COX ATTORNEYS

Simplicity in law

The Standard of Directors Conduct.

Unpacking section 76 of the Companies Act 71 of 2008

By Ian Cox

Section 76 is a play in four acts. The underlying theme running through all four acts is that section 76 does not exclude the common law fiduciary duties owed by a person occupying a position of trust in relation to a company.

Act One: The definition of a director.

The fiduciary duty owed to a company in common law is not limited to a director. The Supreme Court of Appeal ruled in Philips v Fieldstone Africa (Pty) Ltd [2004] 2 All SA 150 that the standard of conduct expected of a director extends to anyone who occupies a position of trust in relationship to the company.

Section 76(1) states that for the purposes of this section the term director <u>includes</u> an alternate director, a prescribed officer and members of board committees including an audit committee. This definition is broader in its scope than the definition of a director in section 75(1) (disclosures of personal financial interests) which does not include members of an audit committee.

The common law rule described in Fieldstone thus remains intact. Senior managers who are not directors as defined and others who fall outside the scope of that definition may still owe a fiduciary duty to the company on account of the fact that they occupy a position of trust.

It is important to note that this position of trust is not the same as the obligation of fealty or loyalty that arises in employment law. A discretionary exercise of power over the company is an inherent feature of a position of trust. This is not a prerequisite of the obligation of loyalty that arises in an employment relationship.

Act Two: Section 76(2) and the duty to avoid conflicts of interests.

Section 76(2) is considerably more complicated. It states:

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 immaterial to the company; or 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.*

This section needs to be read in conjunction with section 75. Interpreting this section is a bit like decoding a Rubik's Cube. In my view it goes like this:

1. The common law duty as pithily expressed by the Honourable Mr Justice Innes CJ in Robinson v Randfontein Estates Gold Mining 1921 AD 168:

   "*Where one man stands to another in a position of confidence involving a duty to protect the interests of that other, he is not allowed to make a secret profit at the other's expense or place himself in a position where his interests conflict with his duty.*"

   remains unchanged outside the scope of section 75 and the way that section deals with the disclosure of personal financial interests.

2. Those who occupy a position of trust in relation to a company but who are not directors as defined in section 75(1) are not bound by section 75 and are not therefore obliged to disclose conflicts of interest even if these involve a personal financial interest. They are nonetheless obliged at common law to avoid conflicts of interests in their dealings with or on behalf of the company. Secret dealings in contravention of this obligation are treated as fraudulent and any decision or transaction that takes place as a result of such dealings may be declared void by the company. This rule is strictly applied and may not be waived. However it does not apply in cases where the shareholders permit non compliance provided that this consent is an informed one. Furthermore shareholders may later condone non compliance and ratify any decisions or transactions that might otherwise be voidable. Thus although members of an audit committee may not be subject to the duty to disclose set out in section 75 they are still subject to the common law duty described above. The same applies to senior managers and indeed any other person who is not a director as defined but who nonetheless occupies a position of trust and thus owe a fiduciary duty to the company.

3. Directors as defined in section 75 are treated differently insofar section 76(2) (a)(i) applies to a personal financial interest as defined in section 75. I dealt with this and a director's duty to disclose in http://www.mondaq.com/article.asp?article_id=209058&lk=1. The companies common law right to permit such conflicts of interest has been modified by section 75. Thus shareholders may no longer permit directors to escape these obligations. Directors may no longer participate in decisions of the board where they are conflicted by a personal financial interest nor may shareholders condone this. The rights previously enjoyed by shareholders are reduced to ratifying decisions of the board otherwise nullified by a failure to properly disclose a personal financial interest.

4. Section 75 only applies to personal financial interests. The common law will continue to apply in respect of section 76(2)(b) and where conflicts arise in respect of interests that do not fall within the definition of a personal financial interest.

5. Section 76(2)(a)(ii) clarifies the common law fiduciary duty to act in the best interest of the company perhaps as a result of the judgement of the Honourable Mr Justice Hussain in Minister of Water Affairs and Mining v Stilfontein Gold Mining Co Ltd 2006 5 SA 333. In that case the court controversially ruled that directors breached their fiduciary duties by resigning en masse because by doing so they harmed the company and were thus in breach of their duty to act in the best interest of the company. This sets the bar too high. As the stock market reveals, resignations often have a foreseeably negative effect on the fortunes of a company. Hopefully it is now clear that the duty will only be breached where the resignation is tainted by malice or fraud. Directors are not obliged to go down with the ship nor are they obliged to put themselves in harms way. They are entitled to seek greener pastures even if their departure will cause the company harm. Resignation has always been the honourable response to a decision a director cannot countenance or to unacceptable pressure from other stakeholders.

Act Three: Section 76(3) and the duty of good faith and care.

Section 76(3) is a simple restatement of the common law. It states:

> *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 in relation to the company as those carried out by that director; and*
>
> *(ii) having the general knowledge, skill and experience of that director.*

The obligations described in section 76(3)(a) and (b) are fiduciary duties as are those described in sections 75 and 76(2). This is made clear in section 77(3). Thus a breach of these sections will give rise to both a claim for damages and a claim for a disgorgement of profits. The latter claim arises immediately a profit is made as a result of a breach of a fiduciary duty. It does not matter if the company suffered damages or wanted or was in a position to take advantage of the opportunity that gave rise to the profit. Those who owe a fiduciary duty whether at common law or in terms of sections 75 or 76 should take care to avoid contravening these provisions.

The common law duty of care owed by a director to the company is not a fiduciary one. It arises in delict. Claims in delict, even those in terms of section 76(3)(c) do not give rise to a claim for a disgorgement of profits. Claims for compensation are limited to delictual damages only. This is reiterated in section 77(2)(b) which expressly limits the remedies available for a contravention of section 76(3)(c) to those that exist in common law for claims in delict. The two claims, one for a breach of a fiduciary duty and the other for a negligent failure to take proper care, should not be confused. As Mr Symington learned to his cost in Symington and others v Pretoria-Oos Privaat Hospitaal Bedryfs (Pty) Ltd [2005] 4 All SA 403 (SCA), even though both may give rise to a similar claim for damages, they must nevertheless be claimed separately. One cannot sue for damages in delict and later argue an entitlement to an award in damages on account of a breach of a fiduciary duty even though they may amount in fact to one and the same thing.

It has been suggested that the test for compliance with sections 75 and 76 is a an objective one rather than the so called subjective objective test that is now applied in common law. I do not agree. Apart from the fact that sections 75 and 76 do not replace the common law, section 76(3)(c) restates the common law duty directors owe in delict to take reasonable care while about their duties as a director in terms of the subjective objective approach. Thus one does not judge the actions of a director on what a reasonable man would do in the situation but rather from the point of view of what the director concerned would reasonably be expected to do having regard to his or her general knowledge skill and experience and bearing in mind the standard of care the company might reasonably expect of a person filling that position. The standard demanded of a director in terms of this test will vary considerably depending on the size and business of the company, the nature of the position and the skill and experience of the director.

This is identical to the approach adopted in the British Companies Act 2006. Section 174 of that act states:

> 1) *A director of a company must exercise reasonable care, skill and diligence.*
>
> 2) *This means the care, skill and diligence that would be exercised by a reasonable person with*

> a) *the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by a director in relation to the company, and*
>
> b) *the general knowledge, skill and experience that the director has.*

It in turn is a codification of the common law approach described by Lord Hoffman in Norman v Theodore Goddard [1991] BCLC 1028 and Re D'Jan of London Ltd [1993] BCC 646. This so called subjective objective approach was followed in South Africa in Howard v Herrigel NNO 1991 (2) SA 660 (A) and Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman 1998 (2) SA 138 (SCA). It is easily contrasted with the objective reasonable man test set out in section 180 of the Australian Corporations Act of 2001. That section states:

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

Act Four: The business judgement rule.

Sections 76(4) and (5) set out what is called the business judgement rule. The idea of a business judgement rule is American but it is now found in other jurisdictions such as Canada, Australia and Germany. The elements of this rule are already inherent in the common law duty of care. The British 2006 Companies Act for example does not have a business judgement rule but the practical application of its common law duty of care in terms of section 174 of the Companies Act 2006 has the same effect.

The general scheme and content of the rule varies from country to country but all find common ground in the principle that directors must exercise diligence while entitling them to place reasonable reliance of facts or advice given by others. Surprisingly the form of the business judgement rule set out in section 76(4) and (5) of the 2008 Companies Act most closely resembles in form at least that set out in sections 180 and 189 of the Australian Corporations Act of 2011.

This test does not replace the common law duty of care . It is in the nature of a safe harbour. Thus section 76(4) says that a director will have satisfied the requirements of section 76(3)(b) and (c) (good faith, for a proper purpose and in the best interests of the company) if he or she takes reasonable diligent steps to become informed about the matter and in circumstances where the director believed the decision was in the best interests of the company.

This safe harbour is not available to a director who fails to disclose a personal financial interest in the matter or having done so fails to recuse himself or herself as required by section 75(5). It also does not help if the directors decision albeit diligently researched and bona fide was nonetheless irrational. The director is however entitled to rely on the reasonable advice and information supplied by the company's employees or professional advisors.

It has been suggested that this safe harbour makes directors safer. I don't agree. Safe harbours may make everything that lies outside them unsafe. You don't have to pass an exam in order to be a director or even be literate. At common law directors are allowed to be poorly educated, inexperienced, and, as is often the case in smaller companies, not entirely up to the job. They are allowed to get things wrong and as the court rolls show, they often do, sometimes disastrously so. The vast majority of directors are not professionals but amateurs put on the board by the shareholders who are often one and the same. They do not always enjoy easy access to competent professional advice or the assistance of highly skilled employees. In times of difficulty they are more likely to resemble storm tossed wrecks struggling to survive than the stately liners envisaged by sections 76(4) and (5).

An overzealous application of the business judgement rule could override the importance of the directors personal circumstances. This will set the bar too high for smaller companies and thereby vastly increase the risk of personal liability of the directors concerned, especially if section 218(2) applies.

Conclusion: King III

The King III Governance principles were launched on 1 September 2009 and came into effect on 1 March 2010. Although the principles rather grandiosely claim to be applicable to all companies they are not. In fact the King codes have no legal effect outside the rules of the Johannesburg Stock Exchange. Furthermore although King III was launched after the enactment of 2008 Companies Act and with a view inter alia aligning the King Codes with this act, they do not in fact always align.

The most obvious misalignment in the context of a directors or senior managers fiduciary duties is the question of independence. King III says that the majority of directors must be independent. It states:

> *63) The board should ensure that there is an appropriate balance of power and authority on the board. No one individual or block of individuals should be able to dominate the board's decision-making.*
>
> *64) The board should comprise a majority of non-executive directors. The majority of non-executive directors should be independent as this reduces the possibility of conflicts of interest and promotes objectivity.*

The 2008 Companies Act does not require that directors be independent. Indeed the it is notable for the lack of any reference to independence. This distinguishes it from the British which deals specifically with the independence of directors. Our law does not demand independence of a company's directors. Section 76(3) limits a director's duties in this regard acting in good faith in the interest of the company and for a proper purpose. Directors may, within the constraints of that obligation and subject to the proper management of any resultant conflicts of interest, serve the interest of the shareholder or other stakeholder who placed them on the board.

The truth is that while King III has practical relevance to those companies who are subject to the enhanced accountability and transparency standards described in Chapter 3 of the 2008 Companies Act, it is of little application to the vast majority company's on the South African register. These companies are by and large owner managed sole proprietorships (and I include subsidiaries in this category) or small businesses carried on in companies operating as so called quasi partnerships. These companies are not only ill suited to structures and accounting standards recommended by King III, they also lack the capacity to implement them. While every sustainably successful business is well led and ethically run this does not mean that every sustainably successful company applies King III.
