Insurance to protect a director against liability – the impact of Section 78 of the Companies Act 71 of 2008

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Declaration

I, ____ ,

declare that this research report is my own unaided work. It is submitted in partial fulfillment of the requirements for the degree of Master of Law (by Coursework and Research Report) at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination.

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Abstract

This research report assesses the impact of section 78 of the Companies Act 71 of 2008 on the indemnification of directors. Global company reform, which took place after the global financial crisis, was largely aimed at the protection of company stakeholders. This was achieved by placing emphasis on director's conduct in managing the affairs of the company.

South Africa, with the enactment of the 2008 Companies Act, followed this global trend by placing more onerous duties and obligations on directors, specifically in sections 75 to 77 of the Companies Act. The new Companies Act places directors at greater risk of being held personally liable by a third party for failure to adhere to the director's duties and obligations.

This report seeks to ascertain the impact of the enactment of section 78, in particular the provision for directors' and officers' liability insurance found in section 78(7). In addition, this report seeks to assess whether the correct balance has been struck between the need to hold directors to account and the need to preserve a director's ability to manage the affairs of the company without fear of personal liability.

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1. Introduction

The global financial crisis and the corporate collapses that followed it led to market interventions by governments globally through various domestic regulations that govern companies.[1] One of the aims of the company regulation reforms was to focus on the accountability of the directors. It was important to ensure that the liability of directors corresponded to the great responsibility with which they are entrusted. This will contribute to the management of the company meeting the goals of good corporate governance, as defined in King IV.[2] The South African legislature has sought to perpetuate this global reform of greater accountability through the enactment of the Companies Act 71 of 2008[3], which has attempted to protect stakeholders and has imposed more onerous obligations on directors.

Directors are central to the day-to-day management of the business of the company, which includes driving strategy and monitoring the exercise of delegated authority, among others, and are therefore vital to the success of the company.[4] This has led to increased obligations being placed on directors and an increased level of risk of directors being held personally liable by the company and third parties for failure to adhere to their duties and obligations.[5] The 2008 Companies Act gives effect to the increase in accountability of directors with the introduction of section 77 which provides a mechanism to hold directors liable. The Companies Act has also provided mechanisms for directors to escape liability in certain circumstances. The business judgement rule found in section 76(4) is an important mechanism that has been analysed relatively often since its inclusion in the Companies Act.[6] A further and less well documented mechanism is section 78(7), which allows directors to have insurance cover for protection against potential liability in terms of section 77. This raises an important question

1 K Dowd 'Moral hazards and the financial crisis' (2009) 29 *Cato Journal* at 140.
2 Ibid at 141.
3 Companies Act 71 of 2008.
4 R Aguilera 'Corporate Governance and Director Accountability: an institutional comparative perspective' (2005) 16 British *Journal of Management* 39-53.
5 C Hill and B McDonnell, Reconsidering board oversight duties after the financial crisis (2013) *189 University of Illinois Law Review* at 859.
6 M Havenga 'The Business Judgment Rule - Should We Follow the Australian Example' (2000) 12 *SA Merc LJ* 25, E Jones 'Directors' Duties: Negligence and the **Business Judgment Rule**' (2007) 19 *SA Merc LJ* 326–336 and L Muswaka' Shielding Directors against Liability Imputations: The Business Judgment Rule and Good Corporate Governance' (2013) *SPECULUM JURIS* (1).

of whether such mechanisms, particularly the ability to shift risk to an insurance company, undermine the obligations placed on directors. This research report aims to deduce to what extent these mechanisms undermine the obligations placed on directors and further whether this ultimately undermines the very important goal of good corporate governance through director accountability. To this end this research report will focus on directors' and prescribed officers' liability insurance and the extent of its impact on the move towards greater director accountability.

South African company law has evolved to impose onerous duties on directors to ensure that they act in the best interests of the company. These duties are found in section 76 of the Companies Act. Directors, however, need to take risks in order to make profits for the company. Therefore, directors are required to perform a balancing act between the 'risk-taking' behaviour that is innate to the entrepreneurial nature of being a director and performing the legal duties imposed on them as directors, which function to protect the company and its stakeholders.[7] Director liability to the company is essential, as it ensures that directors act in the best interests of the company. Should a director fail to act in the best interests of the company, the provisions of the Companies Act provide the company with mechanisms to hold the director to account. These mechanisms include section 77, section 20(6) and section 218(2) of the Act. These mechanisms have been established due to the responsibility directors have with regard to managing the company, as mentioned above. Should a company's directors fail to discharge these responsibilities, the company is unlikely to be profitable. Some of the most significant impacts of these regulatory reforms have been on the higher standard at which directors are held liable, as illustrated in the Act, which makes it impossible for a director to contract out of the fiduciary duties owed to the company. These fiduciary duties are mandatory, prescriptive and unalterable.[8] Section 76 of the Act combines the common law fiduciary duties and the duty of care and skill and has raised the standard of conduct previously expected of directors. This will be explored below in section 2 which deals with directors' duties.

Directors who fail to discharge their duties within the confines of the Act may be held liable by the company for loss suffered, in terms of section 77 of the Act.[9] Furthermore, directors

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[7] M Bekink 'Indemnification and aspects of directors' and officers' liability insurance in terms of section 78 of the Companies Act 71 of 2008' (2011) *SA Merc LJ* 88.
[8] FHI Cassim, MF Cassim, R Jooste, J Shev & J Yeats Contemporary Company Law 2ed (2012).
[9] Ibid at section 77.

may be held liable for the loss suffered by stakeholders as a result of a being in breach of their duties as directors.[10] Section 77 of the Act prescribes certain statutory liabilities for directors. Section 77(2)(a) of the Act states that a director of a company may be held liable for any loss, damages or cost sustained by the company as a consequence of any breach by the director of the duties described in section 76 of the Act. It is conceivable that raising the standards expected of directors is likely to deter directors from failing to discharge the duties imposed on them.[11]

Directors have for some time sought to take precautions against the possibility of being held personally liable for loss suffered by the company or a third party.[12] Some of the ways that this has been achieved has been through express terms in the company's articles of association, under the previous Companies Act excluding the director from liability[13], and through the issuing of an indemnity by the company to the director against legal action.[14] Directors in modern times are desirous to ensure that they are adequately insured against possible personal liability claims. The new Companies Act in section 78(7) makes provision for a company to purchase insurance to protect a director against personal liability. This type of insurance is known as directors' and officers' liability insurance and is governed by the Short Term Insurance Act 53 of 1998. This will be discussed in detail below under section 4. This liability insurance, like most types of insurance, mainly operates to provide indemnity. This provision is not unfamiliar to South African company law, as the Companies Act 71 of 1973, particularly section 247, limited the extent to which a company could indemnify a director against the director's liabilities. The 1973 Companies Act did however, make a concession in that it allowed a company to purchase directors' and officers' liability insurance.[15] The corresponding clause can be found in section 78 of the 2008 Companies Act, as mentioned above, which permits a company to indemnify a director against liability incurred as a result of his role as a director of the company.

[10] Op cit 5 at section 77.
[11] W Bishop & DD Prentice 'Some legal and economic aspects of fiduciary remuneration' (1983) 46 MLR 289 and G Rossouw, A Van der Watt and D Rossouw 'Corporate Governance in South Africa' (2002) 37 *Journal of Business Ethics* at 289.
[12] Op cit 7 at 1.
[13] Op cit 8 at 574.
[14] Op cit at 2.
[15] Companies Act 71 of 1973 Section 247.

Directors' and officers' liability insurance allows a director to be instrumental in the success of a company and removes the fear of personal liability.[16] It does however jeopardize the extent to which a director may be held accountable. Directors often require companies to ensure that they are covered by directors' and officers' liability insurance before agreeing to accept an appointment as director. The premise for this statement was found in *The Directors & Boards Survey,* which found that 87% of the 356 directors surveyed valued the cover of directors' and officers' liability insurance as a 'deal-breaker' when considering an offer to join a board.[17] This form of insurance serves two important purposes. Firstly, as stated above, it protects directors from personal liability and secondly, it allows them enough decision-making freedom to manage the company successfully. The meaning and effect of liability insurance is discussed in more detail below under section 4. It must be noted, however, that directors' and officers' liability insurance may not be used to indemnify a director against all forms of liability such as fraud. This too will be explored in further detail below under section 4. This report will investigate the interaction between the imposition of directors' duties and director liability with section 78 of the Companies Act, which facilitates a directors' right to be indemnified against personal liability in relation to these duties.

The focal research question that this paper will attempt to answer is whether the appropriate balance has been struck between director liability and the ability of directors to manage the company effectively. To answer this question, three sub-questions must be dealt with. Firstly, whether section 77 of the Act and its effect is limited by section 78 of the Act in view of the provisions that protect the director against potential liability. Secondly, whether section 78(7) of the Act provides adequate protection to directors as well as to the company and its stakeholders. Lastly, the report will deduce whether the protection from personal liability provided by directors' and officers' liability insurance to directors allows the appropriate balance to be struck between director liability and the onus that rests on a director to make a profit for the company.

The purpose of this research report is to demonstrate the intricate balancing act that legislators had to perform when drafting the Companies Act, specifically ensuring that the company,

[16] Op cit 3.
[17] The Directors & Boards Survey: D&O Insurance" in *Boardroom Briefing*, Volume 4, No. 1, a publication of Directors & Boards Magazine and GRID Media LLC.

directors and stakeholders are all provided with adequate protection. As mentioned above, directors are responsible for the day-to-day running of the business and wield a great amount of power when making decisions on behalf of the company. Such great power must be managed, which is why it is subject to legislation, such as the Companies Act, which places duties on directors and provides for their personal liability. Therefore, dissecting directors' and officers' liability insurance is crucial to the focal question of this research report, as it provides a middle ground between the power of directors to make decisions on behalf of the company and the need to protect directors against personal liability.

In summary, this research report will deal with directors' duties and their liability in order to identify the risk of personal liability they face. Thereafter, directors' and officers' liability insurance will be discussed, with reference to Canadian company law and its provisions regarding directors' and officers' liability insurance. The analysis of Canadian company law will assist in answering the focal question of this research report as directors' and officers' liability insurance provision in Canada is apposite to the South African Companies Act, insofar as it relates to directors' and officers' liability insurance. The report will then discuss section 78 of the Companies Act, followed by a particular focus on section 78(7), which makes provision for directors' and officers' liability insurance. Furthermore, this research report will argue that directors' and officers' liability insurance provides an effective mechanism in ensuring that directors are provided with an adequate safeguard against personal liability claims while also ensuring that the company and its stakeholders are adequately protected and are able to hold directors to account. In conclusion, this research report will establish that section 78(7) of the Companies Act has provided the necessary balance between directors' need to take risks and the legal duties imposed on directors.

2. Directors' duties

In answering the focal question of this research paper, it is fundamental first to consider directors' duties, as provided for in the Companies Act. With reference to section 78(1) of the Act, "… a 'director' includes former directors, alternate directors, prescribed officers and a person [who is] on the audit committee or is a member of a committee of a board of a company..." In addition, the Act defines a 'prescribed officer' in section 1 as "… a person who within a company performs any function that has been designated by the Minister in terms of section 66(10) ..." The Act, by electing to include prescribed officers in section 1 extends the obligations and liability of directors to prescribed officers. The result of this wide definition of directors is that issues regarding directors' and officers' liability insurance in terms of section 78(7) will in addition apply to prescribed officers as defined by section 1 of the Act. This demonstrates the increased focus of the Companies Act on good governance by senior management of a company. To further attest to this increased focus on good governance, directors may be held personally liable for breach of their fiduciary duties, breach of the duty of care and skill, for allowing the company to trade in bad faith, while in financial distress or insolvent circumstances.[18] These are just some examples of how directors may be held personally liable in terms of the Act, which are discussed further below.

Prior to the coming into effect of the 2008 Companies Act, directors' duties were derived from various sources. These director's duties could be found in a company's memorandum of incorporation, articles of association or contracts entered into with the company.[19] Additional duties, such as the common law duty of care and skill and fiduciary duties, were imposed on directors.[20] The Act now partially codifies the fiduciary duties as well as the duty of care and skill. Directors' duties are now embodied in Section 76 of the Act. The specific duties as set out in the Act will now be considered.

2.1 The fiduciary duties of directors

A director stands in a fiduciary relationship with the company to which he is appointed as a director.[21] This places a duty on the director to act in good faith and in the best interests of the company.[22] In *Howard v Herrigel* the court stated that once a person accepts a position as a director he becomes a fiduciary in relation to the company and is obliged to display the utmost good faith towards the company.[23] Fiduciary duties are derived from South African common law and are largely inherited from English law. At common law, a director's overarching fiduciary duty is to act in good faith and in the best interests of the company.[24] The Act codifies this overarching duty in Section 76(3)(a) and (b), which reads:

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[18] Op cit 5 at Section 77.
[19] N Bouwman "An appraisal of the modification of the director's duty of care and skill" *SA Merc LJ* 21 (2009) 509.
[20] R Stevens 'The duty of care and skill and reckless trading: Remedies in flux? (2016) *SA Merc LJ* at 250.
[21] Op cit 8 at 523.
[22] Op cit at 3 and Benade, Henning, Du Plessis, Delport, De Koker and Pretorius *Entrepreneurial law* (2008) 130.
[23] Howard v Herrigel 1991 (2) SA 660 (A) 678A.
[24] J McLennan 'Directors' fiduciary duties and the 2008 Companies Bill' (2009) *J. S. Afr. L.* at 184.

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

(a) in good faith and for a proper purpose;

(b) in the best interests of the company; …

The Act in section 2 partially codifies the common law fiduciary duties, but this is not exhaustive and common law duties not included in the Act are still applicable and enforceable. Section 2 reads as follows:

(2) A director of a company must -

(a) not use the position of director, or any information obtained while acting in the capacity of a director -

(i) to gain an advantage for the director, or for another person other than the company or a wholly-owned subsidiary of the company; or

(ii) to knowingly cause harm to the company or a subsidiary of the company; and

(b) communicate to the board at the earliest practicable opportunity any information that comes to the director's attention, unless the director -

(i) reasonably believes that the information is -

(aa) immaterial to the company; or

(bb) generally available to the public, or known to the other directors; or

(ii) is bound not to disclose that information by a legal or ethical obligation of confidentiality.

The fiduciary duties owed to a company by directors include:

- the duty not exceed their powers as directors;[25]
- the duty to exercise their power for a proper purpose;[26]

[25] Op cit 8 at 532.
[26] Op cit 8 at 525.

- the duty to exercise an independent and unfettered decision;[27]
- the duty not to make secret profits and [28]
- the duty not place themselves in a position that leads to conflict between their personal interests and those of the company. [29]

In light of the above, it is clear that directors' duties comprise the duty of care and skill as well as the fiduciary duties owed to the company by a director. It is critical to consider whether it is appropriate for a director to be provided with protection where the director has been found to have breached the duty of care and skill or a fiduciary duty. It is arguable that a director's fiduciary duty to a company is at the core of his obligations to the company.[30] With that in mind, it can be argued that should a director breach this fiduciary duty, he should be held personally liable and should not have access to protection in the form of insurance. This will ensure that directors act in the best interests of the company at all times and assuring the protection of the company's stakeholders.

Company law should not hinder directors, through untenable regulations, from making decisions that are in the best interests of the company and are necessary to ensure that the company remains profitable. Directors' and officers' liability insurance, which will be discussed in further detail in this research report, provides a mechanism to balance the need for directors to take risks and make decisions with the duties imposed on directors by law. This balance is necessary to ensure that directors can be effective and manage the company efficiently.

2.2 The duty of care and skill

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

> (c) with the degree of care, skill and diligence that may reasonably be expected of a person -

[27] K Idensohn 'The Regulation of Shadow Directors' (2010) 22 *SA Merc LJ* 326–345.
[28] Op cit 8 at 536.
[29] Op cit 5 at section 76 and M Havenga 'Directors' exploitation of corporate opportunities and the Companies Act 71 of 2008' (2013) 2 *TSAR* 257.
[30] Op cit 24 at 185.

(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.

In exercising his power as a director in good faith, a director is required to act with a degree of care and skill in terms of section 76(3)(c) of the Act. This is not a fiduciary duty. The courts traditionally followed a lenient approach when considering if this duty had been breached. A subjective test was formulated to determine a directors' personal attributes such as intelligence and experience when assessing whether a breach had taken place. Liability was based on delictual principles (The aquilian action) .[31] As a result, this meant that at common law a director, when performing his duties, was required to exercise the degree of care and skill that could be expected from a person with his knowledge and experience.[32] The leading case in South Africa is the case of *Fisheries Development Corporation of SA Ltd v Jorgensen & Another; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd & Others*.[33] This case set the legal precedent at the time in South Africa. This has since been modified with the implication of the new Companies Act. There are three pertinent principles to the precedent. Firstly, the extent of a directors' duty of care and skill will depend on the nature of the company's business. Furthermore, the distinction between executive and non-executive directors was outlined.[34] Executive directors deal with the day-to-day running of the business whereas non-executive directors are not bound to give continuous attention to the company but have to perform their duties at periodical board meetings or any other meeting that may require their attention.[35] Secondly, directors are not required to have any special business acumen, ability or intelligence. A director is, however, expected to perform his duties with the care reasonably expected from a person with his knowledge and expertise. Thirdly, a director is, in the absence of suspicion, justified in trusting that officials will perform duties delegated to them honestly.[36] In the case of *Re Denham & Co*[37] the court held that the director had not been in breach of his duty of care and skill after it had found him negligent in the

[31] N Bouwman 'An appraisal of the modification of the director's duty of care and skill' (2009) 21 *SA Merc LJ* at 510.

[32] Op cit 4.

[33] *Fisheries Development Corporation of SA Ltd v Jorgensen & Another; Fisheries Development of SA Ltd v AWJ Investments (Pty) Ltd & Others* 1980 (4) SA 156 (W) at 156.

[34] This, however, is not the case now in South Africa. With the introduction of the Companies Act 71 of 2008 and the King Code executive directors and non-executive directors are held to the same standard.

[35] Op cit at 19.

[36] Op cit at 19.

[37] (1884) LR 25 Ch D 752.

performance of his duties as a director. This demonstrates that only gross or culpable negligence would lead to a finding that a director was in breach of his duty of care and skill. The precedent set was extremely encouraging for directors and did little to ensure that the balancing act mentioned above was managed appropriately.

This lenient approach became unfit to meet the evolving corporate governance principles, which sought to hold directors accountable.[38] Society and the corporate world had developed and the standard of care expected from a director had changed. The economic and financial crises experienced globally uncovered multiple types of fraud, negligence and irregularities, which ultimately contributed to the crisis. The result of irregularities was increased market intervention through legislation and regulations that were subsequently put in place in order to prevent further economic or financial catastrophes. Therefore, the standard of care expected of a director has increased and the lenient approach consequently needed to be revised. In *Re D'Jan of London Ltd*[39], the court formulated a new approach to deal with the breach of duty of care and skill, which included both objective and subjective elements. This is not a South African case, but the approach corresponds significantly with section 76 of the Act. Section 76(3)(c) of the Act partially codifies the common law duty of care and skill.[40] This codification includes the subjective element, which was formulated under the common law. The first leg contains the objective elements, which set a minimum standard for all directors, and the second leg contains the subjective element, which sets out the standard for directors who have additional skill and experience over and above the minimum standard set out in the first leg. A director is required to meet both the objective and subjective elements set out above.[41]

3. Directors' liability

A director's exposure to personal liability must be fully understood in order for a company to ensure that adequate safeguards, in the form of insurance, can be applied to protect the director against personal liability. Personal liability of directors has taken on greater significance in South African company law upon the enactment of the Companies Act and its significant impact on directors' liability, which will be discussed in further detail below and throughout

[38] M Havenga ' The business judgement rule – We should follow the Australian example' (2000) *12 SA Merc LJ* 25 at 34.
[39] (1993) BCC 646 (Companies Court). At what page ? where is this case referred to? Not a south African case
[40] Op cit 1.
[41] Op cit 5 at 513.

this research report.[42] Further impacts of the Act are that for the first time, South African company law has conferred power upon directors to manage the affairs and business of the company. Prior to the 2008 Companies Act, the power of the board of directors was derived from the constitution of the company and not from statutory law. This power given to directors has lessened the extent to which shareholders may control the company and its directors. In light of this change, greater recourse mechanisms are needed to hold directors liable.

3.1 Liability in terms of section 77

Section 77 of the Companies Act imposes liability on directors for non-compliance with duties imposed on them as directors.[43]An illustration of this is provided for in section 77(2), which states that a director may be held liable for the breach of a fiduciary duty for loss, damage or cost sustained by the company as a consequence of the breach by the director.[44] Furthermore, a director, in terms of Section 77, may be held liable for failing to disclose a personal interest, failing to avoid a conflict of interest or failing to act in good faith and for a proper purpose or in the best interests of the company. Section 77(2)(b) provides that should a director breach the duty to act with the required care and skill, any provision in the Act other than section 77 or any provision of the company's memorandum of incorporation, such a breach would result in the director being held liable according to the common law principles of delict for any loss, damage or cost suffered by the company.[45] In addition, Section 77 (3)(b) provides for further liability of directors where it is found that they have traded recklessly or have conducted the company's affairs with the intention to defraud a creditor. Section 77(6) provides that a single director may be held liable for the totality of loss or damage suffered by a third party due to the breach of a fiduciary duty. This demonstrates the intention of the legislature to ensure that a director who breaches his duties pays the maximum legally permissible monetary compensation. Section 77 and the imposition of liability on a director who breaches his duties can have both positive and negative consequences. The imposition of liability on directors in terms of section 77 may be considered harsh and as a measure that restricts the ability of a director to take the necessary risks associated with the role of a director. Alternatively, the imposition of liability on directors may be considered a necessary measure to ensure that

[42] Op cit at 1.
[43] M Havenga 'Directors' exploitation of corporate opportunities and the Companies Act 71 of 2008' (2013) *TSAR* 2 at 262.
[44] Op cit 1 at Section 77(2).
[45] Ibid at section 72(b).

directors do not abuse their power and protect the company along with its stakeholders. As mentioned above, legislation plays a central role in ensuring the correct balance is struck between imposing director liability and protecting the interests of a company by ensuring that directors are not prevented from taking risks that are central to the running of a company.

Individual directors, however, may invoke the business judgement rule in terms of Section 76(4) of the Act as a protective measure against personal liability. The business judgement rule is a protective measure for directors against liability imputations.[46] The rule shields honest directors from liability where a decision turns out to affect the company adversely.[47] This rule has been codified in section 76(4) of the Companies Act. In terms of this section a director will be protected against claims of breach of the duty to act in the best interests of the company and with the required care and skill. A director is only afforded this protection where it can be shown that the director took diligent steps to be informed, had complied with the rules on conflict of interest and had a rational basis to believe and did believe that the decision made was in the best interests of the company. The business judgement rule, however, cannot be used by directors who were dishonest or irrational and face liability for breach of the duty to act in the best interests of the company.[48] The business judgement rule provides a mechanism to reduce the need for protection of directors through directors' and officers' liability insurance in certain circumstances. If a director has taken diligent steps to be informed, has complied with the rules on the conflict of interest and has a rational basis to believe and did believe that the decision he made was in the best interests of the company, then directors' and officers' liability insurance will be not be required. A question then arises whether directors' and officers' liability insurance is only needed in instances where a director has acted intentionally or with gross negligence outside the scope of his director's duties. This will be elaborated on below. In this instance it will be argued that a director must be held personally accountable in order to ensure that directors act within the scope of their duties and to deter directors from intentionally taking undue risks or acting ultra vires. In addition to section 77, a securities holder may in terms of section 161(1)(b) of the Companies Act apply to a court for an order to rectify harm done to the holder of securities by a director, only to the extent that the director may be held liable in terms of section 77.

[46] Op cit 8 at 563.
[47] L Muswaka 'Shielding directors against liability imputations: The business judgment rule and good corporate governance' *Speculum Juris* 2013 1.
[48] Op cit 5 at section 76(4)(a).

3.2 Liability in terms of section 20(6) and Section 218(2)

Section 77 of the Act is not the only provision that deals with director liability. Directors need to be mindful of section 20(6) and section 218(2) when considering whether they are adequately covered by directors' and officers' liability insurance, as mentioned above. These two provisions stipulate that in terms of section 20(6) any shareholder or in terms of section 218(2) any affected person may hold a director personally liable.

Section 20(6) is an additional provision that provides for the personal liability of a director; it reads as follows:

> "(6) Each shareholder of a company has a claim for damages against any person who intentionally, 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 action has been ratified by the shareholders in terms of subsection (2)."

Section 20(6) of the Companies Act provides that a shareholder of a company has a claim for damages against any person who fraudulently or due to gross negligence is the cause of the company breaching the Companies Act or the Company's Memorandum of Incorporation. The shareholder would bring the action in his or her personal capacity as a shareholder.

Section 218(2) of the Companies Act contains a catch-all provision. This section reads as follows:

> "218. Civil actions
>
> > (2) Any person who contravenes any provision of this Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention."

In terms of this section, any person who has contravened the Act is liable for any loss or damage suffered as a result of that contravention. This section would accordingly allow a creditor to claim against the company as well as against a director who caused loss as a result of a contravention of the Companies Act. This section is particularly important to creditors who wish to recover losses as result of reckless or fraudulent trading, as section 218(2) is seen as the only section in which a creditor may hold a director liable for losses due to reckless or fraudulent trading.[49] A shareholder, however, would be better placed to institute a claim based on section 218(2) and not section 20(6). This is evidenced in terms of section 218(2), as liability is triggered as soon as there is a contravention of any provision of the Companies Act. In contrast, a claim in terms of section 20(6) would require a shareholder to prove fraud or gross negligence, which is not the case in terms of section 218(2). A director will be covered by liability insurance for contraventions of these sections.

3.3 Section 22(1) of the Act read with section 77

Section 22(1) of the Companies Act states that a company must not carry out its business recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose. In terms of section 22(1), if a company continues to incur debts where there is no reasonable prospect of the creditors receiving payment when due, it can be said that the business of the company is being carried on recklessly or negligently as contemplated by section 22(1) of the Act.[50] Furthermore, a director who is managing a company that cannot pay its debts has a duty to pass a resolution for business rescue or to resolve to wind up the company as soon as he becomes aware that the company cannot pay its debts to creditors as and when they are due. In the event that a company cannot pay its debts and directors decide not to place it into business rescue, directors will be obligated to deliver a written notice to affected people confirming that the company is not financially sound and is not being placed into business rescue and providing reasons for such decision.[51]Alternatively, if a company is trading as an insolvent company and there is no prospect for business rescue to succeed, the directors are obligated to file for liquidation.[52] In the event that a director does not act, as provided above, he will be acting in breach of section 22(1) and may be held personally liable in terms of section 77(3)(b). The provision in Section 77(3)(b) states that a director of a company is liable for any loss or damages sustained by a company as a result of the director conducting the affairs of the

[49] HE Wainer, 'The new Companies Act; peculiarities and anomalies' (2009) 125 (4) *SALJ* 806- 826.
[50] Op cit 1 at section 22(1).
[51] Op cit 6 at 861.
[52] Re William Leitch Bros Ltd (1932) ALL ER 892.

business despite being aware that it was being conducted in a manner prohibited by section 22(1).[53]

Directors are now obligated to ensure that they are aware of their legal obligations and duties. This is necessary so as to adequately assess their potential exposure to liability in terms of the Companies Act. Furthermore, companies have to assess a directors' potential exposure to personal liability in order to ensure it has taken out adequate directors' and officers' liability insurance to cover its directors against personal liability claims.

As illustrated above, directors have become increasingly susceptible to being held personally liable by the company or a third party. This inevitably restrains directors from acting in an entrepreneurial manner when making decisions on behalf of the company, since when making a decision, directors need to ascertain whether their conduct may put them at risk of being held personally liable. However, holding directors liable is important to ensure that they do not mismanage the company or act negligently when running the company. Directors' and officers' liability insurance in terms of section 78(7) provides directors with the requisite insurance cover and allows a director to make decisions freely on behalf of the company without being exposed to constant risk of being held personally liable for losses. Therefore, if a director is found to have contravened section 76, section 22(1) or section 20(6) read with section 218(2) directors' and officers' liability insurance may be needed to ensure the director is covered from potential liability.

4. Directors' and officers' liability insurance

When considering the onerous duties placed on directors and the focus on their behavior, it is clear that in today's corporate climate directors face significant exposure to liability based simply on their roles and titles. The Companies Act, as stated above, has had a significant impact on the roles of directors and the power they hold, but importantly, it has also influenced the standard at which director's actions are measured. This necessitates discussions on directors' and officers' liability insurance and its impact on director accountability. This movement towards greater liability and accountability of directors, coupled with the increased

[53] Blue Farm Fashion Limited v Rapitrade 6 (Pty) Ltd and Others (22288/2014) [2016] ZAWCHC 35 (1 April 2016).

complexity of the modern economic world, has increased directors' possible exposure to personal liability.[54] The provisions of the Companies Act dealing with director liability stated above demonstrate the high risk of exposure faced by directors. Directors need to ensure that they are adequately insured against possible personal liability claims in terms of section 77, section 22(1) and section 20(6) read with section 218(2)

Insurance may provide a suitable solution to directors who are at risk of being held personally liable for loss or damage suffered by the company or a third party. Insurance is a contractual agreement for the transfer and allocation of risk.[55] The insured individual transfers certain risks to the insurance company by way of a contractual agreement. [56] The insurance company by way of the contract agrees, upon the occurrence of an uncertain specified objective event, to pay the insurance proceeds to the beneficiary of the insurance or to indemnify the insured person. The insured person is required to pay an insurance premium to be provided with cover. This insurance premium is an amount of money paid to the insurance company within certain agreed upon time limits.[57]

Liability insurance is insurance against a legal liability. It consists of a contract in which an insurance company in return for a premium undertakes to provide policy benefits if an event relating to the incurring of liability occurs.[58] Liability insurance covers individuals and companies against the risk of being held responsible for causing costs borne by other parties during the policy period.[59] Liability insurance therefore covers expenses that result from an action or a failure to act, which leads to a third party incurring a loss.[60] When an insured is held liable by a third party and this is covered by the contract of insurance, the costs, damages or liability incurred will be covered by the insurance company.[61] This claim could arise from a trial or an out of court settlement. This can be differentiated from property insurance, which is

[54] L Trautman and K Altenbaumer-Price 'D & 0 insurance: A primer (2011) 1 *American University Business Law Review* at 337.
[55] H Cousy 'The legal sources of insurance contract law: From a tiny well to a colourful fountain' (2017) *TSAR* 455.
[56] Ibid at 456.
[57] J Lowry and P Rawlings 'Insurance law' (2004).
[58] M Reinecke 'South African insurance law' (2013).
[59] W Jacobs ' Liability insurance in a Nutshell: Simplified Complexities or Complex simplicities' (2009) 21 *SA Merc LJ* 202-227.
[60] Ibid at 220.
[61] Ibid at 221.

insurance coverage purchased to cover any loss to facilities or equipment through events over which the insured has no control.[62]

In essence, liability insurance is an insurance policy which protects the insured person against liability to a third party. A 'liability policy' as defined in the Short Term Insurance Act can be described as a contract in terms of which a person in return for a premium undertakes to provide policy benefits if a trigger event contemplated in the contract occurs. Wenette Jacobs in an article discussing liability insurance refers to directors' and officers' liability insurance as a form of liability insurance and states that "directors' and officers' liability insurance provides cover for an insured against its legal liability towards third parties arising out of the insured's company duties.[63]

A company may choose to purchase insurance on behalf of a director of the company to protect the director against liability incurred in his capacity as a director.[64] Directors' and officers' liability insurance provides cover for damages incurred for an error, a negligent statement or a breach of a duty, but not for fraudulent conduct. This type of insurance is common in the modern corporate workplace.[65] It is an agreement to indemnify directors and officers personally against judgements, settlements and fines arising from negligence lawsuits, shareholder actions and business lawsuits. Like other types of insurance, the fundamental function of directors' and officers' liability insurance is indemnification.[66] The main arguments in support of directors' and officers' liability insurance are that this type of insurance can attract and retain talented individuals to serve as directors. Moreover, the absence of such insurance may encourage conservative management, which may not be in the interests of shareholders.[67] This is central to ensuring that the correct balance is struck between preventing abuse of power by directors and ensuring directors have enough freedom to perform their duties in a manner that will ensure that the company remains profitable and competitive.

[62] R Winter ' The liability insurance market' (2004) 5 *Journal of Economic Perspectives* at 115.
[63] Op cit 59 at 206.
[64] J Core 'On the corporate demand for directors' and officers' insurance' (1997) 64 *Journal of Risk and Insurance* at 63.
[65] Op cit 2.
[66] Black's Law Dictionary (9th ed. 2009).
[67] R Macminn 'Directors, directors and officers insurance, and corporate governance' (2012) 2 *Journal of Insurance Issues* at 159.

Directors' and officers' liability insurance is not a standard type of insurance cover, which can be purchased over the telephone. It is a unique form of insurance, which is often negotiated in order to meet the needs of the company.[68] Premiums are paid by the company and these premiums are typically calculated on the basis of the estimated frequency and severity of claims. Directors' and officers' liability insurance usually provides three types of cover to companies that have purchased the insurance. Firstly, insurance cover is provided in instances where the company is unable to indemnify the directors for losses suffered by the director in accordance with section 78(7) of the Companies Act. This may be due to insolvency or where the company is prevented by law from indemnifying its directors with respect to the loss incurred by the director. This type of insurance cover is unique, as it covers individuals only. In instances where the company is failing, additional insurance may be purchased to ensure a director is indemnified.[69] Secondly, insurance cover is provided in order to reimburse the company for indemnifying a director for claims from third parties. These claims usually arise when a director has breached a fiduciary duty.[70] Lastly, insurance cover is provided in order to pay for losses suffered by the company in limited types of claims. Directors' and officers' liability insurance is taken out by a company in order to minimize loss that may be inflicted on the company by the actions of its directors.[71] This cover, however, has limits and insurance cover cannot be provided for claims arising from fraud or willful misconduct. [72] It is also possible that an insurance provider may refuse to provide cover to a company or to directors who have bad insurance claim records.[73]

To understand directors' and officers' liability insurance better and to assess the impact that this insurance will have on South African corporate governance, it is important to provide some background into this type of insurance, with reference to the United States and Canada. In the United States financial crises involving Enron, WorldCom and other large corporate companies placed the focus on corporate governance.[74] The Sarbanes-Oxley Act introduced in 2002 focused on improving corporate governance by protecting shareholders.[75] This led to greater personal liability for directors and in turn led to an increase in the demand for directors' and

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[68] Op cit 40 at 63.
[69] K Altenbaumer-Price, The basics of D&O insurance: What the heck do A, B and C stand for? (2011) *DICTA* at 6.
[70] Op cit 2 at 89.
[71] Op cit 4 at 90.
[72] Op cit 4 at 91.
[73] Gower & Davies' Principles of Modern Company Law 8 ed (2008) by Paul Davies at 593.
[74] https://www.gsb.stanford.edu/insights/what-led-enron-worldcom (accessed on 25 January 2018).
[75] The Sarbanes–Oxley Act of 2002 (Pub. L. 107–204, 116 Stat. 745, enacted July 30, 2002).

officers' liability insurance.[76] In the United States directors' and officers' liability insurance is now fairly commonplace and Tillinghast-Towers Perrin found in 2002 that 97 per cent of surveyed US firms obtain this type of liability insurance for their directors.[77] Tillinghast-Towers Perrin conducted surveys regarding directors' and officers' liability insurance among corporate companies. United States firms are often mandated to indemnify directors by state corporate law.[78] Directors' and officers' liability insurance in turn reimburses the company for the litigation costs and pays the directors' and officers' costs directly when the firm cannot do it.[79] The local market for directors' and officers' liability insurance may not be as advanced as the market in the United States, but it is foreseeable that directors' and officers' liability insurance will become central to corporate governance in South Africa. This due to the increase in director duties and director liability.

Canadian company law makes provision for directors' and officers' liability insurance in section 124(1) of the Canada Business Corporations Act, which is similar to section 78(7) of the South African Companies Act.[80] Both provisions provide for the purchase of insurance for directors by a company to indemnify directors with respect to claims arising from their role as a director. In Canada a director's personal liability can arise from shareholder litigation or legal action brought by third parties, such as creditors.[81] Similar to the United States, directors can be sued under the corporate law for breach of fiduciary duties or under the securities law, the latter being the most significant source of risk.[82] Directors' and officers' liability insurance is less popular in Canada than in the United States, according to the survey conducted by Tillinghast-Towers Perrin in 2002; in Canadian firms only 84 per cent of surveyed firms carried directors' and officers' liability insurance. The Canada Business Corporation Act allows a company to indemnify its directors against all costs incurred through civil, criminal,

[76] A Oh 'Insuring against another Enron: The role of cross-listing status of Canadian firms on the purchase of directors' and officers' insurance in the aftermath of Sarbanes-Oxley Act of 2002 (2009) 20 -1.
[77] Tillinghast-Towers Perrin (1999, 2000, 2002). Directors and officers liability survey, US and Canadian results 1998, 1999, 2001.
[78] M Boyer 'Directors' and officers' insurance and shareholder protection' (2005) *SSHRC – Canada* at 3
[79] Op cit 33 at 161.
[80] Section 124(1) of the Canada Business Corporations Act provides that a corporation may indemnify a director or officer of the corporation, a former director or officer or another individual who acts or acted at the corporation's request as a director or officer, or an individual acting in a similar capacity of another entity, against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgement, reasonably incurred by an individual in respect of any civil, criminal, administrative, investigative or other proceeding in which the individual is involved because of that association with the corporation or other entity.
[81] Canada Business Corporation Act of 1985.
[82] S Donley and N Kent 2008 'Directors and officers liability in Canada: A review of exposures and coverage available under D&O policies' (2008) Clark Wilson LLP, Vancouver British Columbia, Canada.

investigative or administrative actions. However, in order for a company to be allowed to indemnify a director, two prerequisites must be satisfied. Firstly, the director must have acted honestly and in good faith, with the best interests of the company in mind. Secondly, in cases where a director is involved in criminal or administrative proceedings where a monetary penalty is enforced, the director must have had reasonable grounds to believe that his or her conduct was lawful.[83] The Canadian Supreme Court has found it is necessary for directors to be provided with the necessary indemnification through directors' and officers' liability insurance, as this promotes entrepreneurialism.[84] This is crucial to the balance required between director autonomy and director accountability.

The South African legislative provision regarding directors' and officers' liability insurance, namely section 78(7) of the Companies Act, does not provide for the two prerequisites found in the Canadian Business Corporations Act. This is problematic, as indemnification may only be prohibited for fraud or willful misconduct. Recently in South Africa, in the case of *S v Blue Platinum Ventures,* the managing director of Blue Platinum Ventures became the first director in South Africa to be held personally liable for a mining-related environmental offence.[85] In terms of section 78(7) of the Companies Act, the company would not need to show that the director reasonably believed that his conduct was lawful in order to indemnify the director from a fine stemming from the criminal prosecution. This brings into question whether section 78(7) provides far too broad protection of directors against personal liability. Section 78(7) and the extent to which it provides protection to directors will be discussed in detail below.

In South Africa directors' and officers' liability insurance is governed by the Short Term Insurance Act 53 of 1998. The directors' and officers' liability insurance market only became significant as a result of the introduction of the 1973 Companies Act. As mentioned above, indemnification was dealt with in terms of section 247 of the Act. Companies were allowed to purchase insurance to protect directors against liability and therefore section 247 was central to the initial demand for directors' and officers' liability insurance. The proviso in section 247(1) entitled a company to pay for 'insurance in order to indemnify the company against liability of any director towards the company with respect to any negligence, breach of duty or

[83] Op Cit 48 at Section 124.
[84] Blair v Consolidated Enfield Corp (1995) 4 SCR 5.
[85] *S v Blue Platinum Ventures (Pty) Limited and Another* (2015) ZAGPPHC 980.

breach of trust'.[86] This proviso also meant that directors could pay for their own directors' and officers' liability insurance. The Act, however, was silent on whether a company was allowed to pay for insurance for directors in their personal capacity.[87] This was dealt with by the introduction of the 2008 Companies Act.

5. Analysis of Section 78 of the Companies Act 71 of 2008

Section 78 of the Companies Act deals with the indemnification of directors by a company. To better understand what the term indemnification means, it is necessary to define the term indemnity. Indemnity is defined as 'a duty to make good any loss, damage or liability caused by another person'.[88] This is subject to certain exceptions. Indemnification in the context of section 78 refers to a company's ability to make good any loss, damage or liability incurred by a director of the company.

Section 78(1) of the Act extends the meaning of the word 'director' to include current directors of the company, alternate directors or former directors. It goes further to include a prescribed officer and a member of a board committee or an audit committee. Section 78(1) thus extends the ordinary meaning of the word 'director' in order to widen the scope of section 78.[89] This is important in view of the way modern companies operate, where prescribed officers and board committee members enjoy delegated authority and make important decisions on behalf of the company. Prescribed officers and members of board committees are thus often tasked with making decisions and conducting business, which would usually be considered the duty of a director.[90] It is therefore important to ensure that they too can be indemnified against personal liability. It is arguable that the broader reach of section 78 ensures that third parties have the opportunity to seek adequate recourse against the particular individuals involved in causing loss. Prescribed officers, members of board committees and audit committee members will therefore need to ensure they obtain cover to indemnify themselves against personal liability. Furthermore, former directors require protection in situations in which claims arise after the director has left the company as they may be subject to a claim by a third party.

[86] Blackman et al. Commentary on the Companies Act (Volume 1): Chapter VIII Directors (ss 208-251)
[87] Op cit 2 at 96.
[88] Black's Law Dictionary (9th ed. 2009), available at Westlaw BLACKS.
[89] Op cit 9 at 574.
[90] Op cit 8 at 511.

Section 78(2) provides that subject to sections 78(4) - (6), any provision of any agreement, the memorandum of incorporation or rules of the company or a company resolution, whether implied or express, is void to the extent that it directly or indirectly relieves a director of a duty found in sections 75 or 76 or of any liability found in section 77. Furthermore, provisions that negate, limit or restrict any legal consequences that flow from an act or omission that amounts to willful breach of trust or amounts to willful misconduct are void. Section 78(2) prohibits a director from contracting out of his common law or statutory duties or liabilities. Section 78(2) therefore prohibits certain exemptions or exclusions from duties and liabilities. This is important, as it reinforces the need to hold directors accountable.

In terms of section 78(3), a company is prohibited from directly or indirectly paying any fine imposed on a director of a company who has been convicted of an offence in terms of any national legislation.[91] This is commendable, as it will ensure that directors who commit unlawful acts or omissions will be held accountable and will act as a deterrence mechanism. Section 78(4) provides that a company may advance the expenses incurred by a director to defend himself in any legal proceedings that arise from his dealings as a director of the company. Furthermore, a company may indemnify the director for such expenses if the proceedings are abandoned, or arise in respect of any liability for which the company is allowed to indemnify the director in terms of subsections (5) and (6).[92] This demonstrates how careful the legislature had to weigh up director accountability and director autonomy. In terms of these two sections a company is prohibited from paying a fine on behalf of a director who has been found liable for a contravention of an Act. However, it does allow a company to assist a director who is required to defend himself in legal proceedings. Section 78(3) and 78(4) is another example of where the correct balance has been struck by the legislature.

Section 78(5) of the Companies Act allows a company to indemnify a director against any liability incurred. This provides for wide scope of director indemnification, as directors may be indemnified against liability stemming from their negligence. Section 78(5) indemnification is, however, subject to the exceptions found in section 78(6). Section 78(6) prohibits the indemnification of a director by a company in certain circumstances. A company may not

[91] Op cit at section 78(3).
[92] R Wakefield 'Section 78 of the Companies Act 71 of 2008: Directors' and officers' liability insurance' 2012 (1) *CR* 7.

indemnify a director against liability if that liability arises from lack of authority, reckless or negligent trading or the defrauding of a stakeholder. Furthermore, a director may not be indemnified against liability arising from willful misconduct or willful breach of trust on the part of the director.[93] This is crucial, as it ensures that directors honour the fiduciary duty that they owe to the company and do not willfully breach this duty. This serves to ensure protection of fiduciary duties owed to the company by directors. Section 78(7) deals with directors' and officers' liability insurance and will be dealt with in detail below. Section 78(5) allows for indemnification of a director by a company for costs incurred due to negligence whereby the company contracts to pay the costs incurred by a third party this can be differentiated from section 78(7) which allows a company to indemnify a director through directors' and officers' liability insurance. In terms of section 78(7) the company allocates the risk to an insurance company. However, section 78(8) provides that a company may claim restitution from a director for any money paid directly or indirectly by the company to or on behalf of that director in any manner inconsistent with section 78.[94]

6. Detailed analysis of directors' and officers' liability insurance in terms of section 78(7)

As mentioned above, section 78(7) deals specifically with directors' and officers' liability insurance. This provision is far more detailed compared to section 247 of the Companies Act 73 of 1973. Section 78(7) reads as follows:

> "(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 -
> >
> > > (i) any expenses -
> > >
> > > > (aa) that the company is permitted to advance in accordance with subsection (4)(a); or

[93] Op cit 9 at 576.
[94] Op cit 50 at 2.

(bb) for which the company is permitted to indemnify a director in accordance with subsection (4)(b); or

(ii) any liability for which the company is permitted to indemnify a director in accordance with subsection (5)."

This section provides that a company may purchase insurance to cover a director against liability for which the company is permitted to indemnify the director, unless it is prohibited by the companies' memorandum of incorporation. Furthermore, it allows the company to protect itself against any contingency advanced to the director, or with respect to indemnity that was provided and against any other liability against which the company may indemnify a director. Close reading of section 78(7)(b) reveals that a company has the right to insure itself against any losses arising from a director's breach of his duties found in sections 75 and 76.[95] In terms of section 78(7), a company is not obliged to purchase insurance to protect a director. Therefore, when a company elects to indemnify a director against claims from third parties arising from a director's negligence, the company will either pay the third party on behalf of the director or pay the director directly.[96] It is crucial for a company to elect to purchase insurance to indemnify its directors. The increase in directors' duties and directors' liability has placed directors at greater risk of being found personally liable for loss suffered by a third party.

Companies indemnify directors to ensure that directors are able to take the necessary entrepreneurial risks associated with the role of a director, in order to ensure that directors can perform their duties without fear of liability and to ensure the company remains profitable. Purchasing directors' and officers' liability insurance is advisable for companies, as opposed to the indemnification of a director through a contract or in the company's memorandum of incorporation. This is because indemnifying a director through the company's memorandum of incorporation or through a contract will leave the company at risk of exposure to uninsured liability under the indemnity provided to a director. Directors' and officers' liability insurance provided for in section 78(7) provides directors with a greater degree of certainty when carrying out their increased duties to the company. Furthermore, companies can minimize the amount the company might be liable to pay in a contingency by purchasing insurance.[97]

[95] Op cit 9 at 578.
[96] Op cit 5.
[97] Op cit 50 at 3.

Importantly, directors' and officers' liability insurance affords insurance cover to directors for loss or damages caused by an error, a negligent statement or breach of a duty imposed on a director.[98] Directors' and officers' liability insurance cannot provide insurance cover to directors who commit a fraudulent, dishonest or illegal act or willfully breach a duty owed to the company.[99] This is important, as in business directors are likely to make mistakes that cost the company as well as third parties money. This lessens the onerous nature of sections 75 and 76, which place duties on directors, since directors are protected from innocent lapses in judgment. This is crucial, as directors need to be able to take risks associated with the management of a company whose aim is to make profit, but they cannot misuse this provision to commit illegal acts or willfully breach their duties to the company.

It can be argued that Section 78(7) of the Companies Act and its provision for directors' and officers' liability insurance is critical in enabling directors to perform their duties effectively and efficiently. Only certain talented individuals are consequently suitable for the role of a director who manages a company and makes important decisions on behalf of the company, coupled with onerous director's duties and increased exposure to personal liability. The increased risk of personal liability imposed by the Companies Act makes the role of a director less appealing than it used to be. For this reason companies might find it increasingly difficult to attract talented individuals to serve as directors. Section 78(7), however, provides directors with a solution to the increased exposure to the personal liability risk. The provisions enable a company to attract talented individuals to serve as directors, provided the company ensures that the director is covered by directors' and officers' liability insurance. The provision acts as a mechanism to achieve the correct balance between a director's need to take risks when running the company and the need to ensure that directors are held to account for their conduct.

7. Conclusion

As a means of attracting and retaining competent directors, companies have chosen to protect their directors from personal liability through directors' and officers' liability insurance. Worldwide reform of the laws that govern companies has emphasized directors' duties and

[98] Op cit 4 at 90.
[99] Op cit 4 at 90.

liability.[100] Senior management of a company are at the centre of attention for regulators and legislators. The demand for good corporate governance by senior management has been intensified through the implementation of legislation and regulations. South Africa, in line with global reform, introduced the 2008 Companies Act. The Act has placed onerous duties on directors and increased the level of director liability. The partial codification of directors' duties in section 76 of the Act has led to an increase in the standard of conduct expected from them. This partial codification has allowed South Africa to increase the protection provided to shareholders and other stakeholders.

More onerous duties being placed on directors have led to increased director liability. The personal liability of directors was central to the enactment of the Companies Act 71 of 2008. Section 77 of the Act provides that directors may be held liable for any loss or damage suffered by a third party due to the breach of a directors' duty, reckless trading or a contravention of a provision of the Act.

Due to the global increase in director liability, directors have actively been seeking ways to protect themselves from personal liability. Companies may choose to indemnify directors through provisions placed in the company's memorandum of incorporation or a contract. This, however, is not advisable, as the company will be at risk of being exposed to uninsured liability. Indemnification will not ensure that the company is protected from all claims that may arise against a director. Directors' and officers' liability insurance provides directors with a solution to their increased risk of being held personally liable for loss or damage suffered by a third party. Companies may purchase directors' and officers' liability insurance on behalf of a director. This will provide a director with cover against any loss or damage due to an error, negligent statement, breach of duty or fraudulent conduct.

This paper has demonstrated why directors' and officers' liability insurance is necessary for South African companies. Firstly, it allows companies to attract competent directors who can take the necessary risks in order to ensure the company remains profitable without undue concern about the potential for personal liability. Secondly, it provides a shield for directors against the onerous duties placed on them by section 76 of the Act and potential liability that may be imposed on them in terms of section 77 of the Act. This paper has also demonstrated

[100] Op cit 1 at 859.

instances where directors' and officers' liability insurance may provide too much cover to directors, thus allowing directors to act in a manner that is detrimental to the company in the knowledge that they will be protected from personal liability.

Section 78(7) of the Companies Act specifically deals with directors' and officers' liability insurance. It provides that unless a company's memorandum of incorporation provides otherwise, a company may purchase insurance on behalf of a director in order to protect him against personal liability. Section 78(7) is in clear contrast to one of the aims of the Companies Act, namely to increase the standard expected of directors and increase the level of personal liability of directors. Section 78(7) provides a mechanism to protect directors who have contravened a common law or statutory provision. This decreases the risk of a director being held personally liable for damages or loss suffered by a third party.

The increased need for director liability, however, needs to be balanced with the need for directors to take risks in order to ensure companies remain efficient and profitable. A situation has emerged where legislators need to balance the need for directors to be able to take risks with the legal duties needed to be imposed on directors in order to protect the company and its stakeholders. The legislature when enacting section 78(7) went a long way in attempting to strike this balance. Directors cannot be covered by insurance for liability arising from a fraudulent, dishonest or illegal act or against willful default or a willful breach of a duty owed to the company. This ensures that directors are not protected when they intentionally commit an act or omission that causes harm to a third party.

Section 78(7) of the Companies Act provides that the necessary cover may be purchased by a company for directors who make an error, make a negligent statement or breach a duty owed to the company. Section 78(7) provides companies with the ability to ensure that they can hire and retain highly qualified directors and to enable the directors to perform their duties without fear of personal liability. This benefit for the company and its contribution to the ultimate success of the company clearly outweighs the shortcomings of section 78(7).

This research report has illustrated the tension between the need to hold directors accountable for the way they perform their duties and the need for directors to be able to act without being concerned about possible exposure to personal liability. The Companies Act, specifically section 78(7) in relation to directors' and officers' liability insurance, goes a long way in resolving this tension. Directors' and officers' liability insurance provides a mechanism to balance the need for director accountability and the preservation of their ability to run the company without fear of exposure to personal liability.

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