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The standard of  
directors' conduct



### The standard of directors' conduct

By accepting their appointment to the position, directors imply that they will perform their duties to a certain standard, and it is a reasonable assumption of the shareholders that every individual director will apply his or her particular skills, experience and intelligence to the advantage of the company.

The Act codifies the standard of directors' conduct in section 76. The standard sets the bar very high for directors. The intention of the legislature seems to be to encourage directors to act honestly and to bear responsibility for their actions - directors should be accountable to shareholders and other stakeholders for their decisions and their actions. However, with the standard set so high, the unintended consequence may be that directors would not be prepared to take difficult decisions or expose the company to risk. Since calculated risk taking and risk exposure form an integral part of any business, the Act includes a number of provisions to ensure that directors are allowed to act without constant fear of personal exposure to liability claims. In this regard, the Act has codified the business judgement rule, and provides for the indemnification of directors under certain circumstances, as well as the possibility to insure the company and its directors against liability claims in certain circumstances.

It should be noted that the duties imposed under section 76 are in addition to, and not in substitution for, any duties of the director of company under the common law. This means that the courts may still have regard to the common law, and past case law when interpreting the provisions of the Act.

The codified standard applies to all directors, prescribed officers or any other person who is a member of a board committee irrespective of whether or not that the person is also a member of the company's board. Also, it should be noted that no distinction is made between executive, non-executive or independent non-executive directors. The standard, and consequent liability where the standard is not met, applies equally to all directors.

In terms of this standard a director (or other person to whom section 76 applies), must exercise his or her powers and perform his or her functions:

- in good faith and for a proper purpose
- in the best interest of the company, and
- with the degree of care, skill and diligence that may reasonably be expected of a person carrying out the same functions and having the general knowledge, skill and experience of that director.

The Act prohibits a director from using the position of director, or any information obtained while acting in the capacity of a director to gain an advantage for himself or herself, or for any other person (other than the company or a wholly-owned subsidiary of the company), or to knowingly cause harm to the company or a subsidiary of the company.

Directors have a fiduciary duty to act in the best interest of the company as a whole. Directors owe this duty to the company as a legal entity, and not to any individual, or group of shareholders – not even if the majority shareholder appointed the director. Directors are obliged to act in good faith in the best interest of the company. They should act within the bounds of their powers, and always use these powers for the benefit of the company. Where a director transgresses his or her powers, the company might be bound by his or her action, although he or she can be held personally liable for any loss suffered as a result. The fiduciary duty of directors includes (but not limited to):

- the duty to individually and collectively exercise their powers bona fide in the best interest of the company
- the duty not to exceed their powers
- the duty not to act illegally dishonestly, or ultra vires
- the duty to act with unfettered discretion
- the duty not to allow their personal interests to interfere with their duties
- a director is accountable to the company for secret profits made by virtue of the fiduciary position or from the appropriation of a corporate opportunity
- the duty not to compete with the company
- the duty not to misuse confidential information.

When determining whether a director complied with his or her fiduciary duty, the court may consider whether, in the circumstances, a reasonable person could have believed that the particular act was in the best interest of the company. This is typically known as an objective test.

“... and the directors as occupying a fiduciary position towards the company must exercise those powers bona fide in the best interest of the company as a whole, and not for an ulterior motive ...”

- Treasure Trove Diamonds Ltd v Hyman 1928 AD 464 at 479

The codified standard for director conduct combines “care, skill and diligence” in one single test. The test to measure a director’s duty to exercise a degree of care, skill and diligence provides for an objective assessment to determine what a reasonable director would have done in the circumstances. However, the objective assessment contains subjective elements in that it takes into consideration the, skill and experience of that particular director. In applying the test, a distinction is made between different types of directors.

“the extent of a director’s duty of care and skill depends to a considerable degree on the nature of the company’s business and on any particular obligations assumed by him or assigned to him.... In that regard there is a difference between the so-called full-time or executive director, who participates in the day to day management of the company’s affairs or of a portion thereof, and the non-executive director who has not taken on any special obligation. The latter is not bound to give continuous attention to the affairs of the company. His duties are of an intermittent nature to be performed at periodical board meetings, and at any other meetings that may require his attention.”

- Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd 1980 (4) SA 156 (W)

In a recent Australian case (Centro case) the duty of care and skill was considered with respect to the duty of directors to approve the financial statements of the company. In this case that court found that all non-executive directors were in breach of their duty of care and skill. The failure to notice certain omissions may well be explicable – but here the directors clearly looked solely to management and external advisors. However, if they had acted as the final filter, taking care to read and understand the financial accounts, the errors may have been discovered.

“All directors must carefully read and understand financial statements before they form the opinions which are to be expressed ... Such a reading and understanding would require the director to consider whether the financial statements were consistent with his or her own knowledge of the company’s financial position. This accumulated knowledge arises from a number of responsibilities a director has in carrying out the role and function of a director. These include the following:

- a director should acquire at least a rudimentary understanding of the business of the corporation and become familiar with the fundamentals of the business in which the corporation is engaged;
- a director should keep informed about the activities of the corporation;
- whilst not required to have a detailed awareness of day-to-day activities, a director should monitor the corporate affairs and policies;
- a director should maintain familiarity with the financial status of the corporation by a regular review and understanding of financial statements;
- a director, whilst not an auditor, should still have a questioning mind.”

“... a director is not relieved of the duty to pay attention to the company’s affairs which might reasonably be expected to attract inquiry, even outside the area of the director’s expertise.”

- Australian Securities and Investments Commission v Healey [2011] FCA 717 at 17 and 18

As stated on the previous page, the Act also codifies the business judgment rule. In terms of this rule a director will not be held liable if he or she took reasonable diligent steps to become informed about the subject matter, does not have a personal financial interest (or declared such a conflicting interest) and the director had a rational basis to believe that the decision was in the best interest of the company.

In discharging any board or committee duty, a director is entitled to rely on one or more employees of the company, legal counsel, accountants or other professional persons, or a committee of the board of which the director is not a member. The director, however, does not transfer the liability of the director imposed by this act onto such employee.

“In respect of all duties that may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly. He is entitled to accept and rely on the judgment, information and advice of the management, unless there are proper reasons for querying such. Similarly, he is not expected to examine entries in the company’s books... Obviously, a director exercising reasonable care would not accept information and advice blindly. He would accept it, and he would be entitled to rely on it, but he would give it due consideration and exercise his own judgment in the light thereof”.

- Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty)Ltd 1980 (4) SA 156 (W)

“Nothing I decide in this case should indicate that directors are required to have infinite knowledge or ability. Directors are entitled to delegate to others the preparation of books and accounts and the carrying on of the day-to-day affairs of the company. What each director is expected to do is to take a diligent and intelligent interest in the information available to him or her to understand that information, and apply an enquiring mind to the responsibilities placed upon him or her.”

- Australian Securities and Investments Commission v Healey [2011] FCA 717 at 20

Directors of a company may be held jointly and severally liable for any loss, damage or costs sustained by the company as a result of a breach of the director’s fiduciary duty or the duty to act with care, skill and diligence. The Act sets out a range of actions for which directors may be held liable for any loss, damage or costs sustained by the company. These actions include:

- acting in the name of the company without the necessary authority
- being part of an act or omission while knowing that the intention was to defraud shareholders, employees or creditors
- signing financial statements that was false or misleading in a material respect, or
- issuing a prospectus that contained an untrue statement.

In certain instances companies are allowed to indemnify directors in respect of any liability, or companies may purchase insurance to protect a director against liability (but only for those instances for which the company may indemnify the director), or to protect the company against expenses or liability for which the company may indemnify a director. A company may indemnify a director in respect of any liability, except for:

- any liability arising from situations where the director :
  - acted in the name of the company, signed anything on behalf of the company, or purported to bind the company or authorise the taking of any action by or on behalf of the company, despite knowing that the director lacked the authority to do so
  - acquiesced in the carrying on of the company's business despite knowing that it was being conducted in a reckless manner
  - been a party to an act or omission by the company despite knowing that the intention was calculated to defraud a creditor, employee or shareholder of the company, or had another fraudulent purpose
- any liability arising from wilful misconduct or wilful breach of trust, or
- incurred a fine as a result of a conviction on an offence in terms of national legislation.

Unless the company's Memorandum of Incorporation provides otherwise, a company may purchase insurance to protect a director against any liability or expenses for which the company is permitted to indemnify a director or to protect the company against any expenses or liability for which the company is permitted to indemnify a director. The company may, however, not directly or indirectly pay a fine imposed on the director of the company or of a related company as a consequence of that director having been convicted of an offence unless the conviction was based on strict liability.

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