protection method, the availability of directors' and senior managers' liability insurance should be helpful to directors' and senior managers' quest to vindicate their good name and reputation for alleged breach of duty of care violations.[1016] Ulrich remarked that the courts have recognised the valid benefit to the company of indemnification and liability insurance 'both through the ability to attract qualified board members and also through the defense and vindication of its directors'.[1017] It is logical to argue that directors and senior managers will not bogged down by protracted litigation and the concern about how to fund their defence if exemption clauses are part of their service contract to the company and they have the additional benefit of a right to indemnification and liability insurance for alleged breach of duty of care violation, freeing them up to concentrate on the affairs of the corporation.

6.3.5.2 Limited/no statutory right to indemnification

The points regarding the discretionary nature of indemnification in terms of subsection 78(4) and (5) of the Act apply here, and will not be repeated.[1018] The extent of protection available under subsection 78(7) of the Act is limited and hampered by, among other things, the fact that there is no statutory right to liability insurance for directors and senior managers under the current enforcement framework.

6.3.5.3 Complementary: Dovetailing the Protection

The title of the paper does not succinctly capture the essential elements of the paper. The initial focus was insurance law, but after consulting various sources and resources, it became apparent that liability insurance alone as a protective method will not solve the director liability problem or balance the questions raised herein in a satisfactory manner. The efficiency of the available methods to protect directors and senior managers has to be dealt with comprehensively. A comprehensive assessment of the methods permissible requires that the methods must be dovetailed to provide the maximum measure of protection with the view of protecting directors

[1016] Ulrich H supra op cit note 84 at 234.
[1017] Ulrich H supra op cit note 84 at 234.
[1018] See paragraphs 6.2.3 and 6.2.4.

and senior managers from personal liability for mere breaches of the duty of care because of negligence, as this will be a disincentive for corporate service and may influence directors and senior managers to be overly caution if the risk and lack of adequate protection persists under the current enforcement framework.[1019]

Mongalo urges that 'whatever measures policy makers introduce in order to insulate directors [and senior managers] from personal financial liability should strike a balance between competing policy interests. These include the attraction and retention of directors [and senior managers] and the incentivisation to take good faith risks, on the one hand, and the appropriate imposition of liability on aberrant behaviour, on the other hand.'[1020] It is argued that the development of sustainable methods to achieve a middle ground must start with revisiting the continued blanket prohibition against exemption clauses in subsection 78(2) of the Act. In addition, the refinement of the protection available to directors and senior managers through indemnification and liability insurance is achieved by converting them into a statutory right to secure their position and to achieve legal certainty in subsections 78(4) - (5) and (7) of the Act.[1021]

The impact of directors' and officers' liability insurance on corporate governance is not the focus of this study, and it is suggested that it is an area of further research that deserves attention.[1022] The mainstay of the protection available to company directors and senior managers is indemnification and liability insurance[1023], which is permitted under section 78 of the Act. However, the Act also makes provision for the introduction of the business judgment rule into South African corporate law under section 76(4) of the Act.[1024] Directors and senior

[1019] Mongalo supra op cit note 10 at 154.
[1020] Mongalo T supra op cit note 10 at 156.
[1021] This would entail removing the word 'may' and replacing it with 'must', subject to the qualification in subsections 78(6) of the Act.
[1022] See recommendation and conclusion in Chapter 7.
[1023] The concepts of indemnification and liability insurance are related but also different. The concepts were analysed and unpacked in Chapter 6. A justification of the choice of the title of this paper is that any discussion of the protection of corporate officers and corporate law concepts closely linked to each has to emanate from the main form of protection available to directors and senior managers, being indemnification and liability insurance. The title merely introduces the scope and the extent of protection that is available, the title does not include the term 'exculpation clauses' because of the prohibition. However, investigation into the different forms it becomes apparent that corporate laws and liability insurance (which are under commercial law) are related – see Jacobs W "Liability Insurance in a Nutshell: Simplified Complexities or Complex Simplicities" 2009 (21) SA Merc LJ 202-227.
[1024] The paper has highlighted the limitations of the business judgment rule introduced in section 76(4) of the Act. See Chapter 3, paras 3.2.7; 3.4.4 and 3.7.

managers can also pin their hope for protection under the discretion that the courts have to grant judicial relief under subsections 77(5) and (9) of the Act.[1025]

6.3.5.4 Damages / Costs breakdown

In South Africa, the business judgment rule has yet to be tested by the courts. However, there appears to be a steady rise in personal liability litigation involving directors.[1026] While there have been no notable awards made against directors and senior managers in South Africa currently, it is appropriate to consider the potential severity of the losses directors and senior managers may suffer for damages and defence costs, given the severity of directors' and officers' claims internationally. To illustrate the potential severity and increase in scrutiny, the 'heat maps' for S&P 500 Securities Litigation for Federal Filings in the United States are referenced. The data reveals that the likelihood of an 'S&P 500 company being the subject of a core federal filing nearly doubled to 7.1%'. In other words, this shows that the percentage of S&P 500 companies being the subject of a complaint and a new securities class action being brought against directors and senior managers in federal court increased by 7.1% during the relevant calendar year.

[1025] See section 77 of the Act and Bradstreet R supra op cit note 399 at 145. Some concerns were raised regarding some interpretational difficulties contained in the two subsections. The courts will give guidance on how they see their judicial discretion in section 77.

[1026] Some recent decisions include: *De Bruyn v Steinhoff International Holdings NV and Others* (29290/2018) 2020] ZAGPJHC 145 2022 (1) SA 442 (GJ) (26 June 2020); *Organisation Undoing Tax Abuse NPC and Another v Myeni and Another* [1026] (15996/2007) [2019] ZAGPPHC 957; *Gihwala and Others v Grancy Property Ltd and Others* (20760/14) [2016] ZASCA 35; [2016] 2 All SA 649 (SCA); 2017 (2) SA 337 (SCA) 35*; Sanlam Capital Markets (Pty) Ltd v Mettle Manco (Pty) Ltd and Others* (12/07159) [2014] ZAGPJHC 134; and *Hlumisa Investment Holdings (RF) Ltd and another v Kirkinis and Others* [2020] JOL 47567 (SCA).

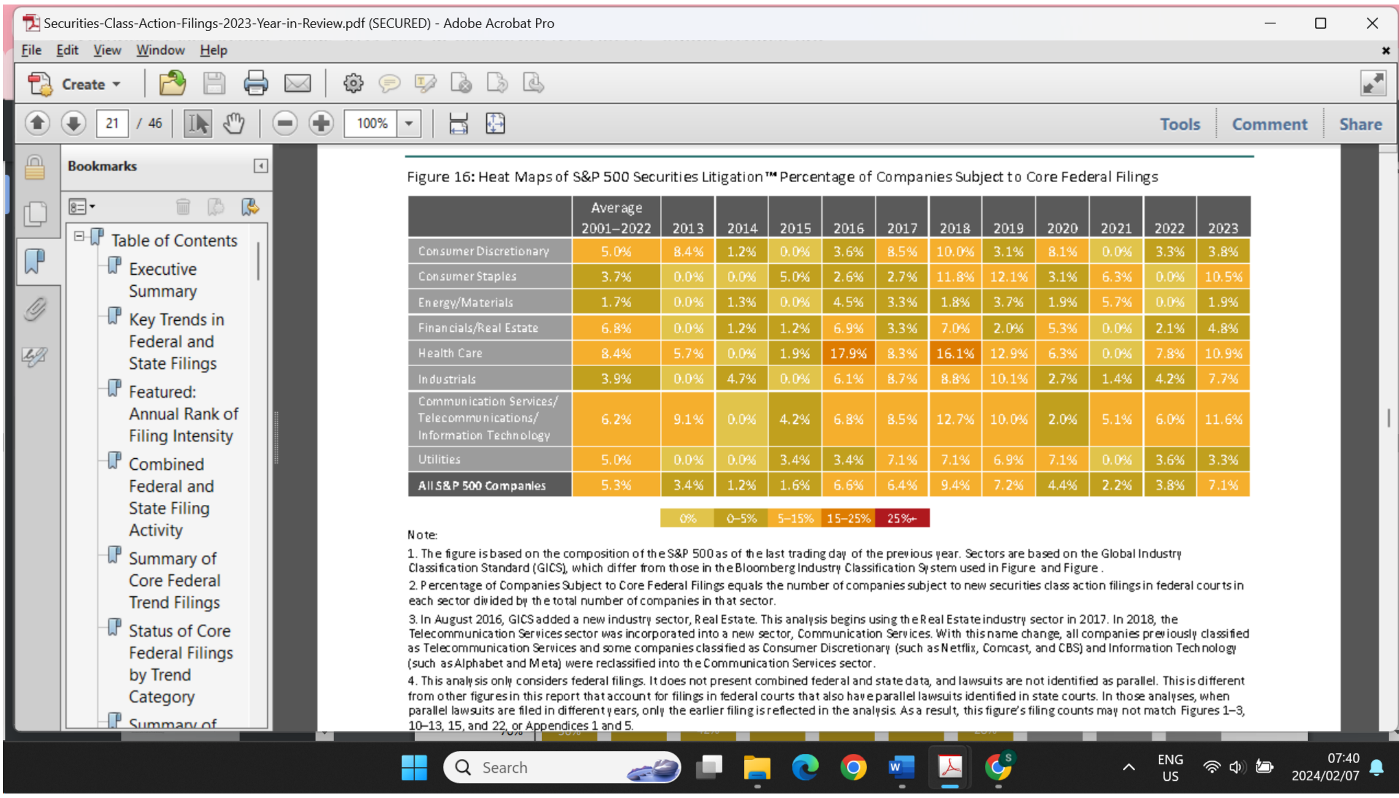


Figure 16: Heat Maps of S&P 500 Securities Litigation™ Percentage of Companies Subject to Core Federal Filings

	Average 2001–2022	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Consumer Discretionary	5.0%	8.4%	1.2%	0.0%	3.6%	8.5%	10.0%	3.1%	8.1%	0.0%	3.3%	3.8%
Consumer Staples	3.7%	0.0%	0.0%	5.0%	2.6%	2.7%	11.8%	12.1%	3.1%	6.3%	0.0%	10.5%
Energy/Materials	1.7%	0.0%	1.3%	0.0%	4.5%	3.3%	1.8%	3.7%	1.9%	5.7%	0.0%	1.9%
Financials/Real Estate	6.8%	0.0%	1.2%	1.2%	6.9%	3.3%	7.0%	2.0%	5.3%	0.0%	2.1%	4.8%
Health Care	8.4%	5.7%	0.0%	1.9%	17.9%	8.3%	16.1%	12.9%	6.3%	0.0%	7.8%	10.9%
Industrials	3.9%	0.0%	4.7%	0.0%	6.1%	8.7%	8.8%	10.1%	2.7%	1.4%	4.2%	7.7%
Communication Services/ Telecommunications/ Information Technology	6.2%	9.1%	0.0%	4.2%	6.8%	8.5%	12.7%	10.0%	2.0%	5.1%	6.0%	11.6%
Utilities	5.0%	0.0%	0.0%	3.4%	3.4%	7.1%	7.1%	6.9%	7.1%	0.0%	3.6%	3.3%
All S&P 500 Companies	5.3%	3.4%	1.2%	1.6%	6.6%	6.4%	9.4%	7.2%	4.4%	2.2%	3.8%	7.1%

0% 0–5% 5–15% 15–25% 25%+

Note:

1. The figure is based on the composition of the S&P 500 as of the last trading day of the previous year. Sectors are based on the Global Industry Classification Standard (GICS), which differ from those in the Bloomberg Industry Classification System used in Figure and Figure .
2. Percentage of Companies Subject to Core Federal Filings equals the number of companies subject to new securities class action filings in federal courts in each sector divided by the total number of companies in that sector.
3. In August 2016, GICS added a new industry sector, Real Estate. This analysis begins using the Real Estate industry sector in 2017. In 2018, the Telecommunication Services sector was incorporated into a new sector, Communication Services. With this name change, all companies previously classified as Telecommunication Services and some companies classified as Consumer Discretionary (such as Netflix, Comcast, and CBS) and Information Technology (such as Alphabet and Meta) were reclassified into the Communication Services sector.
4. This analysis only considers federal filings. It does not present combined federal and state data, and lawsuits are not identified as parallel. This is different from other figures in this report that account for filings in federal courts that also have parallel lawsuits identified in state courts. In those analyses, when parallel lawsuits are filed in different years, only the earlier filing is reflected in the analysis. As a result, this figure's filing counts may not match Figures 1–3, 10–13, 15, and 22, or Appendices 1 and 5.

6.3.5.5 Emerging Trends: Exposure and Coverage

Directors and Senior managers in South Africa under the current enforcement framework face a higher level of risk and liability, which, if left unchecked, could render directors and senior managers 'sitting ducks' and could trigger a crisis should the courts decide to impose personal liability for breach of care violations.[1027]

Some of the concerns for directors and senior managers could emanate from disruptive scenarios, coronavirus (COVID -19) type pandemics, climate change and environmental risks, social and governance (ESG) issues, which are changing and shaping the risk landscape in South Africa.[1028] The role of regulatory bodies in the enforcement of appropriate proprietary standards on the one hand, and the protection of directors and senior managers on the other

[1027] Mongalo T supra op cit note 10 at 155.

[1028] See Allianz Commercial Directors and officers (D&O) insurance insights 2024 The top risk trends boards of management need to guard against - https://commercial.allianz.com/content/dam/onemarketing/commercial/commercial/reports/commercial-directors-and-officers-insurance-insights-2024.pdf - accessed on 7 February 2024.

hand, falls outside the scope of this research, but is worth considering in further research how the regulatory enforcement style will promote these competing policy objectives.[1029]

6.3.5.6 Bouquet Table: Comparing the Protection Available under Each Method

The table below provides a summary of the protection available to directors and senior managers under the various methods and it also indicates which method is the most effective.

Table 1:

Method	Is the method effective against a Damages Claim?	Are Legal Defence Costs Covered?
Exculpation	Yes – an exemption clause is an effective/sustainable defence against a damages claim.[1030]	A qualified yes – if the director or senior manager raises the defence of an exemption clause successfully the cost order will follow the result. However, the director or senior manager may be forced to fund the defence upfront from his or her own pocket if there is no advancement of indemnity or liability insurance.
Indemnification	A qualified yes – provided that the defence is successful and/or the matter is settled or the proceedings are abandoned.[1031]	A qualified yes – provided that the director or senior manager is exonerated and/or the matter is settled or the proceedings are abandoned.[1032] Subject also

[1029] Mongalo T supra op cit note 5 at 155. See the recommendations and conclusions in Chapter 7.
[1030] As stated exculpatory clauses have been described as a ‘a defence to raise and argue the applicability of the bar… to a due care claim…’ which can quickly and effectively dispose of action against a director or senior manager - See *Malpiede* 780 A.2d at 1095.
[1031] Subsection 78(4) – (5) of the Act.
[1032] Subsection 78(4) – (5) of the Act.

		to a claw back for defence costs advances if the defence is not upheld.[1033]
The Business Judgement Rule	Yes – a finding that a director or senior manager complied with the requirements of the business judgment rule is an effective/sustainable defence against a damages claim.[1034]	A qualified yes – if the director or senior manager raises the business judgement rule as defence successfully the cost order will follow the result. However, the director or senior manager may be forced to fund the defence upfront from his or her own pocket if there is no advancement of indemnity or liability insurance.
Liability Insurance	A qualified yes – provided that the defence is successful and/or the matter is settled or the proceedings are abandoned.[1035]	A qualified yes – provided that the director or senior manager is exonerated and/or the matter is settled or the proceedings are abandoned.[1036] Subject also to a claw back for defence costs advances if the defence is not upheld.[1037]
		A qualified yes – if the director or senior manager

[1033] Subsection 78(4)(b) of the Act.

[1034] According to Nietsch the business judgment rule aims to provide a safe harbour for directors and senior managers by restraining judicial control over board decisions – Nietsch M supra op cit note 785 at 180.

[1035] Subsection 78(7) of the Act. See the argument against the absurd result if the construction of the protection available under directors' and officers' policies were to be subject to a clawback if a director or senior officer were to be found to be negligent and liable because it militates against the 'risk transference' purpose of the policy – paragraph 6.3.2.

[1036] Subsection 78(7) of the Act.

[1037]The argument against the absurd result if the construction of the protection available under directors' and officers' policies were to be subject to a clawback if a director or senior officer were to be found to be negligent and liable because it militates against the 'risk transference' purpose of the policy are applicable herein – See paragraph 6.3.2.

Judicial Discretion to Provide Relief	Yes – a finding that a director or senior manager is entitled to relief insulates him or her against damages claim.[1038]	convinces the court that such relief is justified the cost order will follow the result. However, the director or senior manager may be forced to fund the application from his or her own pocket if there is no advancement of indemnity or liability insurance.

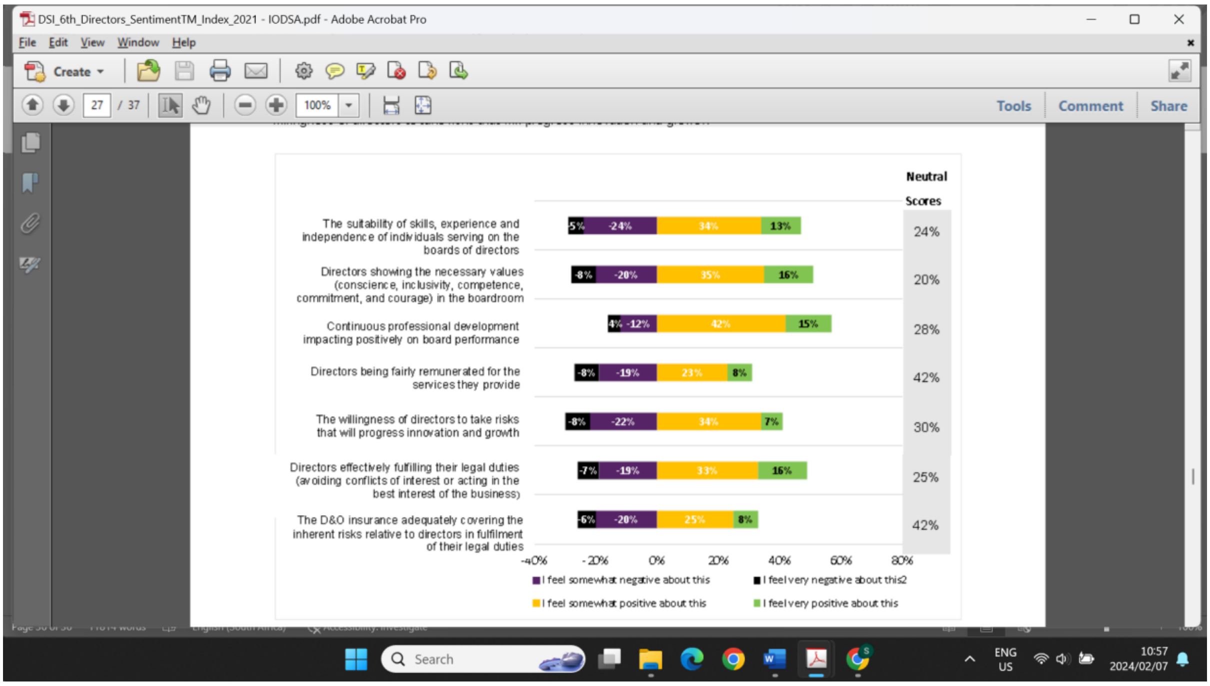
A combination of the above methods will provide effective methods to mitigate the financial disincentive to corporate service for South African directors and senior managers, which has 'a direct effect on the effectiveness of the fiduciary and statutory duties imposed on directors'.[1039]

6.3.5.7 Director and Senior Manager Perception of Directorship Conditions in South Africa

A survey commissioned by the Institute of Directors South Africa[1040] in 2021 revealed that there was a notable decline in the positivity sentiment of company directors with regards to Directors and Officers insurance 'adequately covering the inherent risks relative to directors in fulfilment of their legal duties and directors being fairly remunerated for the services they provide.'[1041] It is clear from the report that the adequacy of the protection available under directors' and officers' insurance is closely linked with the willingness of directors and senior managers to take risks that will progress innovation and growth. Twenty-two per cent of the respondents indicated that they felt negatively about the availability of adequate protection and

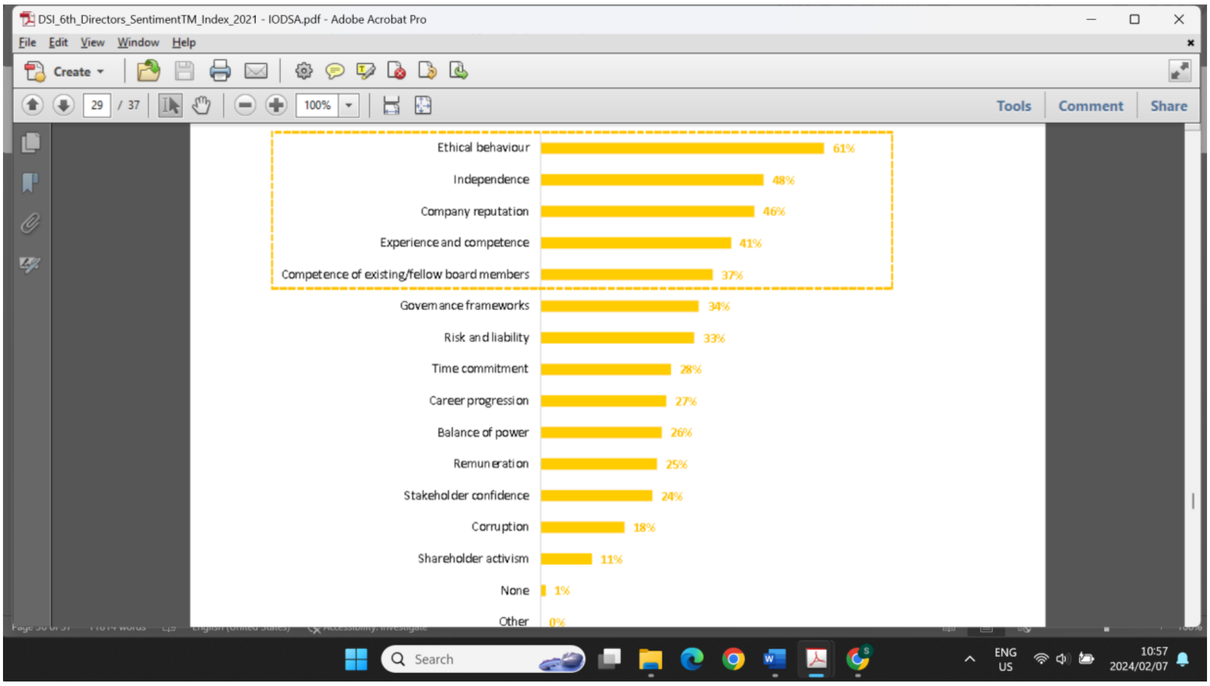
[1038] See section 78(9) of the Act.
[1039] Cassim et al supra op cit note 32 at 775.
[1040] The Institute of Directors South Africa was 'Established in 1960 as a branch of the Institute of Directors in London, the Institute of Directors South Africa (IoDSA) has, over the years, grown to the independent, sizeable professional body it is today. Today the IoDSA is a non-profit company (NPC) with members and is the only professional body for directors that is recognised by the South African Qualifications Authority (SAQA) (ID422). The IoDSA is also a promoter of corporate governance in South Africa, serving as convener and secretariat to the King Committee on Corporate Governance; and having ownership of the various internationally recognised King Codes/Reports.' - https://www.iodsa.co.za/page/who-we-are - accessed on 7 February 2024.
[1041] IoDSA Report 'Directors' Sentiment Index ™ Report: 6th Ed 2021' at 27.

that it would affect their willingness to take on risks that may progress innovation.[1042] While twenty per cent of the respondents felt negatively about directors' and officers' insurance adequately covering the inherent risk relative to directors and senior managers in fulfilment of their legal duties.[1043]



In addition, the findings reveal that risk and liability are a notable concern for directors and senior managers as a factor influencing their willingness to serve on a board. More than thirty per cent of the respondents indicated that risk and liability are factors that influence their willingness to serve on a board.[1044]

[1042] Ibid at 27.
[1043] Ibid at 27.
[1044] Ibid at 27.



6.4 Non-Statutory Responses to the Directors' and Senior Managers' Liability Problem: The Sustainability and Adequacy of Alternative Risk Measures

There is nothing in section 78 of the Act that prohibits a director or senior manager from seeking and purchasing their own private insurance cover if they fear that the company provides is not adequate for their needs.[1045] However, the scope and extent of this cover have to conform to the permissible bounds for liability insurance set in section 78(7) of the Act. The critical question is whether a director or senior manager can negotiate and/or insist on the inclusion of the cost of such insurance against the compensation they receive from the company for their service as director or senior manager. Bekink pointed out that because the provision of protection is at the discretion of the company, there is no obligation on the company to include such an expense in a director's or senior manager's remuneration package.[1046] Until indemnification and liability insurance becomes a statutory right under subsections 78(4) – (5)

[1045] Subsection 78(4) of the Act states that 'the company may advance…' and in subsection 78(7) '…a company may purchase insurance to protect…' Nothing precludes a director or senior manager who has an insurable interest in protecting him or her against personal lability through their savings or purchase of liability insurer in the open insurance market, as part of their own financial and risk management plan if the company and its Memorandum of Incorporation does not make provision for such protection. However, such protection would be at the costs of the individual director or senior manager which is unfortunate and potentially expensive.
[1046] Bekink M supra op cit note 10 at 96.

and (7) of the Act, it will remain a matter of negotiation between the director and senior manager and the company.[1047]

The potential to use non-statutory responses to respond to the director liability problem has not received much attention in South Africa. Slaughter is a strong proponent of the use of non-statutory responses such as cell captive insurance as a method of insulating directors and senior managers from the financial impacts that result from personal liability incurred while acting in a corporate capacity qua director or senior manager.[1048] She supports the use of cell captive insurance as a further method of enabling the corporation to protect its directors and senior managers.[1049]

The lack of prominence for this method in South Africa can perhaps be attributed to the perception that directors' and officers' insurance is perceived as a complex insurance product that is best handled by specialist underwriters and insurers with the necessary knowhow and resources to provide the necessary cover for director and senior manager liabilities and risk.[1050] There are additional compliance and regulatory requirements in terms of the Short Term Insurance Act no 53 of 1998, requiring a company to register internal cell captive insurance companies, which may impact the desirability of this method. [1051] In addition, it is submitted that the extent and scope that a company can provide indemnity to a director and senior manager through cell captives will be constrained by the provisions of subsections 78(4) and (5) of the Act. The criticism of the scope of the permissible instances that a company may advance indemnification to a director and senior managers is equally applicable which relates to the caveat and the fact that a company is not statutorily obliged to provide directors and managers with indemnification for liability and costs reasonably incurred for defending legal proceedings where breach of care violations is alleged in the papers.[1052]

[1047] Bekink M supra op cit note 10 at 96.
[1048] Slaughter S supra op cit note 57 at 181 and 183.
[1049] Slaughter S supra op cit note 57 at 183.
[1050] Mortimore S supra op cit note 609 at 475. It is submitted that the board of directors would have to apply its mind to the object, rules and practicalities of such a cell captive. This could also be dealt with in the Memorandum of Incorporation – see subsections 78(4) and (7) of the Act, which are applicable herein.
[1051] In terms of the Short-Term Insurance Act 53 of 1998 cell captive insurance needs to be conducted under a dedicated insurance licence, and may not be combined with other forms of insurance business.
[1052] See paragraph 6.2.3.

6.5 Conclusion

It has been shown that the United States, in particular the State of Delaware, has developed a model which comprehensively combines exculpatory statutes, expended indemnification and liability insurance rights that provide adequate and enhanced protection to directors and senior managers from the increased susceptibility to personal financial liability, which is a disincentive for corporate service. This model is indicated for the South African jurisdiction because of vulnerabilities directors and senior managers because of the limitation of the other methods such as the business judgement rule and the courts judicial discretion to grant a director and senior manager in certain circumstances. In addition, the protection available to directors and senior managers under subsections 78(4) – (7) of the Act, permitting indemnification and liability insurance remains inadequate to insulate them from the threat of serious financial liability for breaches of the duty of care, in the absence of exculpatory provisions because of the construction of the provisions permitting such relief.

The current legal enforcement framework applicable to directors and senior managers, which prohibits the inclusion of exculpatory clauses as a means of further protection, will continue to be of concern for directors and senior managers in taking up positions within the boards of a company. Further, the prospect of the risk and liability associated with corporate service will have a dampening effect on directors' and senior managers' willingness to take risks that will progress innovation and growth. The South African corporate community and economy as Manning so eloquently put it can ill afford to sacrifice ‘innovation, risk-taking and entrepreneurship’ for the creation of a ‘cautious, prudent-man, trustee-like environment’ in the boardrooms of South African’.[1053]

In addition, an assessment of the viability of non-statutory responses/options such as 'captive insurance' reveals that the effectiveness of such methods is largely dependent on the financial means and foresight of the company concerned, which means that directors and senior managers have no legal basis for insisting on this form of protection as part of their service contract. The fact that directors and senior managers have no legal right to insist on exemption, indemnification, liability insurance and the adoption of risk mitigation measures such as

[1053] Manning B supra op cit note 550 at 1.

captive insurance for claims alleging breach of duty of care suits highlights the inadequacy of the protection under the current enforcement framework. It is expected that this lack of adequate protection via the bouquet of methods available to South African directors and senior managers will serve as a financial disincentive to corporate service, this argument also takes into consideration the inadequacy of the business judgment rule and judicial relief as the possible solution to the liability problem for breach of the duty of care which have been observed under the current legal enforcement framework.

This Chapter will not deal with the underlying substantive liabilities of directors and senior managers, as this has been dealt with.[1054] Rather, it will concentrate on the more legal and practical subject of the extent of indemnification and liability insurance as methods of protecting directors and senior managers against personal liability for duty of care violations under subsections 78(4) – (7) of the Act.[1055] It has also been shown that it is imperative and urgent that South African policy makers revisit the continued blanket prohibition against exemption clauses in subsection 78(2) of the Act, to balance out the potential crisis that may ensue if directors and senior managers are held liable for inevitable errors of judgement. Last, the refinement of the protection available to directors and senior managers through indemnification and liability insurance by converting them into a statutory right to secure their position and to achieve legal certainty in subsections 78(4) - (5) and (7) of the Act is also indicated in order the current enforcement framework to also serve the valid object of companies being able to attract and retain talented individuals for corporate service and providing conditions necessary for the transformation of quality of the pool of persons willing to serve as directors and senior managers.[1056]

[1054] Under the common law, a director who was negligent in managing the affairs of the company was liable to incur delictual liability based on the general principles of the lex Aqualia. See Chapter 3 para 3.1.
[1055] See para 6.1.
[1056] See chapter 7 on the specific proposed amendment to section 78 of the Act.

CHAPTER 7

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

7.1 Introduction and Summary of the Chapters

In South Africa, the duty of 'care', 'skill' and 'diligence' raises certain policy concerns for directors and senior managers in the corporate context.[1057] Johnston submits that the business system has been successful largely because of the willingness of business owners and managers to take risks.[1058] However, if managers are unable to protect themselves against personal financial ruin arising out of lawsuits alleging conduct that is negligence on the part of a director

[1057] Lord Hardwicke in the 1742 United Kingdom decision of *The Charitable Corporation v Sutton* (1742) 2 Atk 400 404 – 406 remarked that 'by accepting a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence'. Directors and senior managers in addition to having to act with honesty and in good faith when exercising their powers and functions, are also required to act with care, skill, and diligence in managing the affairs of the company. See also Hill G & Conaglen M supra op cit note 630 at 2.
[1058] Johnston J supra op cit note 145 at 2035.

or senior manager then '…the dangers of risk-taking may soon appear to exceed the rewards' and 'the entire enterprise system will be the loser'.[1059]

Spisto argues that South Africa needs to find the middle ground between 'encouraging fiduciaries to violate their trust and discouraging them from serving at all'.[1060] He calls for a more permanent and stable solution to the problem of directors' and senior managers' liability. Risk-taking is an essential element of business success, and the law should not discourage directors and senior managers from making risky decisions in the pursuit of maximising the value of corporations.[1061] The methods to be developed must 'balance the need for punishing fiduciaries against the need to protect aggressive directors willing to take good faith risk in the search for profits.'[1062] Slaughter recognises that the availability of protection to directors and senior managers may serve to catalyse desired corporate conduct by encouraging good faith risk-taking that is ultimately necessary for corporate success and profitability.[1063]

Furthermore, the heightened risk of personal financial liability for a breach of the duty of care, skill and diligence may deter competent people from serving on corporate boards as directors or senior managers. A strict enforcement of the duty of care under the current enforcement framework may expose directors and senior managers to catastrophic personal liability for their honest mistakes.[1064] Directors and senior managers are often required to make large-scale business decisions, and the loss resulting from an unsuccessful business decision may well exceed millions of Rands. A further policy consideration for protecting directors and senior managers relates to the need to reduce disincentives for corporate service.[1065] It is argued that when there is no protection available to directors and senior managers the prospects of being subjected to 'the high costs of defending lawsuits and to adverse judgments will outweigh the benefits of a directorship'.[1066]

South African policy makers had an opportunity in the lead-up to the drafting of the Act to develop a much-needed solution to the problem of directors' and senior managers' liability on a meaningful and permanent basis.[1067] Professor Mongalo has expressed his

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[1059] Johnston J supra op cit note 145 at 2035.
[1060] Spisto M supra op cit note 104 at 61.
[1061] Spisto M supra op cit note 104 at 61.
[1062] Spisto M supra op cit note 104 at 61.
[1063] Slaughter S supra op cit note 57 at 185.
[1064] Mongalo T supra op cit note 10 at 157.
[1065] Mongalo T supra op cit note 10 at 185.
[1066] Mongalo T supra op cit note 10 at 185.
[1067] Spisto M supra op cit note 104 at 61.

disappointment at the policy makers' disregard of the American Bar Associations' recommendation in 2001 that consideration be given to a statute 'permitting the memorandum or article to include a provision exculpating directors from liability for money damages in suits by the company – directly or indirectly – or by the shareholders, subject to exceptions for egregious misconduct…'[1068] The omission was surprising because mention was made of the ABA's finding and recommendation of the inclusion of an exculpatory statute for the protection of directors from personal liability for good faith breaches of the duty of care in the policy paper of 2004.[1069] It is argued that policy makers did not avail themselves of the opportunity to provide clarity and legal certainty concerning the position of directors and senior managers under the current enforcement framework. Professor Mongalo has remarked that the current enforcement framework is skewed towards the goal of punishing wrongful directorial conduct rather than mitigating the potential financial liability of directors and senior managers, that take good-faith risks in pursuit of maximisation of profits.[1070] The latter goal he argues is crucial to facilitating the attraction and retention of suitably qualified individuals for corporate service in South Africa.[1071]

The objects of the research were chief among other things, to 'identify whether the current enforcement framework which excludes clauses adequately provides directors and senior managers from liability for personal damages' and to 'investigate and suggest better approaches to balance the object of accountability and protection of directors and senior managers'.[1072] In addition, the research question was formulated as follows: '…Are South African directors and senior managers at a greater risk of being unable to protect their personal assets against liability claims for monetary damages (in the case of a breach of the duty of care), and thus in a less favourable position, when compared with jurisdictions which make provision for both exculpatory clauses and indemnification through liability insurance?'[1073]

[1068] See the ABA Report supra op cit note 12 at 22. See also Mongalo T supra op cit note 10 at 141. Please see also Chapter 4 para 4.2.3.

[1069] See pages 38 -39 of the Policy Paper supra op cit note 15 and more specifically footnote 64. The Policy Paper again raised the question as follows: 'A common debate in all jurisdictions is whether it should be permissible to exculpate, indemnify or insure directors against liability. As South Africa does not have a litigious culture, it is not necessary or desirable to exculpate or indemnify directors against liability, However, in order to enable companies to attract and retain highly qualified directors in circumstances where the actions of directors are increasingly under scrutiny, it may be necessary for a company to be able to indemnify a director against the expense of successfully defending an action against him or her.' – at 38 – 39. See also Chapter 4, para 4.4.2.

[1070] Mongalo T supra op cit note 10 at 156.

[1071] Mongalo T supra op cit note 10 at 156.

[1072] See Chapter 1 at para 2 for a full list of the objects.

[1073] See Chapter 1 at para III for a full list of the sub-questions. The formulation of the research question was inspired by Mongalo's article: see Mongalo T supra op cit note 10 at 141.

In order to reflect on the objectives of the research and to answer these questions regarding the gap in the protection of directors and senior managers, the following matters were discussed. In Chapter 2, a theoretical framework was considered relating to the competing policy interests of accountability and protection of directors and senior managers.[1074] The theories supporting and justifying the holding of directors and senior managers personally liable also known as the 'director aberrant theory' were discussed.[1075] The theories in favour of protecting directors and senior managers commonly referred to as the 'director protection theory' was explained.[1076] Lastly, a combined theory was put forward which also included a review of the role of the regulatory style and the regulator in striking the balance between two valid and competing interests.[1077]

Chapter 3 introduced key concepts which relate to the current enforcement framework that deals with the extended definition of the term 'director' which was examined and evaluated.[1078] The duty of 'care, skill and diligence' and how it relates to business judgement rule and the liability of directors and senior managers was unpacked.[1079] It was argued that the current enforcement framework has been expanded to include a large class of persons and that there is a heightened risk of personal liability for directors and senior managers for breach of care violations.[1080] The chapter also looked at other relief measures available to directors such as judicial relief in terms of subsections 77(5) and 77(9) of the Act.[1081] The directors' and senior managers' separate duty of 'care' and 'skill' and 'diligence' are again dealt with in chapter 5 setting out the United Kingdom's approach, which South Africa has followed, and it was contrasted with the United Kingdom's approach and the protection offered under these two jurisdictions on the duty of care.[1082]

Chapter 4 tracked the evolution of the continued prohibition against exemption clauses in South Africa. Historically, South Africa followed the United Kingdom model and this is also true under the current enforcement framework which contains a blanket prohibition against the inclusion of exemption clauses in the company's Memorandum of Incorporation or any other

[1074] See Chapter 2 at para 2.1.
[1075] See Chapter 2 at para 2.4.
[1076] See Chapter 2 at para 2.5.
[1077] See Chapter 2 at para 2.6 and 2.7.
[1078] See chapter 3, at para 3.2.
[1079] See chapter 3, at para 3.3 to 3.4.
[1080] See chapter 3, at 3.4.
[1081] See chapter 3 at para 3.4.1.2.
[1082] See Chapter 5 at para 5.2 and 5.3 respectively.

contract or resolution.[1083] Arguments for and against the inclusion of exemption clauses in the protection of directors and senior managers for breach of care violations were discussed and the importance of this specific protection is evaluated in light of the inadequacy of other methods of relief available to directors and senior managers under the current enforcement framework.[1084]

Chapter 5 provided a comparative analysis of the available measures of protection of directors and senior managers, by identifying and examining the similarities in both systems and the differing approach to exculpation.[1085] In the United Kingdom, the policy makers have elected to maintain the prohibition against exemption clauses.[1086] In the United States, and in particular the state of Delaware, legal developments prompted the policy makers to relook at the director and officer liability problem.[1087] One of the reasons for considering the United Kingdom jurisdiction is that South Africa shares the same corporate law traditions, in both countries there is a continued prohibition against exempting directors and senior managers from personal liability.[1088] The Delaware model or approach to the director liability problem has been to introduce exculpatory statutes as further protection for directors.[1089] The impact and developments that followed the *Smith v Van Gorkom* decision were mapped out as many United States adopted exculpatory statutes as a form of protection available to corporations to retain and attract suitably qualified individuals.[1090]

In chapter 6, the scope of the available methods of protecting directors and senior managers under section 78 of the Act is considered.[1091] Indemnification and liability insurance are defined and considered.[1092] The likelihood of an insurance crisis or directors crisis being caused by a similar *Smith v Van Gorkom* phenomenon occurring given the heightened risk of personal liability and the lack of adequate protection available under the business judgment rule in the current enforcement framework is considered.[1093]

1083 See Chapter 4 at para 4.2 and 4.4.
1084 See Chapter 4 at para 4.4.1, 4.4.2 and 4.5.
1085 See Chapter 5 at 5.2 to 5.3.
1086 See Chapter 5 at 5.2.3.
1087 See Chapter 5 at 5.3.
1088 See Chapter 5.1.1.
1089 See Chapter 5.3.
1090 See Chapter 5.3.4.
1091 See Chapter 6.1.
1092 See Chapter 6.1. and 6.2.
1093 See Chapter 6 at 6.3.4.

The main aim of this chapter is to make conclusions and recommendations on how to improve the protection available to directors and senior managers under section 78 of the Act. It is recommended among other things that subsection 78(2) of the Act be relaxed to permit exculpatory clauses for honest breach of care violations. Second, the discretionary language be removed from subsections 78(4), (5) and (7). Last, a recommendation on how the potential of non-statutory responses could also contribute to solving the directors' and senior managers' liability problem is suggested.

7.2 A Unifying Theory: A Proposal to Strike a Balance Between the Due Care of Liability of Directors and Senior Managers in South Africa and Protecting Them from Personal Liability for Inevitable Errors of Judgment or Oversight

Chapter 2 provides a theoretical foundation on the foundational principles relating to directors' and senior managers' liability and the fundamentals of a regulatory design in reducing policy failures.[1094] These theories in corporate law are relevant to two equally valid and competing policy considerations of accountability and providing directors and senior managers with protection from personal liability for honest breaches of the duty of care, skill and diligence. corporate legal enforcement.[1095] These theories have been considered based on whether a middle ground can be found between encouraging fiduciaries to violate their trust and discouraging them from serving at all.

While an outright theory may not emerge regarding how to best deal with the director and senior manager liability problem - the need to punish faithless directors and senior managers for egregious conduct and to protect directors and senior managers who take good faith risks for unavoidable errors of judgement – the need to find a middle ground that carefully balances the competing interest is important and of relevance to South African corporate law.

The liability problem tests the legal framework applicable to directors and senior managers. The current enforcement framework needs to be developed to provide more protection for directors and senior managers for honest errors of judgment by improving the methods available to companies. This call was made as far back as 1996 before South Africa

[1094] See Chapter 2 at 2.1.
[1095] Ibid at 2.1.

embarked on a comprehensive review of company law. The ABA made poignant recommendations regarding the inclusion of exculpatory statutes in the protection of directors and senior managers in 2001. In 2004 the issue was recorded in the policy paper for the policy makers consideration. Currently, commentators such as Professor Mongalo have called for policy makers to revisit the continued prohibition against exemption clauses in subsection 78(2) of the Act.

Conditions for corporate service in South Africa need to be improved by enhancing the protection available to directors and senior managers against liability when good faith is exercised in pursuit of risk-taking and innovation.[1096] It is clear that for South Africa's business system to be successful it will require the willingness of corporations and its senior managers to take risks.

The regulator's role under the current legal enforcement framework also needs to be clarified and enhanced to assist in creating the necessary regulatory environment that promotes the protection of directors and senior managers for good faith risk-taking that the economy requires to reach its growth objectives.[1097] The responsiveness of the regulatory style needs to be aimed at procuring compliance than rather being focused on enforcement through the threat of liability.[1098] The old regulatory style was strict and rule-based but was criticised for being reactionary and after the fact in dealing with the enforcement of directors' duties and providing relief.[1099] A new regulatory style was considered and it was clear that the traditional model or style of enforcement and protection of directors' and senior managers' duties and responsibilities were unsuitable for accommodation into a legal enforcement framework that is both flexible and responsive enough to protect directors and senior managers when they merely acted negligently while taking good faith risks in pursuit of profit.[1100]

It is therefore possible to argue through reasoning that the South African model and/or legal enforcement framework as it relates to directors and senior managers is ripe for crisis.[1101] The likelihood of a South African court finding in the footsteps of the *Smith v Van Gorkom* finding particularly regarding the minimal protection available to directors and senior managers through the business judgment rule.[1102] A decision holding directors and senior managers

[1096] See Chapter 2 at 2.5.
[1097] See Chapter 2 at 2.6.
[1098] See Chapter 2 at 2.6.
[1099] See Chapter 2 at 2.6.1.
[1100] See Chapter 2 at 2.6.1.
[1101] See Chapter 2 at 2.7.
[1102] See Chapter 2 at 2.7.

personally liable in South Africa would in all likelihood cause shock and expose the inadequacy of the current enforcement framework to insulate them from liability for monetary damages for honest breach of care violations. If a combined theory is not found the South African protection model needs urgent revision and improvement because it is susceptible to certain triggers as was the case in the *Smith v Van Gorkom* matter. The middle ground is having an enforcement framework that better balances the imperatives of holding directors and senior managers liable for wilful and egregious breaches of their duties while being lenient when the breach involves honest inevitable errors of judgment or lapse of oversight.[1103]

7.3 Guidelines for the Relaxation of the Prohibition Against Exemption Clauses: The Journey Forward

In Chapter 4, the ABA clearly articulated its views on the potential beneficial uses of exemption provisions exculpating directors (and senior managers) in a South African context for monetary damages in respect of legal actions brought by the company for breach of care violations with the exception that directors may not be excused for wailful or egregious behaviour.[1104] It has been argued that it is an opportune time for policy makers to revisit the continued prohibition against exemption clauses.[1105] To give effect to the ABA's recommendations, certain appropriate amendments need to be made to subsection 78(2) of the Act.

The main aim of this chapter is to make recommendations in an attempt to lend credence to the call for the lifting of the blanket continued prohibition against exemption clauses in subsection 78(2) of the Act. The proposed lifting of the prohibition will improve the protective measures available to directors and senior managers under the current enforcement framework and the proposed formulation will only permit the inclusion of the exemption clauses against liability arising out of alleged negligence, good faith and/or honest errors.[1106]

I have gleaned some valuable lessons from the comparable jurisdiction of the State of Delaware which should have influenced the formulation of subsection 78(2) of the Act had policy makers heeded the ABA's 2001 recommendation to include exculpatory clauses in the

[1103] See Chapter 2 at 2.5.4.
[1104] See Chapter 4 at 4.2.3.
[1105] See Chapter 6 at 6.5.
[1106] See Chapter 6 at 6.5.

Memorandum of Incorporation of a separate agreement, provided the agreement or resolution is not in conflict with the provisions of the Memorandum of Incorporation.[1107] The wording contained in sections 102(b)(7) of the Delaware General Corporation Law and section 2.02(b)(4) of the Model Act will be used as a reference guide only – but the proposed wording needs to meet the context requirements of the South African enforcement framework. The provisions of section 102 (b)(7) of the Delaware General Corporation Act as amended on 1 August 2022 state that exculpation is permissible for directors and officers as follows:

> '---(b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters: ---(1) *Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders, or the governing body, members, or any class or group of members of a nonstock corporation; if such provisions are not contrary to the laws of this State. Any provision which is required or permitted by any section of this chapter to be stated in the bylaws may instead be stated in the certificate of incorporation;*'[1108]

(Own emphasis)

Second section 2.02(b)(4) of the Model Act provides that: 'the articles of the incorporation may set forth…a provision *eliminating or limiting* the liability of a director of the corporation or its shareholders for money damages for any action taken, or any failure to take any action as a director….'[1109]

(Own emphasis)

It is clear from the two approaches above that the permissible clauses are broad and this will not necessarily fit the arguments advanced in this research for a concise lifting of the prohibition against directors and senior managers from liability for monetary damages for honest breaches of the duty of care in the management and oversight context of their duties.

[1107] See chapter 4 at 4.2.3.
[1108] Section 102(b)(7) of the DGCL.
[1109] Section 2.02(b)(4) of the United States Model Act.

7.3.1. Proposed Amendments to subsection 78(2) of the Act

Given the shortcomings of the blanket prohibition against exemption clauses in subsection 78(2) of the Act detailed in chapters 4[1110] and 6[1111] subsection 78(2) of the Act in its current form the lack of protection of directors and senior managers through exculpatory clauses that permit protection for honest breach of care violations in the management and oversight context of directors' and senior managers' duty of care and skill is unfortunate in the current enforcement framework. This answers the question of whether the current enforcement framework provides adequate protection to directors and senior managers.[1112] The proposed amendments to subsection 78(2) of the Act will lift the blanket prohibition only in respect of negligent errors or omissions of directors and senior managers qua that capacity for legal liability for monetary damages and legal defence costs for suits by the corporation, its shareholders and third parties. The proposal will suggest that the decision to include exculpatory clauses in the company's Memorandum of Incorporation or a service agreement between a director or senior manager and the company be subject to the shareholder's discretion and subject to the provisions of the MOI and the remainder of section 78 of the Act.

Based on the study and comparisons drawn, in conclusion, it is proposed that subsection 78(2) be amended to read as follows:[1113]

(2) Subject to subsections (4) to (6), any provision of an agreement, the Memorandum of Incorporation or rules of a company, or a resolution adopted by a company, whether express or implied, is void to the extent that it directly or indirectly purports to, <u>save for honest breaches of the duty of care, skill and diligence the shareholders of the company may elect to include a clause or provision in the Memorandum of Incorporation or a separate agreement exempting or eliminating a director from liability for honest breaches of care</u>:

(a) relieve a director of—

[1110] See Chapter 4 at 4.4.
[1111] See Chapter 6 at 6.1 and 6.4.
[1112] See Chapter 1 at para 3.
[1113] The portions in brackets are proposed deletions from this section. The underlined portions are proposed additions to this section.

(i) a duty contemplated in section 75 or 76; or

(ii) liability contemplated in section 77; or

(b) negate, limit or restrict any legal consequences arising from an act or omission that constitutes wilful misconduct or wilful breach of trust on the part of the director.

7.4 Guidelines for The Expansion of Indemnification Rights

Chapter 6 highlighted the scope and extent of protection available to directors and senior managers under the permissible indemnification and liability insurance under subsections 78(4) and (5) of the Act.[1114] The proposed amendments will relate to the (a) discretionary language contained therein

(b) removal of the caveat and clawback; and

(c) tightening of the wording regarding access to indemnification for lack of oversight claims and/or whether a director or senior manager 'gained' knowledge simply because he or she failed to exercise due oversight.

Based on the study and comparisons drawn, in conclusion, it is proposed that subsection 78(4) and (5) be amended to read as follows:[1115]

(4) Except to the extent that a company's Memorandum of Incorporation provides otherwise, the company—

(a) <u>is obliged to</u> advance expenses to a director to defend litigation in any proceedings arising out of the director's service to the company <u>for reasonable expenses and costs incurred in defending litigation where the director has made an honest error of judgement</u>; and

(b) <u>is obliged to</u> directly or indirectly indemnify a director for expenses contemplated in paragraph (a), irrespective of whether it has advanced those expenses, if the proceedings—

[1114] See Chapter 6 at 6.2 and 6.3.

[1115] The portions in brackets are proposed deletions from this section. The underlined portions are proposed additions to this section.

[(i) are abandoned or exculpate the director; or]

(ii) arise in respect of any liability for which the company may indemnify the director, in terms of subsections (5) and (6).

(5) Except to the extent that the Memorandum of Incorporation of a company provides otherwise, a company is obliged to indemnify a director in respect of any liability arising other than as contemplated in subsection (6).

7.5 Guidelines for an Effectual Liability Insurance Framework

Similarly, Chapter 6 also examined the scope and extent of protection available to directors and senior managers under the permissible liability insurance under subsections 78 (7).[1116] The proposed amendments will relate to the (a) discretionary language contained therein (b) removal of the caveat and clawback, and (c) tightening of the wording regarding access to indemnification for lack of oversight claims and/or whether a director or senior manager 'gained' knowledge simply because he or she failed to exercise due oversight.

Based on the study and comparisons drawn, in conclusion, it is proposed that subsection 78(7) be amended to read as follows:[1117]

(7) Except to the extent that the Memorandum of Incorporation of a company provides otherwise, a company is obliged to purchase insurance to protect—

(a) a director against any liability or expenses for which the company is permitted to indemnify a director in accordance with subsection (5); or

(b) the company may elect to purchase insurance to protect the company against—

(i) any expenses—

(aa) that the company is permitted to advance in accordance with subsection (4)(a); or

(bb) for which the company is permitted to indemnify a director in

[1116] See chapter 6 at 6.2 and 6.3.

[1117] The portions in brackets are proposed deletions from this section. The underlined portions are proposed additions to this section.

accordance with subsection (4)(b); or

(ii) any liability for which the company is permitted to indemnify a director in accordance with subsection (5)

7.6 Guidelines for Dovetailing the Available Protection Measures: A Layered Approach for a Comprehensive Model

7.6.1. Proposal to enhance and structure the protection methods:

The table below will show the necessary tweaks to each method to improve and synchronise the model for optimal protection from personal liability for honest errors of judgment.

Table 1:

Method	**Is the method effective against a Damages Claim?** **How to improve the method:**	**Are Legal Defence Costs Covered?** **How to improve the method:**
Exculpation	Relaxation of the prohibition against exemption clauses in subsection 78(2) of the Act.	No. The exemption clause will act as a bar that is dispositive of the matter upfront. It needs to be paired with defence costs under the proposed subsections 78(4),(5) and (7) of the Act.
Indemnification	Elimination of the discretion and 'clawback'.	Yes, provided that they are reasonably incurred.

The Business Judgement Rule	No recommendation.	No recommendation.
Liability Insurance	Elimination of the discretion and 'clawback'.	Yes, provided that they are reasonably incurred.
Judicial Discretion to Provide Relief	No recommendation.	No recommendation.

7.7 Guidelines for Effectual Risk Management: Measures to Enhance Non-Statutory Responses

Another possible non-statutory innovative measure is the inclusion of a contractual limitation of liability clause in directors' or senior managers' service contract as a stop-gap measure that ensures that the director's or senior manager's liability is capped to an agreed figure which is not disproportionate to the modest fees that a director or senior manager receives as payment for service to the company.[1118]This suggestion is based on the principle of fairness and consideration that directors and senior managers should not bear the full brunt of the company's losses especially when they have acted in good faith and the error is an honest error of judgement.

If the company is not willing to include exemption clauses in its Memorandum of Incorporation as a compromise they could agree with the director or senior manager that his or her liability will be capped to twice their annual directorship fees. This would naturally require

[1118] See Chapter 6 at 6.4.

the relaxation of the prohibition against exemption clauses in subsection 78(2) of the Act.[1119] The latter recommendation is based on equity and fairness considerations.[1120]

Directors and senior managers should attend regular training and continuous development courses offered by credible and registered training providers in order to keep abreast of the duties and requirements of corporate services. Companies should develop training packs for onboarding new directors and senior managers to orient them about the requirements of the role of the company concerned. It is also advisable that internal training should be scheduled periodically or on an ad hoc basis as necessary.

It has been demonstrated that it is permissible under subsection 78(7) of the Act for a director or senior manager to purchase their own liability insurance at their own costs. The terms and operation of this cover under the current will be subject to the same constraint as if the policy was purchased by the company. This cover may be crucial for the director or senior manager concerned if the company has elected or neglected to purchase directors' and officers' liability insurance. However, directors and senior managers should through negotiation with the company insist that the cost of such premiums should be a part of their compensation package with the company.

Companies should also consider the development of cell captive insurance, especially for a group of companies to supplement the cover available under liability insurance for their directors and senior managers. There must be safeguards built into the rules of the cell captive insurance regarding when a company in the group may access cover for litigation involving its directors and senior managers. Clear rules need to be developed to deal with any conflict of interest that may arise in practice. In addition, the money pooled into the cell captive needs to be invested to grow the pool and ensure the cell captives' sustainability.

7.8 Capacitating the Regulator: Human Capital and Increased Funding

The Department of Trade and Industry should consider ways to increase the capacity of the CICP to enable it to achieve its objectives. The right persons with the relevant skills and

[1119] See Chapter 6 at 6.4.
[1120] See Chapter 6 at 6.3.1.

background must be employed at the CIPC. The CIPC's budget should be reviewed and it must be determined what is an appropriate allocation for the CIPC to fulfil its ambitious objectives.

The CICP's approach to regulation and enforcement should be responsive driving customer service for all concerned in the value chain through strategic interventions. Corporations and their managers should be encouraged to comply with the ethos of the Act and other self-regulatory codes or practices such as the King Codes. The regulatory culture and framework should intently focus on training aimed at making directors and senior managers aware of their duties and responsibilities, but also encouraging them to be innovative in their approach to problem solving and risk taking.

7.9 Delineation and Further Areas of Research

The outline of the research work is informed by the objects of the research and the research questions. I have identified the following areas for additional focus in separate research:

(i) the role of the regulator and regulatory style;[1121]

(ii) the import of objectifying directors and senior managers separate duty of 'skill' (section 76(3)(c)(ii) of the Act – i.e., the continuous duty of having to upskill;[1122]

(iii) the impact of D & O liability insurance on corporate governance; and[1123]

(iv) the potential impact of non-statutory measures, such as 'cell captive insurance' and limitations of liability clauses, may play in the future.

7.10 Concluding Remarks

The leading question is whether the current legal enforcement regulating directors and senior managers adequately protects them from catastrophic legal liability for breach of care

[1121] See Chapter 2 at 2.6.
[1122] See Chapter 3 at 3.3 and Chapter 5 at 5.2.
[1123] See Chapter 6 at 6.3.

violations committed negligently, in good faith and honestly, in their management and oversight functions as fiduciaries of the company. However, the critical question is whether the South African model or method carefully balances two conflicting imperatives to hold to account directors and senior managers for egregious conduct in breaching proprietary standards imposed by law and the need to encourage directors and senior managers by insulating them from personal liability for honest errors thus allowing South African corporation to attract and retain suitably qualified and talented individuals for corporate service and comforting directors and senior managers sufficiently to take aggressive good faith risks in pursuit of maximisation of the value of the company and its relevant stakeholders, thereby ensuring that South Africa as an investment destination for purposes of incorporation of companies fares favourably with jurisdictions which that permit both exculpatory clauses in the articles of the company and expanded indemnification and liability insurance rights as a composite method of protecting directors and senior managers. The development of these methods will also render South Africa a destination of choice for incorporation both continentally and globally.

The introduction in Chapter 1 outlines some of the key issues in the study regarding the framework regulating directors and senior managers concerning the conflicting policy considerations of accountability and protection of directors and senior managers and how the research proposes to investigate and answer the relevant research question. Chapter 2 discusses the important theory and approach underpinning the need to punish directors and senior managers for faithless and egregious conduct and the need to protect directors and senior managers who take good faith risks. Chapter 3 considers the duties and standards expected from directors and senior managers in the discharge of their duty of care, skill and diligence. The issues that arise because the current enforcement framework increases the standard and potential for liability demonstrate that the framework is skewed towards accountability without providing sufficient protection to directors and senior managers for honest errors and negligent breaches of the duty of care. Chapter 4 traces and discusses the evolution of the continued prohibition against exculpatory clauses in South Africa. Arguments for and against the prohibition are considered together with other methods of relief available to directors and senior managers under the current enforcement framework. Chapter 5 examines the evolution of the standard of the duty of care, skill and diligence and the exemption of directors and senior managers through exculpatory statutes in the United Kingdom and the United States with particular focus being on the state of Delaware which is considered to be preeminent on corporate law issues and the protection of directors and senior managers. The United Kingdom model, which South Africa has subscribed to, is contrasted with the Delaware position with the view of how to best answer the directors' and senior managers' liability problem. Chapter 6 warns of the dangers of the current flaws in the current enforcement framework and the director of insurance crisis that may ensue if the position is left unchecked and if the continued prohibition against exemption clauses persists against honest breaches of the duty of care. In, the last, Chapter 7 an overview is presented of the research with recommendations for policy makers to consider for the development of methods necessary for enhancing the protection of directors and senior managers. Some crucial amendments are proposed for the relaxation of the blanket prohibition against exemption clauses and it is also recommended that the relevant provisions of the Act be amended to provide directors and senior managers with expanded indemnification and insurance rights. It was shown that the development of these methods will move the South African position carefully balancing the imperative to hold directors and senior managers liable and to provide adequate protection for directors and senior managers who are willing to take risks which are essential to the growth of the company and in turn the economy as a whole. Additional areas of study have also been listed that will assist in understanding aspects of the current enforcement framework.

The duty of care, skill and diligence requires directors and senior managers to discharge their management and oversight responsibilities diligently, attentively, and on an informed basis. Subsection 78(2) of the Act should be amended to permit a company's Memorandum of Incorporation to include a provision exempting directors and senior managers from monetary liability for a duty of care violation. This research proposes a re-envisioning of the model of protection and methods available to directors and senior managers for honest errors of judgment and oversight. It is hoped that these new methods will stave off directors or insurance crises in South Africa and serve the purpose of attracting and retaining suitably qualified individuals who are willing to take good faith risks that are aggressive to maximise value for all relevant stakeholders.

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