



**UNIVERSITY of the
WESTERN CAPE**

**THE APPLICATION OF THE BUSINESS JUDGMENT RULE IN FUNDAMENTAL
TRANSACTIONS AND INSOLVENT TRADING IN SOUTH AFRICA: FOREIGN
PRECEDENTS AND LOCAL CHOICES**

A mini-thesis submitted to the Faculty of Law of the University of the Western Cape, in
partial fulfilment of the requirements for the degree of Magister Legum (LLM)



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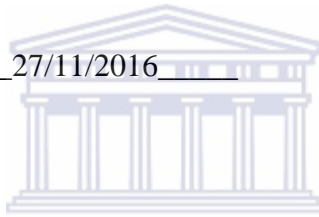
DECLARATION

I, **Imogan Rutanya Smit**, hereby declare that this dissertation is original and has never been presented at any other institution. I also declare that secondary information used has been duly acknowledged in this dissertation.

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DEDICATION

This dissertation is dedicated to the loving memory of my father Jacquin Steve Smit whom I love dearly. No amount of words can describe the important role he played in my life throughout my studies toward my LLB degree. During the process of writing this dissertation, I missed his encouraging words and guidance the most. He was a most loving and supportive father and I will always wish to make him proud. Not a day goes by without my heart longing for him but it makes me happy to know that in spirit he was by my side every step of the way throughout the process of completing this dissertation.



ACKNOWLEDGMENTS

Writing this dissertation was never always a smooth sailing task and I can only thank the Almighty God for giving me the strength to make it through the process. He has proven to be a faithful God by answering my prayers and I believe that I would not have been able to successfully complete this dissertation without His guidance.

I would like to express my sincere gratitude to my supervisor Professor, Riekie Wandrag for the continuous support, feedback and guidance of my dissertation. Without her continuous revision of my consecutive drafts, and her subsequent constructive comments this dissertation would not have been in the format in which it currently is. I was further able to benefit from her profound thinking and knowledge which she expressed through lecturing. As a result of being her student in both my undergraduate as well as postgraduate studies, I knew she expected high quality work and with this in mind I was always able to challenge myself. I could not have done this without you Professor and I will always remain grateful for your support.

I would further like to thank my friends for their continuous encouragement. In particular, my friend, Matt Counsell, who always believed in me and without knowing, often managed to get me to believe in myself.

I am also very grateful for the support provided by my boyfriend, Cheslyn Blaine, throughout this process. I am thankful for his continuous words of encouragement and for the constant reminders that God is by my side. Thank you for always being loving, understanding, and patient and for being by my side. Words often fail to express how much I love and appreciate him.

To make it complete, I must express my thankfulness to the most important people in my life, my family, for their unfailing support. Particular appreciation is given to my mother, Portia Smit, my sisters, Savannah and Quiara Smit as well as my grandparents, Mabel and John Smit. These individuals play a tremendous role in my life and they mean the world to me. My mom has been my supporter, motivator and role model and I am truly grateful for her constant support. She has shown me that no matter how many times life knocks you down it

is always possible to get back up, stronger than you ever were before. I will always strive towards making her proud. My sisters make me strive towards wanting to be a great role model and this ultimately motivates me to succeed in everything I do. My grandparents have always been supportive in every way possible and as their eldest grandchild I live to make them proud. No amount of words can truly express the amount of love and appreciation I have for my family. I am truly grateful for everyone who in one way or another contributed to the completion of this dissertation.



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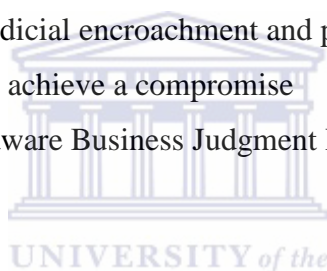


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CHAPTER 1

INTRODUCTION

1.1 BACKGROUND TO THE STUDY

*'The test of responsibility(of directors), therefore, should be, not the certainty of wisdom in others, but the possession of ordinary knowledge; and by showing that the error of the agent is of so gross a kind that a man of common sense, and ordinary attention, would not have fallen into it. The rule which fixes responsibility, because men of unerring sagacity are supposed to exist, and would have been found by the principal, appears to us essentially erroneous.'*¹

The so called business judgment rule (hereinafter referred to as “the BJR or the rule”) that serves to protect directors from liability for negative consequences of honest, reasonable business decisions that went wrong, was developed by the American judiciary in the early 19th Century.² *Percy v. Millaudon*, a Louisiana Supreme Court decision quoted above, articulated what is now referred to as the BJR.³ This case provides the earliest expression of the American BJR.⁴ Delaware courts subsequently issued a series of cases formulating the BJR as a presumption.⁵ Although the earliest expression of the rule was provided by a Louisiana court, the dissertation will focus on the Delaware case law formulation of the rule.⁶

The essence of the BJR is that judges should not second guess directors’ decisions if certain elements of the BJR are fulfilled.⁷ Courts are required to exercise caution when dealing with claims brought by either stakeholders or shareholders against directors who have made *bona*

¹ *Percy v Millaudon* (1829) 8 Mart. (n.s.) 68 (La. 1829) 77-78.

² Durckheim L *Does South Africa Need a Statutory Business Judgment Rule* (published LLM thesis, University of Pretoria, 2012) 5 (hereafter referred to as Durckheim L (2012)).

³ McEachin T 'Theriot v. Bourg: The Demise of the Business Judgment Rule in Louisiana?' (1998) 59 *Louisiana Law Review* 385.

⁴ Keller B 'Australia's Proposed Statutory Business Judgment Rule: A Reversal of a Rising Standard in Corporate Governance' (1999/2000) 4 *Deakin Law Review* 126.

⁵ *Aronson v Lewis* 473 A.2d 805 (Del. 1984).

⁶ Leach J *The Correct Understanding of the Business Judgment Rule in Section 74(6) of the Companies Act 71 of 2008: Avoiding the American Mistakes* (published LLM thesis, University of Cape Town, 2014) 14 (hereafter referred to as Leach J (2014)).

⁷ Giraldo C & Bogota C 'Factors Governing the Application of the Business Judgment Rule: An Empirical Study of the US, UK, Australia and the EU' available at <http://www.juridicas.unam.mx/publica/librev/rev/vniver/cont/111/cnt/cnt5.pdf> (accessed on 10 February 2016).

fide, also referred to as good faith, business decisions.⁸ In order to be protected by the BJR and for it to act as a safe harbour, the court will determine whether certain requirements have been met before applying the rule.⁹ The Delaware courts formulated the BJR as a presumption and in order for directors to be protected by the rule they must have made an informed business decision, in good faith and in the honest belief that the decision will be in the best interest of the company.¹⁰ As will be discussed later, this formulation of the rule is referred to as the traditional BJR.

In addition to the aforementioned formulation, another formulation was provided by the American Law Institute (hereafter referred to as the “ALI formulation”).¹¹ Initially there had been difficulties codifying the ALI version of the rule but later it was successfully codified in paragraph 4.01(c) of the ALI Corporate Governance Project.¹² This formulation requires a director to ensure that he has no personal interest in the matter, he is reasonably informed of the matter prior to making the decision and he rationally believes the decision will be in the best interest of the company.¹³ If the director complies with the aforementioned requirements, the director will be considered to have acted in good faith.¹⁴

Directors owe fiduciary duties to the company and in instances where they breach one or more of these duties they can incur personal liability.¹⁵ The rule thus emerged because of the need to protect directors and it serves as a safe harbour for those individuals who made a decision in conformity with the aforementioned requirements.¹⁶ In commercial terms the rule bestows economic freedoms and freedom of entrepreneurship to directors guided, in any case, by “the best interest of the company”.¹⁷ The most commonly cited reasons for the existence of the rule are that it promotes risk taking, encourages competent persons to serve as

⁸ Durckheim L (2012) 20.

⁹ Giraldo C & Bogota C ‘Factors Governing the Application of the Business Judgment Rule: An Empirical Study of the US, UK, Australia and the EU’ available at <http://www.juridicas.unam.mx/publica/librev/rev/vniver/cont/111/cnt/cnt5.pdf> (accessed on 10 February 2016).

¹⁰ *Aronson v Lewis* 473 A.2d 805, 812 (Del. 1984).

¹¹ Durckheim L (2012) 21.

¹² Durckheim L (2012) 21.

¹³ American Law Institute, ALI Corporate Governance Project (1994).

¹⁴ American Law Institute, ALI Corporate Governance Project (1994).

¹⁵ Hughes J, Pendleton G & Toren J ‘SHAREHOLDER DERIVATIVE LITIGATION: A Primer for Insurance Coverage Counsel’ available at http://media.lockelord.com/files/uploads/documents/17908572_1.pdf (accessed on 23 June 2016).

¹⁶ DeMott D ‘Directors’ Duty of Care and the Business Judgment Rule: American Precedents and Australian Choices’ available at <http://epublications.bond.edu.au/blr/vol4/iss2/> (accessed on 10 February 2016).

¹⁷ DeMott D ‘Directors’ Duty of Care and the Business Judgment Rule: American Precedents and Australian Choices’ available at <http://epublications.bond.edu.au/blr/vol4/iss2/> (accessed on 10 February 2016).

directors, prevents judicial second-guessing and promotes judicial efficiency. It further provides directors with sufficient freedom to manage the company and it ensures that the interest of shareholders and those of directors are balanced.¹⁸

Initially the Delaware formulation of the BJR was straightforward but over the course of time it was given a myriad of formulations which caused some courts and commentators to stray from the simple conception of the BJR.¹⁹ The straightforward version of the rule is referred to as the traditional business judgment rule.²⁰ This traditional version of the rule simply requires the directors to have made an informed decision, in good faith and in the honest belief that it would be in the best interest of the company.²¹ However, when Delaware courts were of the opinion that shareholders needed more protection in certain transactions, the modern BJR was created.²² The modern BJR consists of the Entire Fairness Doctrine (hereafter referred to as the “EFD”), the Unocal standard and the Revlon standard.²³ In instances where shareholders have managed to prove that directors have failed to act in an informed, good faith and honest manner or contrary to the best interests of the company, Delaware courts would apply the EFD which then places the burden on directors to prove that the transaction was entirely fair to the company and its stockholders.²⁴ In instances where the matter at hand deals with a hostile takeover and shareholders are alleging that the directors failed to act in accordance with their duties, Delaware courts would opt for the application of the Unocal standard.²⁵ Furthermore, if a case before the Delaware court concerns defences taken by directors to prevent a hostile bidder from succeeding in his bid for the sale and control of the corporation, the court will apply the Revlon standard.²⁶ The EFD is the most onerous of them all and it is often difficult for directors to satisfy thereby prohibiting them from receiving the

¹⁸ Rosenberg D ‘Galactic Stupidity and the Business Judgment Rule’ (2007) 32 *Journal of Corporation Law* 301.

¹⁹ Kennedy-Good S & Coetzee L ‘The Business Judgment Rule (Part 1)’ (2006) 27 *Obiter* 73.

²⁰ Aronson S, Tomkins S & Hassi T et al ‘Shareholder Derivative Actions: From Cradle to Grave’ available at <https://www.mondaq.com/pdf/clients/87654.pdf> (accessed on 19 November 2016).

²¹ *Aronson v Lewis* 473 A.2d 805, 812 (Del. 1984).

²² La Croix K ‘A Look at the Modern Business Judgment Rule’ available at <http://www.dandodiary.com/2015/08/articles/director-and-officer-liability/a-look-at-the-modern-business-judgement-rule/> (accessed on 04 August 2016).

²³ Siegel M ‘The Illusion of Enhanced Review of Board Actions’ (2013) 15 *University of Pennsylvania Journal of Business Law* 600.

²⁴ Haims J & Beha J ‘n re MFW Shareholders Litigation: Controlling Shareholder in Going-Private Transaction May Gain the Benefit of the Business Judgment Rule’ available at <https://media2.mofo.com/documents/130816-in-the-courts.pdf> (accessed 19 August 2016).

²⁵ Bainbridge S ‘The Geography of Revlon-Land’ (2013) 81 *Fordham Law Review* 3294.

²⁶ Bainbridge S ‘Lost in Revlon-land: An acquisition by a public corporation should not trigger Revlon’ available at <http://www.professorbainbridge.com/professorbainbridge.com/2011/05/lost-in-revlon-land-an-acquisition-by-a-public-corporation-should-not-trigger-revlon.html> (accessed on 19 August 2016).

protection of the BJR.²⁷ The effect of the modern BJR is that the courts will apply a heightened standard of judicial review prior to applying the traditional BJR.²⁸ Although the modern BJR seems clear in Delaware, other states have been uncertain as to whether they should adopt the modern version of the rule as they are confused as to the scope and application of the rule.²⁹

Regardless of the uncertainties and problems attached to the formulation of the BJR as a result of Delaware's expansion of the rule, various countries continued to incorporate the rule into their law, South Africa being one of these countries.³⁰ The rule is thus relatively new in South Africa as it was only incorporated into South African law in 2011 by way of the section 76(4) of the Companies Act 71 of 2008 (hereafter referred to as the "New Act").³¹ Under the Act, the BJR will have a practical effect of countering or alleviating the new less subjective and more rigorous duty of directors to exercise reasonable care, skill and diligence in the performance of their duties.³²

In terms of section 76(4)(a), if a director has taken reasonably diligent steps to become informed about the matter, had no personal financial interest in the subject matter of the decision, disclosed any personal financial interest s/he might have in the subject matter of the decision and believed that the decision would be in the best interest of the company, the director is presumed to have exercised his power in the best interest of the company and with reasonable care, skill and diligence.³³ If the aforementioned has been satisfied, the BJR would protect the director from incurring any personal liability for the harm suffered by the company.³⁴

²⁷ *Golden Cycle, LLC v. Allan*, No. CIV.A. 16301, 1998 WL 892631 (Del. Ch. Dec. 10, 1998) 11.

²⁸ La Croix K 'A Look at the Modern Business Judgment Rule' available at <http://www.dandodiary.com/2015/08/articles/director-and-officer-liability/a-look-at-the-modern-business-judgement-rule/> (accessed on 04 August 2016).

²⁹ Du Plessis J 'Open Sea or Safe Harbour? American, Australian and South African Business Judgment Rules Compares: Part 1' (2011) 32 *The Company Lawyer* 342-347.

³⁰ Cassim FHI, Cassim MF & Cassim R et al *Contemporary Company Law* 2 ed (2013) ch 11 (hereafter referred to as Cassim et al (2013)).

³¹ Leach J (2014) 20.

³² Cassim FHI et al (2013) ch 11.

³³ Cassim FHI et al (2013) ch 11.

³⁴ Cassim FHI et al (2013) ch 11.

The concern with the rule in South Africa is that there has only been one case which has very briefly dealt with the BJR and its elements.³⁵ As a result thereof, there is still uncertainty as to how South African courts will apply the rule especially as it lacks good faith as a requirement in section 76(4) of the New Act. There is further uncertainty as to whether South Africa should follow Delaware by adopting the modern BJR which includes the Entire Fairness Doctrine, the Unocal standard and the Revlon standard.

1.2 RESEARCH QUESTION AND OBJECTIVES

The main purpose of this study is to provide clarity as to whether South African courts should adopt the modern BJR to apply to certain transactions. The study will unpack and address whether the modern BJR should be applied to mergers and acquisitions as well as insolvent trading transactions. Recommendations will be made, indicating how clarity and certainty on the aforementioned issues could be provided in South Africa. This study will outline the development of the BJR as well as the problems associated with the rule. More clarity on the research objectives is provided below.

The study will be guided by the following objectives:

- To give an overview of the Delaware Business Judgment Rule
- To discuss the different formulations of the BJR in America
- To give an overview of the different interpretations of the BJR
- To analyse the application of the BJR in various contexts such as mergers and acquisitions as well as insolvent trading
- To analyse the BJR as it currently stands in South Africa
- To consider the directors' duties and liabilities
- To critically discuss the failure to include 'good faith' as a requirement in section 76(4) of the Companies Act 71 of 2008
- To critically discuss whether a modified business judgment rule and heightened scrutiny will be needed in South Africa, for certain transactions, which include mergers & acquisitions as well as insolvent trading

³⁵ *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and others* 2014 (5) SA 179 (WCC).

1.3 SIGNIFICANCE OF THE STUDY

The study will be insightful and make a considerable contribution to the application of BJR by South African courts. It will assist with ensuring that there is certainty surrounding the application and scope of the BJR in order to prevent the uncertainties prevalent in America, as a result of Delaware's expansion of the rule. With the BJR being relatively new in South Africa it is essential to address these issues as soon as possible and to provide the readers with insight into the topic.

This research is further interesting because the angle differs from that of previous commentators in the sense that the focus is not on whether it was wise to adopt the rule into South African law, the focus is rather on how this rule can be applied in various contexts and the limitations to the application and scope of the rule in certain transactions. Furthermore, the study will demystify the uncertainties surrounding the scope of the BJR in order to ensure that clarity is provided in South Africa.

Essentially the findings might assist South African courts of law as well as the legal representatives by clearly highlighting the contexts within which the BJR may be applied to protect directors who make risk entailed decisions.

1.4 LIMITATIONS TO THE STUDY

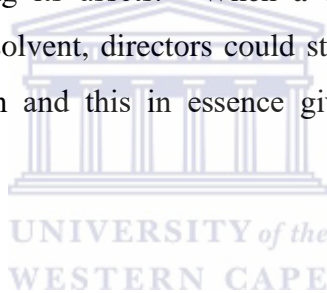
For the purpose of this study, only the application of the BJR in certain transactions will be studied. The question as to whether it was wise to incorporate the rule into South African law will not be addressed.

1.5 RESEARCH METHODOLOGY

Given the purpose of the study, an analytical research methodology is required. Various articles will be relied upon in order to discuss the purpose of the BJR. When analysing the certain transactions within which the rule could be applied, reference will be made to judicial decisions as well as articles. The Companies Act 71 of 2008 as well as case law will be used to critically discuss the formulation and application of the BJR in South Africa whilst articles, foreign legislation and case law will be used to provide a detailed discussion on the

formulation and application of the rule in America, with emphasis on Delaware. International and South African focused textbooks, year books and journal articles will also be considered when analysing the various aspects of the research and subject matter.

Furthermore, two terms play an essential role later in this dissertation, namely mergers and acquisitions as well as insolvent trading. Merger refers to the process of the joining together of two companies.³⁶ When companies merge they combine their resources into a single business and it results in the owners of the pre-merger companies having to share in the ownership of the merged business.³⁷ Acquisitions, also referred to as takeovers, involve a process whereby the acquirer, usually a bigger financially sound firm, purchases the target company which is considerably smaller.³⁸ On the other hand, there are two definitions provided for insolvency. The first definition provides that if a company is unable to pay its debts as it becomes due, it could be declared insolvent.³⁹ The second definition refers to the corporations' liabilities exceeding its assets.⁴⁰ When a company falls within one of the aforementioned definitions of insolvent, directors could still trade in an attempt to improve the company's financial position and this in essence gives effect to the term 'insolvent trading'.⁴¹



1.6 CHAPTER OUTLINE

This thesis consists of five chapters.

Chapter 1: Introduction

This chapter serves as an introduction to the study. It consists of the problem statement, purpose of the study, significance of the study, research methodology and chapter outline. In essence, its purpose is to provide the readers will a clear overview of what the rest of the thesis will consist of.

³⁶ Coyle B *Mergers and Acquisitions* (2000) 2 (hereafter referred to as Coyle B (2000)).

³⁷ Coyle B (2000) 2.

³⁸ Malik M, Anuar M & Khan S et al 'Mergers and Acquisitions: A Conceptual Review' (2014) 4 *International Journal of Accounting and Financial Reporting* 521.

³⁹ Fraudulent Transfers Act, Title 6, Delaware Code §§ 1302(a)-(b).

⁴⁰ Fraudulent Transfers Act, Title 6, Delaware Code §§ 1302(a)-(b).

⁴¹ Boelter J 'Fiduciary Duties and the Zone of Insolvency' available at http://www.navigant.com/~media/WWW/Site/Insights/Disputes%20Investigations/Fiduciary_Duties_Zone_Insolvency.pdf (accessed on 15 August 2016).

Chapter 2: The Business Judgment Rule in Delaware

This chapter will provide a detailed discussion into the history of the BJR in America, focusing on Delaware. This will include a discussion of the history, directors' duties and liabilities, formulations, interpretations and shortfalls of the BJR.

Chapter 3: The Application of the BJR in Fundamental Transactions

Chapter 3 will deal with application of the modern BJR to certain transactions, including mergers and acquisitions and insolvent trading. This will include discussions of mergers and acquisitions and insolvent trading as well as the Entire Fairness Doctrine, Unocal Standard and the Revlon Standard.

Chapter 4: The Business Judgment Rule in South Africa

This chapter will start off by analysing the history, competing views of the incorporation of the rule into SA law and the directors' duties and liabilities in South Africa. Thereafter, the formulation of the rule in section 76(4) and the differences between the Delaware and South African rule will be considered.

Chapter 5: Conclusion and Recommendations

In this chapter the conclusions are drawn based on the research conducted and obtained in this dissertation. Thereafter recommendations will be made as to how South African courts can deal with the failure to include good faith as a requirement in section 76(4). Further recommendations will be made as to whether South African courts should adopt the modern BJR in order to apply it to certain fundamental transactions.

CHAPTER TWO

THE DELAWARE BUSINESS JUDGMENT RULE

2.1 INTRODUCTION

The term ‘business judgment rule’ has been evolving and it has taken on fresh meanings in new and different situations.⁴² As a result thereof, there is a large amount of uncertainty surrounding the BJR which gives rise to much concern.⁴³ In the past, academics and the judiciary have spent a large amount of time attempting to understand the underlying policy justifications, the correct theoretical formulation as well as the correct practical application of the BJR.⁴⁴ What was designed to be a straightforward rule has now become a rule which academics and the judiciary are battling to understand.⁴⁵ Today, this remains a problem as the uncertainty surrounding the rule continues and it raises many concerns as the BJR has been adopted in a number of other countries.⁴⁶ The concern is whether the same issues which currently exist in Delaware regarding the BJR would arise in countries which have subsequently adopted the rule.⁴⁷ Although there have been various attempts to answer the questions surrounding the application of the BJR, the answers do not resolve the lingering uncertainty attached to the BJR.⁴⁸

The State of Delaware (hereafter referred to as ‘Delaware’) has been referred to as the corporate capital of the world and its courts have become the most preeminent venues in the United States for resolving corporate disputes.⁴⁹ The corporate law rules adopted in Delaware, such as the BJR, are thus adopted and followed in the rest of the United States.⁵⁰ The BJR is a key concept in Delaware corporate law and the Delaware courts have been

⁴² Duesenburg R ‘The Business Judgment Rule and Shareholder Derivative Suits: A View from the Inside’ (1982) 60 *Washington University Law Review* 311.

⁴³ Manning B ‘The Business Judgment Rule in Overview’ (1984) 45 *Ohio State Law Journal* 617 (hereafter referred to as Manning B (1984)).

⁴⁴ National Paralegal College ‘The Business Judgment Rule’ available at http://nationalparalegal.edu/public_documents/courseware_asp_files/businessLaw/Directors&Officers/BusinessJudgmentRule.asp (accessed on 23 February 2016).

⁴⁵ Durckheim L (2012) 13.

⁴⁶ Durckheim L (2012) 16.

⁴⁷ Leach J (2014) 25-28.

⁴⁸ Veasey E ‘Business Judgment Rule and Shareholder Derivative Actions: Background’ (1981) 6 *Delaware Journal of Corporate Law* 518.

⁴⁹ Ridgley H & Reed J ‘Delaware Corporate Law and Litigation: What Happened in 2015 and What it Means For You in 2016’ available at <https://www.dlapiper.com/~media/Files/Insights/Publications/2016/02/DelawareCorporateLawandLitigationReport20152016.pdf> (accessed on 25 June 2016).

⁵⁰ Holland R ‘Delaware’s Business Judgment Rule: International Variations’ available at <http://global.blogs.delaware.gov/2015/04/09/delawares-business-judgment-rule-international-variations/> (accessed on 23 June 2016).

developing and expanding the application of the rule.⁵¹ As previously mentioned, the expansion of the BJR is the cause of all the confusion attached to the rule.⁵² Based on the aforementioned it is necessary to focus on the history, developments as well as the problems surrounding the application of the Delaware BJR.

For the purpose of this chapter it should be borne in mind that the term “director” refers to disinterested directors. It is important to note that the term ‘disinterested directors’ refers to directors who do not have a personal or financial interest in a matter concerning the corporation which is material and is likely to affect his judgment.⁵³

Prior to discussing the BJR it is necessary to analyse the directors’ duties and liabilities as provided by Delaware corporation law. In doing so, it would become easier to understand the BJR and why it was developed. Thereafter the focus will shift to the history and purpose of the BJR as well as the most common formulation of the rule, application and problems surrounding the application of the rule.

2.2 DIRECTORS’ FIDUCIARY DUTIES

The business and affairs of Delaware corporations are the responsibility of the board of directors and in fulfilling their responsibilities, they are given fiduciary duties as well as non-fiduciary duties.⁵⁴ These duties require the directors to act in the best interest of the corporation thereby protecting the interests of the stockholders.⁵⁵ The non-fiduciary duties imposed on the directors are not a point of discussion in this chapter but the Delaware fiduciary duties will be critically discussed.

Initially, directors were given two fiduciary duties, namely, the duty of loyalty and the duty of care.⁵⁶ However, recently the Delaware Supreme Court has introduced the duty of good

⁵¹ LaCroix K ‘A Look at the Modern Business Judgment Rule’ available at <https://www.lexisnexis.com/legalnewsroom/corporate/b/blog/archive/2015/08/18/a-look-at-the-modern-business-judgment-rule.aspx?Redirected=true> (accessed 25 June 2016).

⁵² Manning B (1984) 617.

⁵³ Glover S *Business Separation Transactions: Spin-Offs, Subsidiary IPOs and Tracking Stock* (2006) 6.

⁵⁴ Lafferty W, Schmidt L & Wolfe D ‘A Brief Introduction to the Fiduciary Duties of Directors Under Delaware Law’ (2012) 116 *Penn State Law Review* 839 (hereafter referred to as Lafferty W et al (2012)).

⁵⁵ Lafferty W et al (2012) 839.

⁵⁶ Rossi F ‘Making sense of the Delaware Supreme Court’s Triad of Fiduciary Duties’ available at <http://poseidon01.ssrn.com/delivery.php> (accessed on 23 June 2016).

faith as a fiduciary duty resulting in the existence of a triad of fiduciary duties.⁵⁷ Other jurisdictions have started accepting the aforementioned triad of fiduciary duties.⁵⁸ Although the duty of good faith plays an integral part in both the duty of care and the duty of loyalty, the Delaware Supreme Court decided that good faith is an integral duty and thus needed to be dissected from the rest.⁵⁹ It is necessary to analyse these duties in order to grasp a better understanding of the BJR.

2.2.1 Duty of Loyalty

In the case of *Stone v Ritter* the court concluded that the duty of loyalty should be defined as an obligation to act in good faith to advance the best interest of the corporation.⁶⁰ According to the Delaware Supreme Court:

‘where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith’.⁶¹

In making the aforementioned statement, the court went further and concluded that the duty to act in good faith is a condition of the fundamental duty of loyalty.⁶² In essence what this means is that a director cannot act loyally towards a corporation unless he acts in the good faith belief that his actions are in the corporation’s best interests.⁶³ The duty of loyalty requires directors to act in the best interest of the company instead of acting in their own interests.⁶⁴ Directors should thus avoid engaging in transactions which would result in a conflict of interests.⁶⁵

⁵⁷ Rossi F ‘Making sense of the Delaware Supreme Court’s Triad of Fiduciary Duties’ available at <http://poseidon01.ssrn.com/delivery.php> (accessed on 23 June 2016).

⁵⁸ Rossi F ‘Making sense of the Delaware Supreme Court’s Triad of Fiduciary Duties’ available at <http://poseidon01.ssrn.com/delivery.php> (accessed on 23 June 2016).

⁵⁹ Rossi F ‘Making sense of the Delaware Supreme Court’s Triad of Fiduciary Duties’ available at <http://poseidon01.ssrn.com/delivery.php> (accessed on 23 June 2016).

⁶⁰ *Stone v. Ritter* 911 A.2d 362 (Del. 2006).

⁶¹ *Stone v. Ritter* 911 A.2d 362 (Del. 2006) 370.

⁶² *Stone v. Ritter* 911 A.2d 362 (Del. 2006) 369-370.

⁶³ Strine L, Hamermesh L, Balotti R et al ‘Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law’ available at http://www.law.uchicago.edu/files/file/strine_duty_of_good_faith.pdf (accessed on 21 June 2016).

⁶⁴ *In re Chelsea Therapeutics International Ltd. Stockholders Litigation*, Consol. C.A. No. 9640-VCG.

⁶⁵ Bradshaw G ‘Duty of Care and Duty of Loyalty owed by Directors in Delaware’ available at <http://www.bradshawlawgroup.com/duty-of-care-and-duty-of-loyalty-owed-by-directors-in-delaware/> (accessed on 21 June 2016).

Transactions which involve conflict of interests are referred to as self-dealing transactions.⁶⁶ The concept is that directors focus on their own interests and in doing so they may not reach an agreement that is fair and beneficial to the company.⁶⁷ An example of a self-dealing transaction is when a director has a direct or indirect personal financial interest in a matter involving the corporation.⁶⁸ In a situation like this a director is required to disclose the information to the board of directors but failure to do so would amount to a breach of his duty of loyalty.⁶⁹ Another instance which requires loyalty is when a corporate opportunity arises and a director is expected to make the opportunity available to the corporation before pursuing it for his own benefit.⁷⁰ Failure to make the opportunity available to the corporation would result in a breach of the duty of loyalty.⁷¹

2.2.2 Duty of Care

In the General Corporation Law of the State of Delaware, the duty of care is considered to be a fiduciary duty.⁷² This is an important factor to note as it differs fundamentally from South Africa which considers the duty of care to be a non-fiduciary duty.⁷³

The duty of care sets a threshold for the way in which the board of directors is required to make decisions and perform their supervisory functions.⁷⁴ The duty of care consists of three separate facets, namely, good faith, reasonable belief and reasonable care.⁷⁵ Once again it is evident that good-faith is a requirement of the duty of care just as it is for the duty of loyalty. In dissecting the three facets mentioned above it is important to note that when a director is required to exercise good faith, he or she is required to be honest and to avoid any conflict of

⁶⁶ Black B 'The Principal Fiduciary Duties of Board of Directors' available at <http://www.oecd.org/daf/ca/corporategovernanceprinciples/1872746.pdf> (accessed on 21 June 2016).

⁶⁷ Black B 'The Principal Fiduciary Duties of Board of Directors' available at <http://www.oecd.org/daf/ca/corporategovernanceprinciples/1872746.pdf> (accessed on 21 June 2016).

⁶⁸ Hearn C & Friend A 'Feeling Conflicted? Identifying and Resolving Conflicts of Interests' available at <https://m.acc.com/chapters/houst/upload/N2658084.pdf> (accessed on 22 June 2016).

⁶⁹ Dignam A & Lowry J *Company Law* 8ed (2014) 348.

⁷⁰ Hearn C & Friend A 'Feeling Conflicted? Identifying and Resolving Conflicts of Interests' available at <https://m.acc.com/chapters/houst/upload/N2658084.pdf> (accessed on 22 June 2016).

⁷¹ Dignam A & Lowry J *Company Law* 8ed (2014) 348.

⁷² Eisenhofer J & Moyna C 'What Is the State of Delaware Law as It Relates to the Scope of Fiduciary Duties Owed to Investors in So-Called Alternative Entities? (Part 1)' available at <http://www.bna.com/state-delaware-law-n17179921815/> (accessed on 23 June 2016).

⁷³ Rahman L *Defining the Concept of "Fiduciary Duty" in the South African Law of Trusts* (published LLM Thesis, The University of the Western Cape, 2006)25.

⁷⁴ Palmiter A *Corporations: Examples and Explanations* 6ed (2009) 230 (Hereafter referred to as Palmiter A (2009)).

⁷⁵ Dahlberg V (2008).

interest when performing his duties.⁷⁶ Reasonable belief deals with the substance of the director's business decision.⁷⁷ Reasonable care on the other hand, is concerned with the procedural aspects of a director's decision-making as directors are required to be sufficiently informed prior to making a business decision.⁷⁸

The Delaware Supreme Court further articulated the duty of care in *Smith v Van Gorkom* by stating that it is a director's duty to exercise an informed business judgment.⁷⁹ The duty thus requires directors to inform themselves prior to making a business decision, of all the information, which is reasonably available to them.⁸⁰ Although the board is expected to be informed, it is not expected of them to be informed of every fact.⁸¹ Failure to make an informed business decision would result in a breach of the duty of care which in essence, would imply the real possibility of liability for negligence.⁸² The duty thus requires directors to be found liable in instances where the company suffers harm as a result of the director's failure to perform his or her duties.⁸³ Case law thus illustrates that only when directors have made business decisions in accordance with the required standard of care, will they be shielded by the rule.⁸⁴

Having discussed the two duties which have traditionally been the only fiduciary duties imposed on directors, the recently added duty of good faith will be analysed.

2.2.3 Duty of Good Faith

The aforementioned makes it quite clear that good faith is interrelated with the duty of care and the duty of loyalty. The element of good faith can be implemented as a substitution for the definition of loyalty and it can be adopted as an element to assess the breach of the duty

⁷⁶ Roberston J 'Primer for directors of non-profit corporations (Rights, Duties and Practices)' available at <https://www.ic.gc.ca/eic/site/cilp-pdci.nsf/eng/cl00692.html> (accessed on 21 March 2016).

⁷⁷ Palmiter A (2009) 230.

⁷⁸ Palmiter A (2009) 231.

⁷⁹ *Smith v Van Gorkom* 488 A.2d 858.

⁸⁰ Lafferty W et al (2012) 842.

⁸¹ Lafferty W et al (2012) 842.

⁸² Rosenberg D 'Supplying the Adverb: The Future of Corporate Risk-Taking and the Business Judgment Rule' available at <https://www.baruch.cuny.edu/.../BriloffPrizeFac08-DavidRosenberg> (accessed on 23 June 2016).

⁸³ Eisenberg M 'Whether the Business Judgment Rule Should be Codified' available at <http://www.clrc.ca.gov/pub/BKST/BKST-EisenbergBJR.pdf> (accessed on 27 February 2016).

⁸⁴ Johnson L 'The Modest Business Judgment Rule' (2000) 55 *Business Law Review* 637.

of care.⁸⁵ However, as a result of the Delaware Supreme Court's decisions to make good faith a separate fiduciary duty, it is necessary to analyse the importance of this duty.

The existence of good faith as a separate duty arose in the decision of the Delaware Supreme Court in *Cede & Co. Technicolor Inc.*⁸⁶ The matter dealt with application of the BJR to a decision of the board of directors to approve a merger.⁸⁷ The court required the plaintiff to prove that the directors 'breached any one of the triads of their fiduciary duty which is good faith, loyalty of due care'.⁸⁸ This was the first time a Delaware court referred to fiduciary duties as a triad of duties.⁸⁹

In defining good faith, Delaware courts have focused on the definition of bad faith.⁹⁰ The decision of the Chancery Court in *In Re The Walt Disney Company Derivative Litigation* provided further clarification on the duty of good faith.⁹¹ According to the court, directors will have breached their duty to act in good faith if they 'consciously and intentionally disregarded their responsibilities by adopting a 'we do not care about the risks' attitude concerning a material corporate decision'.⁹² Directors thus intentionally disregard their responsibilities knowing that the corporation could potentially be harmed.⁹³ Delaware courts have stated that the concept of bad faith refers to improper motives or personal gain as well as arbitrary actions or conscious disregard for the interests of the corporation including the rights of stockholders.⁹⁴

Having analysed the triad of fiduciary duties owed by directors to the corporation and its stockholders, it is necessary to consider the potential liability of directors should they breach one of the aforementioned duties. Questions such as who can institute claims and how they can institute their claims come to mind when thinking of director liability.

⁸⁵ Strine L, Hamermesh L, Balotti R et al 'Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law' available at http://www.law.uchicago.edu/files/file/strine_duty_of_good_faith.pdf (accessed on 21 June 2016).

⁸⁶ *Cede & Co and Cinerama Inc v Technicolor Inc* 1990 Del.

⁸⁷ *Cede & Co and Cinerama Inc v Technicolor Inc* 1990 Del.

⁸⁸ *Cede & Co and Cinerama Inc v Technicolor Inc* 1990 Del 361.

⁸⁹ *Cede & Co and Cinerama Inc v Technicolor Inc* 1990 Del 361.

⁹⁰ Davis G & Whitley D 'Directors' Fiduciary Duties: Increasing Focus on Good Faith and Independence' (2009) 83 *The Florida Bar Journal* 38.

⁹¹ *In re the Walt Disney Company Derivative Litigation* 825 A.2d 275 (Del. Ch. 2003) 37-38.

⁹² *In re the Walt Disney Company Derivative Litigation* 825 A.2d 275 (Del. Ch. 2003) 289.

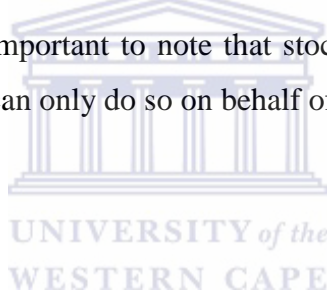
⁹³ Davis G & Whitley D 'Directors' Fiduciary Duties: Increasing Focus on Good Faith and Independence' (2009) 83 *The Florida Bar Journal* 38.

⁹⁴ Rossi F 'Making sense of the Delaware Supreme Court's Triad of Fiduciary Duties' available at <http://poseidon01.ssrn.com/delivery.php> (accessed on 23 June 2016).

2.3 DIRECTORS' LIABILITY

One of the downfalls of being a corporate director is the exposure to financial liability which all directors potentially face.⁹⁵ The Delaware Court of Chancery hears more than 200 cases a year, most of which involve director liability.⁹⁶ As previously discussed, directors have fiduciary duties and they potentially face personal liability for damages arising from the breach of any of the fiduciary duties.⁹⁷ It is essential to bear in mind that liability needs to be looked at from two perspectives, namely, when a company is solvent and when it is insolvent. The reason for this is that the persons who may institute the claims differ although the manner in which the claims can be instituted remains the same.⁹⁸

According to the court in *Gheewalla*, when a company is solvent the stockholders are the ultimate beneficiaries of the corporation's growth and increased value.⁹⁹ Stockholders have thus been given a right to bring claims against a director for an alleged breach of one of the aforementioned duties.¹⁰⁰ The manner in which stockholders can bring such claims is referred to as derivative actions.¹⁰¹ It is important to note that stockholders do not have the right to directly sue the directors as they can only do so on behalf of the corporation.¹⁰²



⁹⁵ Lajoux A 'D&O Liability: A Downside of Being a Corporate Director' available at <https://corpgov.law.harvard.edu/2015/06/23/do-liability-a-downside-of-being-a-corporate-director/> (accessed on 23 June 2016).

⁹⁶ Lajoux A 'D&O Liability: A Downside of Being a Corporate Director' available at <https://corpgov.law.harvard.edu/2015/06/23/do-liability-a-downside-of-being-a-corporate-director/> (accessed on 23 June 2016).

⁹⁷ Hughes J, Pendleton G & Toren J 'SHAREHOLDER DERIVATIVE LITIGATION: A Primer for Insurance Coverage Counsel' available at http://media.lockelord.com/files/uploads/documents/17908572_1.pdf (accessed on 23 June 2016).

⁹⁸ Callison J 'Why a Fiduciary Shift to Creditors of Insolvent Business Entities is Incorrect as a Matter of Theory and Practice' available at <https://www.law.umaryland.edu/faculty/conferences/Twilight/CALLISON.PDF> (accessed on 19 November 2016).

⁹⁹ *Programming Fund v Gheewalla* 930 A.2d (Del. 2007) 92, 99.

¹⁰⁰ Huebner M & McCullough H 'The Fiduciary Duties of Directors of Troubled U.S Companies: Emerging Clarity' available at <https://www.google.com/search?client=firefox-delaware+who+can+claim+from+directors+for+breach+of+fiduciary+duties&oq=delaware+who+can+claim+from+directors+for+breach+of+fiduciary+duties/> (accessed on 23 June 2016).

¹⁰¹ Huebner M & McCullough H 'The Fiduciary Duties of Directors of Troubled U.S Companies: Emerging Clarity' available at <https://www.google.com/search?client=firefox-delaware+who+can+claim+from+directors+for+breach+of+fiduciary+duties&oq=delaware+who+can+claim+from+directors+for+breach+of+fiduciary+duties/> (accessed on 23 June 2016).

¹⁰² Goldberg S 'Fiduciary duties of a director of a Delaware corporation, the current standard' available at <http://www.delawarellcblog.com/2009/10/fiduciary-duties-of-a-director-of-a-delaware-corporation-the-current-standard/> (accessed on 23 June 2016).

The aforementioned differs slightly when a corporation has been declared insolvent.¹⁰³ Although a corporation is insolvent, directors are still expected to make important decisions in managing the corporation and thus still owe fiduciary duties to the corporation.¹⁰⁴ Although creditors may not directly sue the directors, they are entitled to institute a derivative action against the directors who breached their fiduciary duties.¹⁰⁵

The purpose of the derivative suit is to restore the damage suffered by the corporation as a result of the director's conduct.¹⁰⁶ A derivative suit can be used for a variety of corporate traumas such as self-dealing, waste of corporate assets and misconduct on behalf of the directors.¹⁰⁷

Given the potential liability faced by directors, Delaware courts have created various defences which could be raised by directors should a derivative action be taken against them.¹⁰⁸ These defences include indemnification, insurance, exculpation and the business judgment rule.¹⁰⁹ However, for the purpose of this dissertation, the only defence which will be elaborated on is the BJR. The purpose of this dissertation is not to discuss indemnification, insurance and exculpation as this has been successfully done elsewhere.¹¹⁰ Having considered the duties and liabilities faced by the directors of a corporation it is necessary to begin the discussion with the focal point of this dissertation which is the BJR.

¹⁰³ LaCroix K 'Insolvent Company Directors' Duties to Creditors Under Delaware' available at <http://www.dandodiary.com/2014/12/articles/director-and-officer-liability/insolvent-company-directors-duties-to-creditors-under-delaware-law/> (accessed on 23 June 2016).

¹⁰⁴ LaCroix K 'Insolvent Company Directors' Duties to Creditors Under Delaware' available at <http://www.dandodiary.com/2014/12/articles/director-and-officer-liability/insolvent-company-directors-duties-to-creditors-under-delaware-law/> (accessed on 23 June 2016).

¹⁰⁵ *Programming Fund v Gheewalla* 930 A.2d (Del. 2007) 101-102.

¹⁰⁶ Wilder C 'The Demand Requirement and the Business Judgment Rule: Synergistic Procedural Obstacles to Shareholder Derivative Suits' (1985) 5 *Pace Law Review* 633.

¹⁰⁷ Hughes J, Pendleton G & Toren J 'SHAREHOLDER DERIVATIVE LITIGATION: A Primer for Insurance Coverage Counsel' available at http://media.lockelord.com/files/uploads/documents/17908572_1.pdf (accessed on 23 June 2016).

¹⁰⁸ Davis B, Howard J & McMahon et al 'Corporate Governance Advisory' available at <http://www.alston.com/Files/Publication/> (accessed on 23 June 2016).

¹⁰⁹ Davis B, Howard J & McMahon et al 'Corporate Governance Advisory' available at <http://www.alston.com/Files/Publication/> (accessed on 23 June 2016).

¹¹⁰ Harris T 'Indemnification, Exculpation and D&O Insurance Protection of Governing Persons' available at http://www.texasbarcle.com/Materials/Events/6149/40702_01.pdf (accessed on 01 July 2016).

2.4 THE BUSINESS JUDGMENT RULE

2.4.1 History

Prior to the creation of the BJR, there had been a large number of publicised suits and threats thereof against directors.¹¹¹ Corporate directors were thus referred to as ‘sitting ducks for shareholder and third party liability suits’.¹¹² The suits were instituted for different reasons such as negligence and bad judgment on the part of directors.¹¹³ However, most suits were based on the allegation that directors were acting in their own interest at the expense of the company and in doing so they breached their duty of loyalty.¹¹⁴

By its nature the BJR is designed to achieve a compromise between the two competing values, namely, authority and liability.¹¹⁵ The authority element refers to the need to ensure that directors maintain their decisional powers, whereas liability indicates the importance of holding directors liable for business decisions.¹¹⁶ The liability element furthermore emphasises the need to prevent and correct inappropriate conduct of the directors.¹¹⁷

In order to prevent directors from being exposed to personal liability the common law BJR was introduced.¹¹⁸ As mentioned in chapter 1, *Percy v. Millaudon* articulated what is now referred to as the BJR.¹¹⁹ Although the focus of this dissertation is on the Delaware BJR, it is necessary to refer to *Percy v. Millaudon*, as it provided the earliest expression of the BJR.¹²⁰ Other States, such as the State of Delaware, subsequently issued a series of cases which focused on the BJR and Delaware courts played a central role in developing the rule.¹²¹ However, the Delaware case law formulation of the BJR has been widely entrenched into

¹¹¹ Bishop J ‘Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers’ (1968) 77 *The Yale Journal* 1078 (hereafter referred to as Bishop J (1968)).

¹¹² Bishop J (1968) 1078.

¹¹³ E.g. *Sylvia Martin Foundation, Inc. v. Swearingen* 260 F. Supp. 231 (S.D.N.Y. 1966) (dismissing stockholder's complaint for failure to join indispensable parties; dictum that stockholder did not state a derivative cause of action in charging directors with having financed European operations by borrowings in Europe at interest rate higher than those charged by American lenders, apparently for the patriotic purpose of checking the gold drain).

¹¹⁴ Bishop J (1968) 77, 1078.

¹¹⁵ Ponta A & Catana R ‘The Business Judgment Rule and its Reception in European Countries’ (2015) 4 *The Macrotheme Review* 127 (hereafter referred to as Ponta A (2015)).

¹¹⁶ Ponta A & Catana R (2015) 127.

¹¹⁷ Ponta A & Catana R (2015) 127.

¹¹⁸ Eichelberger J ‘Unification of Corporate Director Liability: Should the European Union adopt a U.S. Style Business Judgment Rule?’ available at <http://www.cde-montpellier.com/wp-content/uploads/M%C3%A9moire-Jonathan-EICHELBERGER.pdf> (accessed on 27 June 2016).

¹¹⁹ *Percy v Millaudon* (1829) 8 Mart. (n.s.) 68 (La. 1829).

¹²⁰ *Percy v Millaudon* (1829) 8 Mart. (n.s.) 68 (La. 1829).

¹²¹ *Aronson v Lewis* 473 A.2d 805 (Del. 1984).

most parts of the American corporate law jurisprudence.¹²² Delaware being referred to as the corporate capital is the reason for the aforementioned.¹²³

In *Percy v Millaudon* the court refused to hold the directors liable for losses suffered by the company resulting from the theft of funds by the bank's president and a cashier.¹²⁴ In refusing to hold the directors liable the court relied on what is now referred to as the BJR.¹²⁵ According to the court,

'The only correct mode of ascertaining whether there was fault in an agent, is by enquiring whether he neglected the exercise of that diligence and care, which was necessary to a successful discharge of the duty imposed on him. There are many things which, in their management, require the utmost diligence, and most scrupulous attention. There are others, whether the duties imposed are presumed to call for nothing more than ordinary care and attention, and where the exercise of that degree suffices.'¹²⁶

The aforementioned statement illustrates that in applying the rule, the court looked at whether anything has come to the directors' knowledge which could have made the directors' question the loyalty of the president and cashier.¹²⁷ However, in instances where no suspicions were raised and the directors paid attention to the ordinary affairs of the corporation, it is sufficient to conclude that they have fulfilled their fiduciary duties.¹²⁸ In other words, if the situation would have placed a prudent man on guard, a degree of care is required in order to avoid the inappropriate conduct of the president and cashier.¹²⁹ When determining whether the director acted in a manner in which the prudent man would have acted, the court focuses on the possession of ordinary knowledge of the director, instead of focusing on the wisdom of third parties who are in the same position as the director in question.¹³⁰ If the court finds that the

¹²² Leach J (2014).

¹²³ Ridgley H & Reed J 'Delaware Corporate Law and Litigation: What Happened in 2015 and What it Means For You in 2016' available at <https://www.dlapiper.com/~media/Files/Insights/Publications/2016/02/DelawareCorporateLawandLitigationReport20152016.pdf> (accessed on 25 June 2016).

¹²⁴ *Percy v Millaudon* (La. 1829) 76-80.

¹²⁵ *Percy v Millaudon* (La. 1829) 76-80.

¹²⁶ *Percy v. Millaudon* (La. 1829) 68.

¹²⁷ Wolfe R 'The Fiduciary Duties of Directors and Officers under the Louisiana Business Corporation Act of 2014' available at <http://law.loyno.edu/sites/law.loyno.edu/files/Wolfe-Proof.pdf> (accessed on 26 July 2016).

¹²⁸ Wolfe R 'The Fiduciary Duties of Directors and Officers under the Louisiana Business Corporation Act of 2014' available at <http://law.loyno.edu/sites/law.loyno.edu/files/Wolfe-Proof.pdf> (accessed on 26 July 2016).

¹²⁹ *Percy v. Millaudon* (La. 1829) 74-75.

¹³⁰ Wolfe R 'The Fiduciary Duties of Directors and Officers under the Louisiana Business Corporation Act of 2014' available at <http://law.loyno.edu/sites/law.loyno.edu/files/Wolfe-Proof.pdf> (accessed on 26 July 2016).

error of the director is an error which a man of common sense and ordinary attention would have avoided, the directors will incur personal liability for their negligence.¹³¹ In the *Percy* case the court found the directors' failure to detect the scheme of the bank's president and a cashier as an error in judgment.¹³² The court further held that a director cannot be held liable if the error he made was one which a prudent man would have made.¹³³

Delaware courts have acknowledged that the administration of a corporation involves making many risk entailed business decisions, not all of which will prove successful.¹³⁴ Some business decisions run the risk of turning into disasters which would subsequently be detrimental to the company.¹³⁵ Projects that cause the company to suffer a loss and the decision to grant loans which are never repaid are common examples of business decisions with an undesirable outcome. As discussed earlier in this chapter, directors have a triad of fiduciary duties, namely, the duty of loyalty, duty of care and the recently added duty of good faith and should these duties be breached, directors can incur personal liability.¹³⁶ However, what happens when the board of directors comply with their duties in making a business decision but the decision turns out to be disastrous? This is exactly why prior to the establishment of the BJR, directors were referred to as 'sitting ducks' for derivative actions.¹³⁷ The moment the corporation is harmed, stockholders approach courts and rely on derivative actions, which could potentially cause directors to pay a large sum of money from their personal pockets.¹³⁸

Based on the aforementioned it is clear that the rule was developed in order to protect directors from incurring personal liability provided that they have acted in the required manner.¹³⁹ The term 'required manner' refers to the criteria provided by the courts for

¹³¹ Wolfe R 'The Fiduciary Duties of Directors and Officers under the Louisiana Business Corporation Act of 2014' available at <http://law.loyno.edu/sites/law.loyno.edu/files/Wolfe-Proof.pdf> (accessed on 26 July 2016).

¹³² *Percy v Millaudon* (1829) 76-80.

¹³³ *Percy v Millaudon* (1829); According to the court the determination of responsibility thus depends on whether the director possessed ordinary knowledge and whether a man of common sense would have ended up in the same situation as the director in question.

¹³⁴ Duesenberg R 'The Business Judgment Rule and Shareholders Derivative Suits: A View from the Inside' (1982) 60 *Washington University Law Review* 313 (Hereafter referred to as Duesenberg (1982)).

¹³⁵ Duesenberg R (1982) 313.

¹³⁶ Hughes J, Pendleton G & Toren J 'SHAREHOLDER DERIVATIVE LITIGATION: A Primer for Insurance Coverage Counsel' available at http://media.lockelord.com/files/uploads/documents/17908572_1.pdf (accessed on 23 June 2016).

¹³⁷ Bishop J (1968) 1078.

¹³⁸ Wilder C 'The Demand Requirement and the Business Judgment Rule: Synergistic Procedural Obstacles to Shareholder Derivative Suits' (1985) 5 *Pace Law Review* 633.

¹³⁹ Giraldo C & Bogota C 'Factors Governing the Application of the Business Judgment Rule: An Empirical Study of the US, UK, Australia and the EU' available at <http://www.juridicas.unam.mx/publica/librev/rev/vniver/cont/111/cnt/cnt5.pdf> (accessed on 03 September 2015).

determining whether the rule should apply to the situation at hand. The criteria require the decision to be a business decision, it must be an informed decision (duty of care), there should be an absence of a conflict of interests (duty of loyalty) and the decision should have a rational basis.¹⁴⁰ The rule will be applicable regardless as to how controversial, unpopular or wrong the decision might turn out to be and directors will furthermore be protected if their conduct is in accordance with the aforementioned criteria.¹⁴¹ It is thus clear that corporate directors are provided with extensive protection against personal liability by the BJR.¹⁴² The criteria will be discussed in detail at a later stage, at this point it is just stated for purpose of clarity.

Although the modern courts continue to insulate directors from liability for honest mistakes according to the above mentioned traditional rule, the Delaware courts began attaching a more expansive role to the BJR in the 1980s.¹⁴³ Initially, the rule applied in instances where there are no procedural infirmities but Delaware courts went further by applying the rule in cases where procedural infirmities have been mitigated by a special committee, stockholder approval, or partial substantive review by the court.¹⁴⁴ If the procedural infirmities were sufficiently muted by way of one of the aforementioned, the court would respect the directors' decision by applying the BJR.¹⁴⁵ Therefore, what is now referred to as the 'modern business judgment rule', is applied in various fundamental transactions such as takeovers and mergers.¹⁴⁶ This aspect of the rule will however be elaborated on in Chapter 4 of the dissertation.

¹⁴⁰ Branson D 'The Rule That Isn't a Rule – The Business Judgment Rule' (2002) 36 *Valparaiso University Law Review* 635.

¹⁴¹ Lane M *Representing Corporate Officers, Directors, Managers, and Trustees* 2ed (2015) 31.

¹⁴² Varzaly J 'Protecting the Authority of Directors: An Empirical Analysis of the Statutory Business Judgment Rule' available at <http://www.sef.hku.hk/aslea2011/private/paper/31.%20Jenifer%20Varzaly%20full%20paper.pdf> (accessed on 22 March 2016).

¹⁴³ Smith G 'The Modern Business Judgment Rule' available at <http://ssrn.com/abstract=2620536> (accessed on 08 March 2016).

¹⁴⁴ Smith G 'The Modern Business Judgment Rule' available at <http://ssrn.com/abstract=2620536> (accessed on 08 March 2016).

¹⁴⁵ Smith G 'The Modern Business Judgment Rule' available at <http://ssrn.com/abstract=2620536> (accessed on 08 March 2016).

¹⁴⁶ Fleischer A & Sussman A 'Director's Fiduciary Duties in Takeovers and Mergers' available at http://www.friedfrank.com/siteFiles/ffFiles/sri_directors_duties.pdf (accessed on 28 June 2016).

2.5 COMMON FORMULATIONS OF THE RULE IN AMERICA

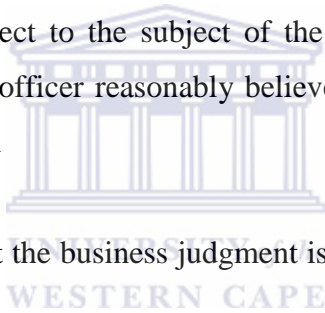
There are two common formulations of the rule in America.¹⁴⁷ These formulations include the American Law Institute (ALI) Version and the Delaware case law formulation.¹⁴⁸

2.5.1 ALI Version

Initially the American Law Institute struggled to codify the BJR.¹⁴⁹ However, the rule was later codified in paragraph 4.01(c) of the ALI Corporate Governance Project.¹⁵⁰ Paragraph 4.01(c) provides the following:

‘A director or officer who makes a business judgment in good faith fulfils the duty under this Section if the director or officer:

- (1) is not interested in the subject of the business judgment;
- (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
- (3) rationally believes that the business judgment is in the best interests of the corporation’¹⁵¹



The ALI version recognises the functional role of the BJR as it provides a test which courts will apply in order to determine whether a director should be held liable or not, for the harm suffered by the corporation.¹⁵² Stated differently, the aforementioned test will provide for liability or non-liability of directors based on the manner in which his business judgment was made.¹⁵³ The test is centred on three aspects.¹⁵⁴ The first aspect is that a director is financially

¹⁴⁷ Eichelberger J ‘Unification of Corporate Director Liability: Should the European Union adopt a U.S. Style Business Judgment Rule?’ available at <http://www.cde-montpellier.com/wp-content/uploads/M%C3%A9moire-Jonathan-EICHELBERGER.pdf> (accessed on 29 June 2016).

¹⁴⁸ Eichelberger J ‘Unification of Corporate Director Liability: Should the European Union adopt a U.S. Style Business Judgment Rule?’ available at <http://www.cde-montpellier.com/wp-content/uploads/M%C3%A9moire-Jonathan-EICHELBERGER.pdf> (accessed on 29 June 2016).

¹⁴⁹ Durckheim L (2012) 21.

¹⁵⁰ American Law Institute, ALI Corporate Governance Project (1994).

¹⁵¹ American Law Institute, ALI Corporate Governance Project (1994).

¹⁵² Hopt K, Kanda H & Roe M et al *Comparative Corporate Governance: The State of the Art and Emerging Research* (1998) 326 (hereafter referred to as Hopt K, Kanda H & Roe M et al (1998)).

¹⁵³ Hopt K, Kanda H & Roe M et al (1998) 326.

¹⁵⁴ Hopt K, Kanda H & Roe M et al (1998) 326.

and personally disinterested in the business transaction.¹⁵⁵ Secondly, the director needs to rationally believe that the decision is in the best interest of the corporation and thirdly, the director needs to ensure that he makes an informed business decision.¹⁵⁶

It is evident that paragraph (c)(1) relates to the fiduciary duty of loyalty in that a conflict of interest should be avoided.¹⁵⁷ However, it is essential to pay attention to the difference between (c)(2) and (c)(3). To be more specific, it is important to look at the words ‘reasonably’ and ‘rationally’ as they are often used interchangeably but in this instance the standards differ quite fundamentally.¹⁵⁸ The reasonable standard is an objective test which requires a court to look at whether a third-party would have acted in the same manner as the director.¹⁵⁹ In other words, it is an aspirational standard of conduct.¹⁶⁰ The rationality test on the other hand, is a subjective test as the focus is placed on the ability of a director to use his power and judgment prior to making a final business decision.¹⁶¹ Rationality requires logical thinking to take place and as a result thereof, when directors are expected to exercise rationality, the manner in which this is done can take different forms.¹⁶² Therefore, unlike reasonableness, there are no uniform criteria used by Delaware courts to determine rationality.¹⁶³ The rationality test is thus far less stringent in comparison to the reasonable test ‘as it is easy to characterise a directors conduct as imprudent or unreasonable but it is very uncommon to characterise a directors’ conduct as irrational’.¹⁶⁴

¹⁵⁵ Hopt K, Kanda H & Roe M et al (1998) 326.

¹⁵⁶ Hopt K, Kanda H & Roe M et al (1998) 326.

¹⁵⁷ Hearn C & Friend A ‘Feeling Conflicted? Identifying and Resolving Conflicts of Interests’ available at <https://m.acc.com/chapters/houst/upload/N2658084.pdf> (accessed on 22 June 2016).

¹⁵⁸ Veasey N ‘On Corporate Codification: A Historical Peek at the Model Business Corporation Act and the American Law Institute Principles Through the Delaware Lens’ available at <http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1611&context=lcp> (accessed on 29 June 2016).

¹⁵⁹ Veasey N ‘On Corporate Codification: A Historical Peek at the Model Business Corporation Act and the American Law Institute Principles Through the Delaware Lens’ available at <http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1611&context=lcp> (accessed on 29 June 2016).

¹⁶⁰ Veasey N ‘On Corporate Codification: A Historical Peek at the Model Business Corporation Act and the American Law Institute Principles Through the Delaware Lens’ available at <http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1611&context=lcp> (accessed on 29 June 2016).

¹⁶¹ Bainbridge S ‘The difference between reasonableness and rationality in corporate law’ available at <http://www.professorbainbridge.com/professorbainbridge.com/2010/09/the-difference-between-reasonableness-and-rationality.html> (accessed on 07 September 2016).

¹⁶² Bainbridge S ‘The difference between reasonableness and rationality in corporate law’ available at <http://www.professorbainbridge.com/professorbainbridge.com/2010/09/the-difference-between-reasonableness-and-rationality.html> (accessed on 07 September 2016).

¹⁶³ Bainbridge S ‘The difference between reasonableness and rationality in corporate law’ available at <http://www.professorbainbridge.com/professorbainbridge.com/2010/09/the-difference-between-reasonableness-and-rationality.html> (accessed on 07 September 2016).

¹⁶⁴ Eisenberg M ‘The Divergence of Standards of Conduct and Standards of Review in Corporate Law’ (1993) 62 *Fordham Law Review* 443.

2.5.2 The Delaware Case Law Formulation

Over the years Delaware case law developed the other common formulation of the BJR. A hallmark of the Delaware BJR is that a court will not substitute its judgment for that of the boards (also referred to as directors) provided that the board's decision has a rational purpose.¹⁶⁵ The Delaware BJR furthermore seeks to uphold the full and free exercise of the managerial powers which directors of Delaware corporations are granted.¹⁶⁶

The Delaware BJR was formulated in *Aronson v Lewis*.¹⁶⁷ The court in *Aronson* formulated the BJR as:

‘a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company. Absent an abuse of discretion, that judgment will be respected by the Courts. The burden is on the party challenging the decision to establish facts rebutting the presumption’.¹⁶⁸

Based on the aforementioned, when a court invokes the BJR presumption, it assesses the boards conduct not by focusing on the outcome of a given decision or assessing the wisdom thereof, but instead, the court focuses on the process the board took in reaching its decision.¹⁶⁹ Should the BJR be applied by the court, the board's decision will be upheld provided that a rational reason can be attributed to it.¹⁷⁰ However, the protection provided by the aforementioned formulation is not absolute.¹⁷¹ The rule's presumptions can be rebutted by the plaintiff stockholder provided that the plaintiff can prove that the director breached their duty of care, loyalty or good faith.¹⁷² Should the plaintiff fail to prove that the director

¹⁶⁵ Holland R ‘Delaware's Business Judgment Rule: International Variations’ available at <http://global.blogs.delaware.gov/2015/04/09/delawares-business-judgment-rule-international-variations/> (accessed on 29 July 2016).

¹⁶⁶ *In Re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 746 (Del. Ch. 2005) (quoting *Cede*, 663 A.2d at 1162).

¹⁶⁷ *Aronson v Lewis* 473 A.2d 805, 812 (Del. 1984).

¹⁶⁸ *Aronson v Lewis* 473 A.2d 805, 812 (Del. 1984).

¹⁶⁹ Warren I & Aronstam B ‘Delaware's Business Judgment Rule and Varying Standards of Judicial Review for Assessing Director Conduct in M&A Transactions’ available at http://www.ramllp.com/media/article/12_Canadian%20Institute%20Article.pdf (accessed on 29 June 2016).

¹⁷⁰ *In Re Walt Disney Co. Derivative Litig.* 906 A.2d at 74 (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971))

¹⁷¹ Warren I & Aronstam B ‘Delaware's Business Judgment Rule and Varying Standards of Judicial Review for Assessing Director Conduct in M&A Transactions’ available at http://www.ramllp.com/media/article/12_Canadian%20Institute%20Article.pdf (accessed on 29 June 2016).

¹⁷² *In Re Walt Disney Co. Derivative Litig.*, 906 A.2d at 52.

breached any one of the previously stated duties the BJR will provide the board with substantive protection.¹⁷³

On the other hand, there are instances in which the plaintiff might succeed in proving that the board has breached one of their fiduciary duties.¹⁷⁴ In these instances the burden shifts to the defendant directors and the Entire Fairness Doctrine (EFD) is applied by the courts.¹⁷⁵ The EFD plays a pivotal role in Delaware case law alongside other enhanced standards of judicial scrutiny. The EFD as well as the two other standards, namely the Unocal and Revlon standards, will be discussed in detail in chapter 3 of this dissertation.

2.6 DIFFERENCES BETWEEN THE COMMON FORMULATIONS

The ALI formulation is purely a ‘safe harbour’ in the sense that directors will only be protected by the BJR if he or she can prove the elements stipulated in paragraph 4.01(c).¹⁷⁶ With the ALI formulation the burden of proof is placed on the defendant directors as they are expected to prove the presence of each element provided in paragraph 4.01(c).¹⁷⁷ Should the director be in conformity with the elements, he will not incur personal liability for a business decision, regardless as to how bad the outcome of the business decision may be.¹⁷⁸

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The Delaware version of the rule differs quite fundamentally from the ALI version in that it is formulated as a presumption.¹⁷⁹ Therefore, instead of placing the burden on the directors to prove that they have fulfilled their fiduciary duties in order to be protected by the BJR, the directors are presumed to have acted in conformity with their duties.¹⁸⁰ Unlike the ALI version, the initial burden is placed on the plaintiff stockholders who are required to prove

¹⁷³ *Emerald Partners v. Berlin* 787 A.2d 85, 91 (Del. 2001).

¹⁷⁴ Warren I & Aronstam B ‘Delaware’s Business Judgment Rule and Varying Standards of Judicial Review for Assessing Director Conduct in M&A Transactions’ available at http://www.ramllp.com/media/article/12_Canadian%20Institute%20Article.pdf (accessed on 29 June 2016).

¹⁷⁵ Chalian S & Bandura K ‘The Business Judgment Rule and the Entire Fairness Doctrine’ available at <http://www.rc.com/documents/Primer%20on%20Business%20Judgment%20Rule.pdf> (accessed on 29 June 2016).

¹⁷⁶ *Toebelman vs. Missouri-Kansas Pipe Line Co*, 41 F. Sup p, 334, 339, Del. 1941.

¹⁷⁷ Durckheim L (2012) 12.

¹⁷⁸ Durckheim L (2012)12.

¹⁷⁹ Hecker Webb ‘Controlling Shareholder Duty of Loyalty: Entire Fairness or Business Judgment’ available at [https://law.ku.edu/sites/law.ku.edu/files/docs/recent-developments/\(2\)HeckerControllingShareholderDutyofLoyalty](https://law.ku.edu/sites/law.ku.edu/files/docs/recent-developments/(2)HeckerControllingShareholderDutyofLoyalty) (accessed on 29 June 2016).

¹⁸⁰ Furlow C ‘Good Faith, Fiduciary Duties, and the Business Judgment Rule in Delaware’ (2009) 3 *Utah Law Review* 1083.

that the directors breached one or more of their fiduciary duties.¹⁸¹ This version furthermore includes a potential additional step in the court proceedings as it requires the directors to prove that the business decision and transaction were fair towards the corporation and its stockholders.¹⁸² This step will only be relied upon in cases where the stockholder successfully rebuts the presumption.¹⁸³

Although the BJR has different formulations, it is furthermore interpreted in different manners. The manner in which the rule is interpreted can largely influence the judicial findings regarding the liability of directors.¹⁸⁴ It is thus necessary to consider the various interpretations of the BJR.

2.7 COMPETING INTERPRETATIONS OF THE BUSINESS JUDGMENT RULE

There are two traditional interpretations of the BJR which arise out of American corporate case law.¹⁸⁵ These interpretations are referred to as the standard of review approach and the abstention doctrine.¹⁸⁶ However, in addition to the two additional approaches, a newer interpretation of the rule was established which is the rule as an immunity doctrine.¹⁸⁷ The correct interpretation of the rule has the ability of contributing towards the innovation of business.¹⁸⁸ This section of the dissertation will critically analyse each of the aforementioned interpretations as they differ quite fundamentally.

2.7.1 Standard of Review Approach

Traditionally, the BJR has been referred to as a standard of liability although it has never been enunciated as such.¹⁸⁹ The effect of viewing the rule as a standard of liability is that courts would first review the quality of the decisions taken by the board of directors prior to

¹⁸¹ Furlow C 'Good Faith, Fiduciary Duties, and the Business Judgment Rule in Delaware' (2009) 3 Utah Law Review 1083.

¹⁸² Brauerman S 'When Business Judgment Isn't Enough: The Impact of The Standard of Review on Deal Litigation' available at http://www.americanbar.org/publications/blt/2014/05/delaware_insider.html (accessed on 29 June 2016).

¹⁸³ Brauerman S 'When Business Judgment Isn't Enough: The Impact of The Standard of Review on Deal Litigation' available at http://www.americanbar.org/publications/blt/2014/05/delaware_insider.html (accessed on 29 June 2016).

¹⁸⁴ Ponta A & Catana R (2015) 125.

¹⁸⁵ Ponta A & Catana R (2015) 125.

¹⁸⁶ Bainbridge S 'The Business Judgment Rule as Abstention Doctrine' available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=429260 (accessed on 30 June 2016).

¹⁸⁷ McMillan L 'The Business Judgment Rule as an Immunity Doctrine' available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2266489 (accessed on 30 June 2016).

¹⁸⁸ Ponta A & Catana R (2015) 125.

¹⁸⁹ McMillan L 'The Business Judgment Rule as an Immunity Doctrine' (2013) 4 *William & Mary Business Law Review* 521 (Hereafter referred to as McMillan (2013)).

applying the rule but this review is however limited.¹⁹⁰ Some courts and commentators are of the opinion that directors will be protected provided that they have acted in good faith.¹⁹¹ The opposing view is that the rule raises the bar from mere negligence to gross negligence or recklessness.¹⁹² Delaware courts define gross negligence and recklessness as a careless disregard for the corporation's best interests.¹⁹³ Therefore, if a director makes a business decision and disregards the substantial and justifiable risk, he or she could be said to have been grossly negligent or reckless.¹⁹⁴

The case of *Cede & Co. v Technicolor Inc.* clearly illustrates the rule as a standard of liability. When dealing with the matter, the Superior Court focused on the board of directors' decision-making process.¹⁹⁵ The court was of the opinion that there were some deficiencies in the procedure followed by the board in order to reach its decision and as a result the court was of the opinion that the duty of care was breached.¹⁹⁶ Based on the aforementioned it is clear that the courts review the decision-making procedure followed by directors but the review by the courts is limited. The problem here is that by viewing the rule as a standard of liability, courts will be doing exactly what the BJR was created to avoid, which is the interference with business decisions.¹⁹⁷

2.7.2 The Rule as an Abstention Doctrine

‘According to this interpretation of the rule, the presumption of good faith does not create a standard of liability, but it rather creates a negative presumption of the judicial review of due diligence and prudence’.¹⁹⁸

¹⁹⁰ McMillan L (2013) 521.

¹⁹¹ Zwyer T ‘The Business Judgment Rule Shields Corporate Officers and Directors from Liability for Acts of Negligence and Carelessness’ available at <http://www.lexisnexis.com/legalnewsroom/lexis-hub/b/commentary/archive> (accessed on 21 March 2016).

¹⁹² Eisenberg M ‘The Divergence of Standards of Conduct and Standards of Review in Corporate Law’ (1993) 62 *Fordham Law Review* 437.

¹⁹³ Hosto & Buchan Law Firm ‘Degree of Culpability’ available at <http://www.hostobuchan.com/newsletters-2/business-law/degree-of-culpability/> (accessed on 21 March 2016).

¹⁹⁴ Hosto & Buchan Law Firm ‘Degree of Culpability’ available at <http://www.hostobuchan.com/newsletters-2/business-law/degree-of-culpability/> (accessed on 21 March 2016).

¹⁹⁵ Glover S *Business Separation Transactions: Spin-Offs, Subsidiary IPOs and Tracking Stock* 1ed(2006) 9.

¹⁹⁶ Prickett W & Brown R ‘Cede v Technicolor : The Supreme Re-illuminates Existing Lines of Delaware’s Level Playing Field’ available at <http://www.djcl.org/wp-content/uploads/2014/08/Cede-v.-Technicolor-The-Supreme-Court-Re-Illuminates-Existing-Lines-Of-Delawares-Level-Playing-Field.pdf> (accessed on 23 March 2016).

¹⁹⁷ Sharfman B ‘Understanding Maryland’s Business Judgment Rule’ available at <http://www.duqlawblogs.org/blj/wp-content/uploads/2012/05/sharfman.pdf> (accessed on 23 March 2016).

¹⁹⁸ Johnson L. ‘The Modest Business Judgement Rule’ (2000) 55 *Business Law Review* 625, Under a proper understanding of the Business Judgment Rule as a policy of non-review, the substantive force of the Rule

In other words, courts refrain from questioning the business decision taken by directors as the presumption assumes that the board of directors have acted in accordance with the requirements of the rule.¹⁹⁹ When the BJR is referred to as an abstention doctrine the rule becomes a procedural guide as it requires the plaintiff to rebut the presumption by producing facts which could prove that the director failed to act in accordance with his or her duties.²⁰⁰ Failure to produce such evidence results in the director being protected by the rule and the effect thereof is that the director will not be held personally liable.²⁰¹ Commentators such as Professor Bainbridge are of the opinion that the BJR is better viewed as an abstention doctrine.²⁰² When it is viewed as an abstention doctrine courts will refuse to interfere with the business decision taken by directors regardless as to whether the decision proves to be detrimental to the corporation provided that it has a rational basis.²⁰³

Case law has made it quite evident that the interpretation of the BJR as an abstention doctrine is adopted by Delaware courts. The *Aronson* case cites two cases to support its statement of the BJR as including a presumption.²⁰⁴ In *Kaplan v Centex Corp* the Chancellor stated that the acts of directors are ‘presumptively acts performed in good faith and in the best interest of the company and the minority shareholder who challenges the *bona fides*, also referred to as good faith, purpose has the burden of proof’.²⁰⁵ This clearly indicates that courts support the conception of the BJR as a presumption which in essence means that it supports the rule’s explanation as an abstention doctrine.

The *Shlensky v Wrigley* case is referred to as the baseline case which refers to the rule as an abstention doctrine. The court stated that the judiciary should only intervene in business decisions in instances where directors’ decisions prove to be tainted by fraudulent interests.²⁰⁶ However, the court goes further to state that in instances where fraud and conflict of interests

always applies in a duty of care case, immunizing the quality of the business decision from judicial review whether or not care was exercised.

¹⁹⁹ *Orman v. Cullman* 794 A.2d 5, 19–20 (Del. Ch. 2002).

²⁰⁰ Furlow C ‘Good Faith, Fiduciary Duties, and The Business Judgment Rule in Delaware’ available at <http://epubs.utah.edu/index.php/ulr/%EE%80%80article%EE%80%81/viewFile/249/221> (accessed on 08 March 2016).

²⁰¹ Bainbridge S ‘The Essential Business Judgment Rule’ available at <http://www.professorbainbridge.com/professorbainbridge.com/2013/07/the-essential-business-judgment-rule.html> (accessed on 10 March 2016).

²⁰² Bainbridge ‘The Business Judgment Rule as an Abstention Doctrine’ available at <http://papers.ssrn.com/sol3/papers.cfm> (accessed on 12 March 2016).

²⁰³ *Dahlberg V* (2008).

²⁰⁴ Balotti R ‘Rejudging the Business Judgment Rule’ (1993) 48 *The Business Lawyer* 1340.

²⁰⁵ *Kaplan v Centex Corp* 284 A.2d 119 (Del. Ch. 1971).

²⁰⁶ *Shlensky v Wrigley* 95 Ill.App.268, 237 N.E.2d 776 (Ill.App. 1 Dist. 1968) (Hereafter *Shlensky v Wrigley* 1968).

are not present, the conduct of the directors should be regarded as absolute when they are making business decisions.²⁰⁷ In these instances, the court does not have the authority to substitute its judgment for that of directors.²⁰⁸ Instead, the courts will apply the BJR and the directors will not be held liable for the harm suffered by the corporation.²⁰⁹

2.7.3 The Rule as an Immunity Doctrine

The BJR as an immunity doctrine requires the directors to be insulated from incurring personal liability for actions performed while acting in their capacity as directors.²¹⁰ The immunity doctrine enables directors to be comfortable with their business decisions and should unsatisfied stockholders take action against them, they could be protected.²¹¹ The idea is for directors to be able to exercise their discretionary rights in order for their duties to be performed effectively.²¹²

In adopting this interpretation of the rule, the court will be highlighting the importance of the position of an individual as a director instead of highlighting the importance of the person filling the position.²¹³ This doctrine operates in a similar manner to the standard of review approach, since the effect is the same.²¹⁴ Both forms of interpretation insulate directors from liability for their business decisions which cause harm to the corporation.²¹⁵ The rules are similar in that the courts will first analyse the directors' decision prior to granting them the immunity.²¹⁶ However, the procedural analysis is different as it focuses on situations which could disqualify the directors from the immunity afforded by the BJR.²¹⁷ Factors such as fraud, self-dealing or the director's failure to ensure that he is fully informed could lead to disqualification from the protection afforded by the rule.²¹⁸

Although Delaware courts have interpreted the BJR as an abstention doctrine by viewing the rule as a presumption, the standard of review interpretation of the rule is increasingly being

²⁰⁷ *Shlensky v Wrigley* (1968).

²⁰⁸ *Shlensky v Wrigley* (1968).

²⁰⁹ Triem F 'Judicial Schizophrenia in Corporate Law: Confusing the Standard of Care with the Business Judgment Rule' available at

<http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1071&context=alr> (accessed on 30 June 2016).

²¹⁰ McMillan L (2013) 542.

²¹¹ McMillan L (2013) 530.

²¹² Ponta A & Catana R (2015) 131.

²¹³ Ponta A & Catana R (2015) 131.

²¹⁴ Ponta A & Catana R (2015) 131.

²¹⁵ Ponta A & Catana R (2015) 131.

²¹⁶ Ponta A & Catana R (2015) 131.

²¹⁷ McMillan L (2013) 530.

²¹⁸ McMillan L (2013) 542.

widely accepted by some members of the Delaware courts.²¹⁹ It could thus be argued that the prevailing interpretation of the rule is the rule as a standard of review. Directors are required to prove that certain elements have been met before receiving the protection afforded by the rule.²²⁰ The next section of this chapter will critically analyse the elements of the Delaware BJR. These elements play a crucial role as courts will take each element into consideration in order to ensure that the director made a business decision in the required manner.²²¹

2.8 ELEMENTS OF THE DELAWARE BUSINESS JUDGMENT RULE

In order for the BJR to shield directors from liability and to protect directors' decisions from judicial second-guessing, four elements are taken into consideration.²²² As previously mentioned the business decision needs to be an informed decision, which was made in good faith and the board of directors honestly believed that the decision taken would be in the best interest of the company.²²³ As previously mentioned, although Delaware courts have treated the rule as a presumption, they began shifting away from this approach and instead began viewing the rule as a standard of review.²²⁴ The courts will thus consider certain elements in order to determine whether the directors should be afforded the protection of the BJR.²²⁵ These elements will be discussed in detail below.

2.8.1 Business Decision

The director must have made a conscious decision and properly evaluate the risks involved in making the decision.²²⁶ Where the director failed to act, he or she will not be protected by the rule, unless the director made a deliberate decision not to act.²²⁷ Decisions can be divided into ordinary and extraordinary decisions.²²⁸ Ordinary decisions are decisions such as the sanctioning of a dividend whereas extraordinary decisions would be the decision to merge a

²¹⁹ Bainbridge S 'The Business Judgment Rule as an Abstention Doctrine' available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=429260 (accessed on 27 July 2016).

²²⁰ Seidler C 'Assessing the Wisdom of the Business Judgment Rule in Corporate Control Contests: Is it Time to Make Shareholders' Interests Paramount' (1990) 23 *Loyola of Los Angeles Law Review* 926 (hereafter referred to as Seidler C (1990)).

²²¹ Cara F 'The Business Judgment Rule and Unocal: Twin Barriers to Shareholder Welfare' (1989) 5 *Journal of Civil Rights and Economic Development* 200.

²²² Seidler C (1990) 926.

²²³ *Einhorn v. Culea* 2000 WI 65, 19, 235 Wis. 2d 646, 612 N.W.2d 78.

²²⁴ Branson D (2002) 635.

²²⁵ Branson D (2002) 635.

²²⁶ Branson D (2002) 631.

²²⁷ Branson D (2002) 631.

²²⁸ S Kennedy-Good & L Coetzee *The Business Judgment Rule Part 1* (2006) 62.

large asset and the approval of the stockholders is necessary.²²⁹ As far as ordinary decisions are concerned the application of the rule appears to be straightforward whereas with extraordinary decisions the application is far more complicated, however the latter will be discussed in Chapter 4 of this dissertation.²³⁰

2.8.2 Informed Decision

Directors are required to inform themselves prior to making a business decision, of all the material information reasonably available to them.²³¹ Although the board must be reasonably informed, the board is not expected to be reasonably informed of every fact.²³² In order to determine whether the board was informed of all the material information, the court will consider the quality of the information, the advice considered by the board and whether the board had sufficient opportunity to acquire knowledge regarding the situation, prior to acting on it.²³³ Directors should carefully examine information in order to protect the interest of the company.²³⁴

The expectation of the directors to make informed decisions is interrelated with the duty of care.²³⁵ In the *Cede* case the Delaware Supreme Court referred to the *Van Gorkom* case in order to find that the defendant directors breached their duty of care by making an uninformed business decision.²³⁶ The duty of care thus requires the directors to inform themselves of all the material information reasonably available to them and this should be done prior to making the decision.²³⁷

2.8.3 Absence of Conflict of Interest

A further requirement is that a director should not have an interest in the subject matter of the decision. An example of a conflict of interest is when a director has a direct financial interest in the matter which could result in the decision being tainted for the benefit of the director.²³⁸ Therefore, in order to be protected by the BJR corporate directors are required to be

²²⁹ Miller R *Business Law Today, Standard: Text & Summarized Cases* 10ed (2014) 763.

²³⁰ S Kennedy-Good & L Coetzee *The Business Judgment Rule Part 1* (2006) 62.

²³¹ *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

²³² Lafferty W et al (2012) 842 .

²³³ *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1075 (Del. Ch. 1985).

²³⁴ Lafferty W et al (2012) 842.

²³⁵ *Cede & Co and Cinerama Inc v Technicolor Inc* 1990 Del 367.

²³⁶ *Cede & Co and Cinerama Inc v Technicolor Inc* 1990 Del 367.

²³⁷ *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (quoting *Aronson*, 473 A.2d at 812).

²³⁸ Palm C & Kearney M 'A Primer on the Basics of Directors' Duties in Delaware: The Rules of the Game (Part I)' (1995) 40 *Vill. Law Review* 1297, 1313-14 (hereafter referred to as Palm & Kearney (1995)).

disinterested and independent.²³⁹ Independence means that a director's decision is based on the corporate merits of the subject before the board rather than inessential influences that would convert a valid business decision into a faithless act.²⁴⁰

As previously discussed under the 'Director's Duties' section of this dissertation, it was clearly stated that the duty of loyalty requires the directors to have no financial or personal interest in the business transaction.²⁴¹ It is thus clear that the duty of loyalty comes into effect with the 'absence of conflict of interest' element of the BJR.

2.8.4 Rational Basis

A decision taken by a director needs to be capable of having a coherent explanation.²⁴² When making a business decision, directors are required to act in good faith which ultimately means that directors should be honest.²⁴³ It has further been argued that a director, who acts irrationally or unwisely, may not be acting in good faith.²⁴⁴ Similarly, if a director acts without a rational business purpose, the court will be of the opinion that he acted in bad faith.²⁴⁵

Directors are however not guaranteed the protection afforded by the presumption created by the BJR.²⁴⁶ In instances where the plaintiff proves that the director breached his or her duty of care or acted in bad faith the presumption will be rebutted and the director will not be afforded the protection granted by the rule.²⁴⁷

Although the elements need to be present in order for the BJR to be applied, the BJR will not be applicable to anyone. It is thus essential to consider who can be protected by the rule based on the position they fulfil.

²³⁹ Palm & Kearney (1995) 1309-12.

²⁴⁰ Weinberger L 'The Business Judgment Rule and Sphere Sovereignty' available at http://www.cooley.edu/lawreview/docs/archive_volumes/volume27_2/27-2%20weinberger.pdf (accessed on 28 February 2016).

²⁴¹ Hopkins B & Blazek J *Private Foundations: Tax Law and Compliance* 3ed(2008)77.

²⁴² *Brehm v. Eisner* 746 A.2d 244, 264-65 (Del. 2000).

²⁴³ Davis G & Whitley D 'Directors' Fiduciary Duties: Increasing Focus on Good Faith and Independence' (2009) 83 *The Florida Bar Journal* 38 (Hereafter referred to as Davis G & Whitley D (2009)).

²⁴⁴ Weinberger L 'The Business Judgment Rule and Sphere Sovereignty' available at http://www.cooley.edu/lawreview/docs/archive_volumes/volume27_2/27-2%20weinberger.pdf (accessed on 28 February 2016).

²⁴⁵ Davis G & Whitley D (2009).

²⁴⁶ Warren I & Aronstam B 'Delaware's Business Judgment Rule and Varying Standards of Judicial Review: Assessing Director Conduct in M&A Transactions' available at http://www.ramllp.com/media/article/12_Canadian%20Institute%20Article.pdf (accessed on 28 February 2016).

²⁴⁷ *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 52 (Del. 2006).

2.9 APPLICATION OF THE BUSINESS JUDGMENT RULE

American case law illustrates that the application of the rule has been extended to trustees, chief accountants in the capacity of temporary directors and the controlling shareholder, when carrying out managerial functions normally performed by directors or managers.²⁴⁸ On the other hand, the minority shareholders and employees have not been covered by this rule.²⁴⁹ Delaware courts have furthermore extended the application of the rule to officers.²⁵⁰ Recent cases in states such as California have however stated that officers should not be afforded the protection provided by the BJR.²⁵¹

It is important to bear in mind that a director will only be afforded the protection of the rule if he or she is a disinterested director.²⁵² The rule is thus inapplicable to intimidated directors and uninformed directors.²⁵³ A director is considered to be an intimidated director in instances where he allows another director with a financial or personal interest in the matter, to influence him in making a business decision.²⁵⁴ Therefore, although a director is disinterested, if he allows an interested director to intimidate him into making a decision, he will be considered interested.²⁵⁵ Uninformed directors on the other hand, are directors who fail to spend considerable time in making the decision and who furthermore do not obtain advice from qualified experts.²⁵⁶

Now that there is an understanding as to the history of the rule and how it operates, it is necessary to consider the importance of the rule. The policy justifications of the rule will be considered as it furthermore illustrates why the BJR is important and why Delaware courts deemed it necessary to establish the rule.

²⁴⁸ DeMott D 'Directors' Duty of Care and the Business Judgment Rule: American Precedents and Australian Choices *'available at <http://epublications.bond.edu.au/blr/vol4/iss2/>* (accessed on 02 March 2016).

²⁴⁹ DeMott D 'Directors' Duty of Care and the Business Judgment Rule: American Precedents and Australian Choices *'available at <http://epublications.bond.edu.au/blr/vol4/iss2/>* (accessed on 02 March 2016).

²⁵⁰ *Kelly v Bell* 266 A.2d 878, 879 (Del. 1970).

²⁵¹ Bailey D 'The Business Judgment Rule under Attack' available at <http://www.baileycavalieri.com/169-The%20Business%20Judgment%20Rule%20Under%20Attack.pdf> (accessed on 26 March 2016).

²⁵² *New Jersey Carpenters Pension Fund v Info GROUP Inc.*, 2011 Del. Ch. LEXIS 147.

²⁵³ Bailey D 'The Business Judgment Rule under Attack' available at <http://www.baileycavalieri.com/169-The%20Business%20Judgment%20Rule%20Under%20Attack.pdf> (accessed on 26 March 2016).

²⁵⁴ The D&O Report 'Directors & Officers Beware: Business Judgment Rule Under Attack' available at <http://www.acegroup.com/bm-en/media-centre/directors-officers-beware.aspx> (accessed on 28 July 2016).

²⁵⁵ *Official Committee of Unsecured Creditors v Baldwin* 2011 U.S. App. LEXIS 19312.

²⁵⁶ The D&O Report 'Directors & Officers Beware: Business Judgment Rule Under Attack' available at <http://www.acegroup.com/bm-en/media-centre/directors-officers-beware.aspx> (accessed on 28 July 2016).

2.10 THE PRACTICAL IMPORTANCE OF THE BUSINESS JUDGMENT RULE

The rule emerged because of the need to protect persons owing duties to companies and it serves as a safe haven for those individuals who made a decision in conformity with the elements of the rule.²⁵⁷ In commercial terms the BJR bestows economic freedoms and freedom of entrepreneurship to directors guided by ‘the best interest of the company’.²⁵⁸

The most commonly cited reasons for the existence of the rule are that it promotes risk taking, encourages competent persons to serve as directors, prevents judicial second-guessing and it allows directors sufficient freedom to manage the company.²⁵⁹ These purposes will be discussed below.

2.10.1 Promotes Risk Taking

Given the inherently risky character of business decisions, the most thought through decisions could end disastrously.²⁶⁰ The duties of directors consist of establishing corporate policy, weighing major business decisions and overseeing management.²⁶¹ The decisions taken by directors may not be susceptible to a right or wrong analysis at the time they are made.²⁶² Although the decisions of directors were not wrongly made, the decision may prove to be wrong at a later stage.²⁶³ If no protection was provided to directors for risk entailed business decisions, they would have been far more cautious and hesitant to take risks which in essence could be beneficial to the company.²⁶⁴ Therefore, the BJR encourages directors to take risks which are essentially beneficial to the shareholders because they will receive better investment returns.²⁶⁵ The removal of the BJR could cause honest directors to exercise

²⁵⁷ Davies P et al *Corporate Boards in European Law: A Comparative Analysis* 1ed (2013) 49.

²⁵⁸ Vasiljević M ‘Civil Law and the Business Judgment Rule’ available at <http://anali.ius.bg.ac.rs/Annals%202012/Annals%202012%20p%20007-038.pdf> (accessed on 23 March 2016).

²⁵⁹ Rosenberg D ‘Galactic Stupidity and the Business Judgment Rule’ available at <https://www.questia.com/library/journal/1G1-161502276/galactic-stupidity-and-the-business-judgment-rule> (accessed on 06 September 2015).

²⁶⁰ Ponta A (2015) 37.

²⁶¹ Pietrafesa G ‘Application of the Business Judgment Rule to Corporate Officers’ available at https://www.bestlawyers.com/Downloads/Articles/2302_1.pdf (accessed on 01 March 2016).

²⁶² *In re PSE&G Shareholder Litigation*, 315 N.J. Super. 323, 327 (Ch. Div., 1998) (Hereafter referred to as *In re PSE&G Shareholder Litigation* (1998)).

²⁶³ *In re PSE&G Shareholder Litigation* (1998).

²⁶⁴ Weinberger L ‘The Business Judgment Rule and Sphere Sovereignty’ available at http://www.cooley.edu/lawreview/docs/archive_volumes/volume27_2/27-2%20weinberger.pdf (accessed on 28 February 2016).

²⁶⁵ Weinberger L ‘The Business Judgment Rule and Sphere Sovereignty’ available at http://www.cooley.edu/lawreview/docs/archive_volumes/volume27_2/27-2%20weinberger.pdf (accessed on 28 February 2016).

excessive caution and this may suppress effective leadership.²⁶⁶ The BJR therefore acts as a mechanism which allows directors to have more discretion and it allows companies to regulate its risk levels.²⁶⁷ Without the rule the courts would indirectly be determining the risk level of companies.²⁶⁸

2.10.2 Competent Directors

It can be argued that the BJR actually encourages qualified and experienced persons to act as directors.²⁶⁹ If the aforementioned persons knew that they could easily incur personal liability for risky business decisions, it could easily deter them from fulfilling the position as a director.²⁷⁰ The BJR is thus designed to provide the directors with protection in their business decision and in essence it ensures that directors will not be deterred from pursuing potentially profitable, but risky, endeavours.²⁷¹

2.10.3 Avoiding Judicial Encroachment and Promoting Judicial Efficiency

It has been argued that courts and judges are not in the best position to evaluate business decisions as it does not fall within their scope of expertise.²⁷² Courts and commentators have suggested that the complexity of business matters is beyond the intellectual reach of courts and litigation is thus not always a suitable tool to evaluate corporate business decisions.²⁷³ Courts could end up becoming ‘super directors’ if they scrutinize and fail to respect the decisions made by honest directors in good faith and on a rational basis.²⁷⁴ The case of *Warshaw v Calhoun* supports the aforementioned rationale.²⁷⁵ The court wrote that the

²⁶⁶ Heim R *Going Public in Good Times and Bad: A Legal and Business Guide* 1ed (2002) 174.

²⁶⁷ Martinez A ‘Re-Examining the Business Judgment Rule from a Comparative Perspective: Is it Really in the Shareholders’ Interest?’ available <http://clsbluesky.law.columbia.edu/2016/02/26/re-examining-the-business-judgment-rule-from-a-comparative-perspective-is-it-really-in-the-shareholders-interest/> (accessed on 23 March 2016).

²⁶⁸ Durckheim L (2012) 9.

²⁶⁹ Murty J ‘Zapata Corp. v. Maldonado: A Middle Ground When Applying the Business Judgment Rule to the Termination of Derivative Suits’ (1982) 31 *Cath. U. L. Rev.* 539.

²⁷⁰ LaCroix K ‘Guest Post: The Business Judgment Rule under Attack’ available at <http://www.dandodiary.com/2014/01/articles/director-and-officer-liability/guest-post-the-business-judgment-rule-under-attack/> (accessed on 23 March 2016).

²⁷¹ Johnson L ‘Corporate Officers and the Business Judgment Rule (2005)60 *The Business Lawyer* 456.

²⁷² Mares R *The Dynamics of Corporate Social Responsibilities* Vol 33 (2008) 29.

²⁷³ S Kennedy-Good & L Coetzee *The Business Judgment Rule Part 1* (2006) 62.

²⁷⁴ S Kennedy-Good & L Coetzee *The Business Judgment Rule Part 1* (2006) 62.

²⁷⁵ *Warshaw v Calhoun* A.2d 487, 492-93 (Del. 1966).

judiciary should not interfere with the business judgment of directors in cases where there is a failure to prove bad faith on the part of the director or gross abuse of his or her discretion.²⁷⁶

The rule furthermore promotes judicial efficiency as it allows courts to preserve their valuable resources by disposing of complex business litigation.²⁷⁷ Without the rule, the stockholders will have more reason to flood the court with derivative suits and the court is already operating under the constraints of scarce resources.²⁷⁸ Therefore, in preventing the courts from being flooded with derivative suits the courts will be in a position to focus on more important matters.

2.10.4 Designed to achieve a compromise

The BJR is designed to achieve a compromise between two competing values.²⁷⁹ This compromise needs to be determined on a case-by-case basis by evaluating the exercise of authority and liability.²⁸⁰ ‘Authority’ refers to the need to preserve the directors’ decision making powers whilst ‘liability’ indicates the importance of being able to hold a director accountable for the breach of his duties.²⁸¹ Authority and liability cannot exist independently in modern corporate law and the rule thus plays a vital role in striking a balance between the two.²⁸² The problem with the existence of authority and liability is that it allows for an increase in corporate opportunism which includes cases such as self-dealing, common errors, negligence and carelessness.²⁸³ The BJR thus plays an important role in these situations as it ensures that directors will only be afforded protection in instances where one of the aforementioned factors is not present.²⁸⁴ Directors thus have knowledge of the fact that if they act in a manner which is contrary to their duties, they will incur personal liability. The amount being claimed from the director would most likely not be a small amount and not only will the director have a bad reputation for breaching his duties but he could furthermore

²⁷⁶ *Warshaw v Calhoun* A.2d 487, 492-93 (Del. 1966).

²⁷⁷ Branson D (2002) 632.

²⁷⁸ Park J ‘The Business Judgment Rule: A Missing Piece in the Developing Puzzle of Korean Corporate Governance Reform’ (2003) 3 *Journal of Korean Law* 30.

²⁷⁹ Ibrahim D ‘Individual or Collective Liability for Corporate Directors?’ available at <http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=2726&context=facpubs> (accessed 23 March 2016).

²⁸⁰ Scarlett A ‘A Better Approach for Balancing Authority and Accountability in Shareholder Derivative Litigation’ available at https://kuscholarworks.ku.edu/bitstream/handle/1808/20095/02-Scarlett_Final.pdf?sequence=1 (accessed on 20 March 2016).

²⁸¹ Ponta A & Catana R (2015) 127.

²⁸² Ponta A & Catana R (2015) 127.

²⁸³ Ponta A ‘The business judgment rule - approach and application’ 5 (2015) *Judicial Tribune* 36 (Hereafter referred to as Ponta A (2015)).

²⁸⁴ Ponta A (2015) 36.

be dismissed from the corporation. The BJR can therefore be referred to as a barrier which ensures that directors are careful when performing their duties.²⁸⁵

Although the BJR was designed to achieve the aforementioned rationales, the rule has its shortfalls. These shortfalls could potentially have a negative impact on the countries who adopt the Delaware BJR into their corporate law.²⁸⁶

2.11 SHORTFALLS OF THE DELWARE BUSINESS JUDGMENT RULE

Confusion with respect to the BJR has been created by numerous varying formulations of the rule and the fact that courts have often stated the rule incompletely or with elliptical shorthand references contributes to this confusion.²⁸⁷ The expansion of the rule by Delaware courts appear to be the centre of all problems surrounding the rule and various issues such as uncertainty and complexity flow from the Delaware formulation.²⁸⁸ The alterations to the application of the rule promote lack of consensus regarding the rule's application.²⁸⁹ Samuel Arsht is of the opinion that the misunderstanding surrounding the rule stems from the general failure to distinguish the BJR from presumptions and limitations surrounding the rule's application and from the courts' tendency of using poor language in expressing the rule.²⁹⁰

The exact relationship between the BJR and the duty of care remains an enigma and it is a source of great confusion.²⁹¹ Some academics are of the opinion that the rule defines the contents of a director's duty of care whilst others feel that the rule should be an element of the duty of care instead of it being the other way around.²⁹² In other words, they feel that the rule sets the required standard of care which is expected from directors.²⁹³ Although the rule and the duty of care are interrelated, the BJR was not designed to be a substitute for the duty of care.²⁹⁴ In Delaware, the rule is being prioritized whilst the duty of care is not receiving the same attention and in doing so the courts are deeming directors to be performing at a higher

²⁸⁵ Ponta A (2015) 36.

²⁸⁶ Durckheim L (2012) 6.

²⁸⁷ A.L.I. Principles of Corporate Governance: Analysis and Recommendations paragraph 4.01 at 173 (1994).

²⁸⁸ Leach J (2014) 30.

²⁸⁹ Gevurtz F 'The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?' (1994) 67 *South California Law Review* 287.

²⁹⁰ Arsht S 'The Business Judgment Rule Revisited' (1979) 8 *Hofstra Law Review* 93-94.

²⁹¹ Rhee R 'The Tort Foundation of Duty of Care and Business Judgment' (2013) 88 *Notre Dame Law Review* 1139.

²⁹² Du Plessis J 'Open Sea or Safe Harbour? American, Australian and South African Business Judgment Rules Compared' (2011) 1 *Company Lawyer* 347.

²⁹³ Du Plessis J 'Open Sea or Safe Harbour? American, Australian and South African Business Judgment Rules Compared' (2011) 1 *Company Lawyer* 347.

²⁹⁴ Smith G 'The Modern Business Judgment Rule' available at <http://poseidon01.ssrn.com/delivery.php> (accessed on 01 March 2016).

level than they might actually be performing.²⁹⁵ In prioritizing the BJR, courts are failing to sufficiently emphasise the affirmative nature of directors' duties.²⁹⁶ The rule after all presumes that directors have acted on an informed basis, in good faith and in the honest belief that the decision is in the best interest of the company.²⁹⁷ Commentators argue that directors should not get the benefit of the doubt that they are fulfilling their duties unless proven differently.²⁹⁸ There should instead be certainty that they are affirmatively fulfilling their duties.²⁹⁹ The obligation of affirmatively fulfilling their duties is masked by the formulation of the rule as a presumption as this formulation misleadingly suggests that directors have fulfilled their duties.³⁰⁰

The countless formulations of the rule have caused uncertainty about the rule's contents. The Delaware Supreme Court recently held that the Delaware cases describing the rule have been imprecise and as a result, it contributed to confusion and misuse of the rule.³⁰¹ The confusion pertaining to the scope and application of the rule began early as it is present in the case of *Percy v Millaudon*.³⁰² On the one hand the rule is described as insulating corporate directors and officers from personal liability or as validating corporate dealings. The interpretation of the rule can largely influence the judicial findings regarding the liability of directors.³⁰³ In some instances the Delaware courts refer to the rule as a presumption but they seem unaware of what the law of evidence teaches the legal community about presumptions.³⁰⁴ The presumption in this context assumes that a director's decision was taken in accordance with the required standard of care.³⁰⁵ However, if the plaintiff, who is the shareholder, can prove that the duty of care was breached, the presumption will fall away.³⁰⁶ The problem with viewing the rule as a presumption is illustrated in the case of *In re Walt Disney Company*

²⁹⁵ Johnson L 'Rethinking Judicial Review of Director Care' (1999) 24 *Del. J. Corp. L.* 787 (Hereafter referred to as Johnson L (1999)).

²⁹⁶ Johnson L (1999) 787, 805.

²⁹⁷ *Cede & Co.*, 634 A.2d at 360-61.

²⁹⁸ Johnson L (1999) 429 (With reference to Seidler C, Assessing the Wisdom of the Business Judgment Rule in Corporate Control Contests: Is It Time to Make Shareholders' Interests Paramount, 23 *LOY.L.A.L.REV.* 919, 923 (1990) argues that the rule as a presumption is not a useful tool).

²⁹⁹ *Francis v. United Jersey Bank* 432 A.2d 814, 823 (N.J. 1981)

³⁰⁰ *Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1246 (Del. 1999).

³⁰¹ Peebles R 'Use and Misuse of the Business Judgment Rule in Close Corporation' (1985) 60 *Notre Dame Law Review* 458.

³⁰² Arshat S 'The Business Judgment Rule Revisited' 8 (1979) *Hofstra Law Review* 101.

³⁰³ Ponta A & Catana R (2015) 125.

³⁰⁴ Branson D 'The Rule That Isn't a Rule – The Business Judgment Rule' (2002) 36 *Valparaiso University Law Review* 645 (Hereafter referred to as Branson D (2002)).

³⁰⁵ Dahlberg V (2008).

³⁰⁶ Holland R 'Delaware's Business Judgment Rule: International Variations' available at <http://global.blogs.delaware.gov/2015/04/09/delawares-business-judgment-rule-international-variations/> (accessed on 07 March 2016).

Derivative Litigation. The plaintiff proved the director's lack of independence and in doing so the presumption should have been rebutted.³⁰⁷ The court however refused to review the merits of the decision and the BJR was applied.³⁰⁸

Delaware's lack of deliberation on the use and misuse of the presumption may not be problematic in Delaware but it could affect outcomes elsewhere.³⁰⁹ It will not be problematic in the State of Delaware because the Delaware courts have an understanding as to how the presumption of the BJR is to be applied.³¹⁰ They require a lot more proof before a presumption can be rebutted by the plaintiff stockholder whereas courts in other countries might merely require a 'pin prick' to rebut the presumption.³¹¹ This pin prick refers to a mere establishment of conflict of interest which would lead to the presumption being rebutted.³¹² For example, Indiana incorporated the Delaware BJR into its corporate law and this rule was blended with Indiana's understanding of a presumption.³¹³ The problem is that the courts in Indiana will come to a completely different result in comparison to the Delaware courts with the risk of holding directors liable.³¹⁴ Based on the aforementioned, the problem is that Delaware courts are familiar with their way of having a presumption rebutted whereas in other countries this might differ significantly.³¹⁵

Courts in Delaware have stated that the BJR applies to officers but they have not analytically linked the rule to the fiduciary duties of corporate officers.³¹⁶ Therefore, in cases concerning officers, it remains unclear whether judges will deploy the BJR in the same manner that it has been used for corporate directors.³¹⁷ The Delaware courts have not had the opportunity to fully consider the policy case for and against the application of the rule to officers and as a result, the applicability of the rule to corporate officers remains a topic of concern.³¹⁸ The

³⁰⁷ *In re Walt Disney Company Derivative Litigation* (1998).

³⁰⁸ *In re Walt Disney Company Derivative Litigation* (1998).

³⁰⁹ Branson D (2002) 645.

³¹⁰ Branson D (2002) 646.

³¹¹ Branson D (2002) 646 (with reference to *In Re Walt Disney Company Derivative Litigation* in which the court refused to acknowledge that the plaintiffs rebutted the presumption by proving that the directors acted with a lack of independence and instead the court applied the BJR. This illustrated that the Delaware courts expect much more from the plaintiff stockholders prior to deciding whether the presumption was successfully rebutted or not.).

³¹² Branson D (2002) 646.

³¹³ Branson D (2002) 646.

³¹⁴ Branson D (2002) 646.

³¹⁵ Branson D (2002) 646.

³¹⁶ Johnson L 'Corporate Officers and the Business Judgment Rule' (2005) 60 *Business Law Review* 443.

³¹⁷ Lawrence A 'Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson' (2005) 60 *Business Law Review* 865.

³¹⁸ Johnson L 'Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose' available http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2359187 (accessed on 04 March 2016).

case of *Gantler v Stephens* is a perfect illustration of the court's failure to deal with the applicability of the rule to corporate officers.³¹⁹ The court merely dealt with the fiduciary duties of the officers and the analysis of the applicability of the rule in the case was conspicuously absent.³²⁰ This is evident because the court found the officers liable for the breach of their fiduciary duties and there was clearly no application of the rule.³²¹ Therefore, as far as officers in Delaware are concerned, there is currently no pre-existing historical policy or doctrinal connection between fiduciary duties and the BJR, as the case is with directors.³²² It is thus uncertain as to whether Delaware courts will apply the approach adopted for directors to officers.

2.12 CONCLUSION

Although in certain parts of this chapter the BJR rule in America was analysed, the focus was particularly placed on the Delaware BJR. Having discussed different formulations of the rule, it is evident that the Delaware case law formulation plays a more prominent role as it has been largely adopted across America. Delaware courts may have started off applying the straightforward BJR but a change came about. Initially, Delaware courts refrained from interfering with the business decisions of directors but eventually the courts deviated from the abstention doctrine approach and began adopting a standard of review approach. However, it should be borne in mind that the standard of review approach is only adopted in certain transactions which warrant the interference of the court. In adopting a standard of review approach, Delaware courts began expanding the BJR and gave it fresh meanings in different situations. These situations include mergers and acquisitions as well as insolvent transactions. In these transactions, Delaware courts have adopted a heightened standard of judicial review by creating the Entire Fairness Doctrine, Unocal Standard and the Revlon Standard. In doing so, a straightforward rule has now become a complex rule.

The question which thus arises pertains to the certain transactions to which the rule will be applied by Delaware courts. As previously mentioned, these transactions consist of mergers and acquisitions as well as insolvent transactions but the subsequent chapter will focus the lens on particular detail pertaining to these transactions as well as the aforementioned heightened standards of judicial review. It was thus necessary to first understand the

³¹⁹ *Gantler v Stephens* 965 A.2d 695 (Del. 2009).

³²⁰ *Gantler v Stephens* 965 A.2d 695 (Del. 2009).

³²¹ Johnson L (accessed on 04 March 2016) 414.

³²² Johnson L (accessed on 04 March 2016) 415.

straightforward version of the BJR in order to become familiar with the background, purpose and formulation of the rule. With having this understanding, it will become easier to understand why and how Delaware courts have stepped away from the straightforward version of the rule, which is the ultimate purpose of chapter 3.



CHAPTER 3

THE APPLICATION OF THE DELAWARE BUSINESS JUDGMENT RULE IN FUNDAMENTAL TRANSACTIONS

3.1 INTRODUCTION

As noted in chapter two, the origin of the BJR lies in America and for over 150 years the rule performed a relatively straightforward task.³²³ Prior to the 1980s, the Delaware BJR provided directors with protection against liability for honest mistakes provided that they acted carefully, with loyalty and in good faith.³²⁴ This version of the rule is referred to as the ‘traditional business judgment rule’.³²⁵ However, in the 1980s Delaware courts began developing and expanding the application of the rule.³²⁶ The courts realised that certain situations require the shareholders to be granted more protection against the business decisions of directors.³²⁷ As a result, in certain transactions courts might deviate from the BJR and instead, the courts will apply an enhanced standard of judicial review. According to Chief Justice Strine, ‘the heightened scrutiny applies because of a concern that the board might harbour personal motivations in the sale context that differ from what is best for the corporation and its stockholders’.³²⁸

This expanded BJR is what commentators view as the ‘modern business judgment rule’, as courts will determine whether the boards’ decision is worthy of respect and this occurs prior to determining whether the BJR is applicable or not.³²⁹ In doing so the courts have illustrated that the modern BJR is not a one-size-fits-all doctrine but rather a movable boundary, marking the shifting line between judicial scrutiny and judicial deference’.³³⁰ Delaware courts

³²³ Smith D ‘The Modern Business Judgment Rule’ available at http://digitalcommons.law.byu.edu/faculty_scholarship/51/ (accessed on 04 August 2016).

³²⁴ Smith D ‘The Modern Business Judgment Rule’ available at http://digitalcommons.law.byu.edu/faculty_scholarship/51/ (accessed on 04 August 2016).

³²⁵ Ferrara R, Abikoff K & Gansler L *Shareholder Derivative Litigation: Besieging the Board* (2005)5-4.

³²⁶ Smith D ‘The Modern Business Judgment Rule’ available at http://digitalcommons.law.byu.edu/faculty_scholarship/51/ (accessed on 04 August 2016).

³²⁷ Jarrett T ‘Surviving Enhanced Judicial Scrutiny of Directors’ Decisions—Reaching the Protection of the Business Judgment Rule (1995) 60 *Missouri Law Review* 677.

³²⁸ *In re Dollar Thrifty S’holder Litig.*, 14 A.3d 573, 597 (Del. Ch. 2010).

³²⁹ La Croix K ‘A Look at the Modern Business Judgment Rule’ available at <http://www.dandodiary.com/2015/08/articles/director-and-officer-liability/a-look-at-the-modern-business-judgement-rule/> (accessed on 04 August 2016).

³³⁰ La Croix K ‘A Look at the Modern Business Judgment Rule’ available at <http://www.dandodiary.com/2015/08/articles/director-and-officer-liability/a-look-at-the-modern-business-judgement-rule/> (accessed on 04 August 2016).

have thus been applying the rule in various types of mergers and acquisitions transactions (hereafter referred to as M&A) as well as in insolvent trading transactions.

The purpose of this chapter is thus to dissect M&A and insolvent trading, in order to critically analyse how courts have dealt with actions brought against the directors' for their business decisions in the aforementioned transactions. Initially the focus will be placed on M&A transactions and an explanation of mergers and acquisitions will be provided for purposes of a holistic approach and better understanding. Thereafter the directors' duties in M&A transactions will be explained as it will provide an understanding as to why the courts have been applying the traditional BJR to the transactions. This section will furthermore illustrate why and how Delaware courts have deviated from the application of the traditional rule in order to apply an enhanced standard of review instead. These enhanced standards consist of the EFD, the Unocal Standard and the Revlon Standard. The focus will then shift to insolvent trading and the duties imposed on directors in these circumstances will be analysed. Thereafter the application of the BJR to directors' decisions' taken while a company is insolvent and near insolvency will be dealt with.

3.2 MERGERS AND ACQUISITIONS

In order to grasp a complete understanding as to why Delaware courts have been applying the BJR and in some instances a heightened standard of judicial review, to the decision of directors taken in M&A transactions, it is necessary to define and discuss the terms. An understanding of M&A has become increasingly important in modern businesses as it is always taking place in the corporate world.³³¹

3.2.1 Defining Merger and Acquisition

The subsequent definitions of merger and acquisition will illustrate that the meanings of the terms differ but because they ultimately lead to two companies becoming one, the terms are used interchangeably.³³² Merger refers to the process of the joining together of two companies.³³³ When companies merge they combine their resources into a single business and it results in the owners of the pre-merger companies having to share in the ownership of

³³¹ Wallace W & Moles P 'Mergers and Acquisitions' available at <https://www.ebsglobal.net/EBS/media/EBS/PDFs/Mergers-Acquisitions-Course-Taster.pdf> (accessed on 02 August 2016).

³³² Tong W 'Literature Review': Definition of Mergers and Acquisitions' available at http://studentsrepo.um.edu.my/3938/3/2_LITERATURE_REVIEW.pdf (accessed on 03 August 2016).

³³³ Coyle B *Mergers and Acquisitions* (2000) 2 (hereafter referred to as Coyle B (2000)).

the merged business.³³⁴ Acquisitions, also referred to as takeovers, involve a process whereby the acquirer, usually a bigger financially sound firm, purchases the target company which is considerably smaller.³³⁵ As far as acquisition is concerned, the acquirer (the purchaser) can purchase a part of or the entire target company (the company being purchased).³³⁶ Acquisitions consist of friendly and hostile acquisitions which largely depend on how the target company perceives the acquirer.³³⁷ In friendly takeovers, the board of directors of the target firm is willing to agree to the acquisitions whereas with a hostile takeover, the board opposes the acquisition.³³⁸

Directors play very important roles in M&A transactions and their decisions can largely impact the company which in essence impacts the shareholders. There are various negative consequences of M&A's which can affect the shareholders. Among these consequences are the possibilities of a temporary drop in share value as well as volatile stock prices.³³⁹ Shareholders can furthermore experience a dilution of voting power caused by an increased number of shares released during the merger process.³⁴⁰ It could be argued that the negative consequences faced by shareholders coupled with the inherent conflicts directors might have in M&A transactions, have convinced Delaware courts that shareholders are in need of more protection.³⁴¹ The next section will thus consider the duties directors are required to perform when making vital decisions in M&As.

³³⁴ Coyle B (2000) 2.

³³⁵ Malik M, Anuar M & Khan S et al 'Mergers and Acquisitions: A Conceptual Review' (2014) 4 *International Journal of Accounting and Financial Reporting* 521 (hereafter referred to as Malik M, Anuar M & Khan S et al (2014)) .

³³⁶ Malik M, Anuar M & Khan S et al (2014) 521.

³³⁷ Wilkinson J 'Mergers and Acquisitions' available at <http://strategiccco.com/mergers-and-acquisitions-ma/>(accessed on 04 August 2016).

³³⁸ Kleiman R 'Takeovers' available at <http://www.referenceforbusiness.com/encyclopedia/Str-The/Takeovers.html>(accessed on 04 August 2016).

³³⁹ Investopedia 'How does a merger affect the shareholders?' available at <http://www.investopedia.com/ask/answers/040815/how-does-merger-affect-shareholders.asp> (accessed on 07 September 2016).

³⁴⁰ Investopedia 'How does a merger affect the shareholders?' available at <http://www.investopedia.com/ask/answers/040815/how-does-merger-affect-shareholders.asp> (accessed on 07 September 2016).

³⁴¹ Warren I & Aronstam B 'Delaware's Business Judgment Rule and Varying Standards of Judicial Review for Assessing Director Conduct in M&A Transactions' available at http://www.ramllp.com/media/article/12_Canadian%20Institute%20Article.pdf(accessed on 07 September 2016).

3.2.2 Director's Duties in M&A Transactions

As previously discussed in chapter 2, the board of directors of a corporation owe fiduciary duties to the corporation. These duties consist of the duty of care, duty of loyalty and the duty to act in good faith. Although these duties were discussed in chapter 2, it is necessary to highlight important aspects of these duties as far as it relates to M&A transactions.

The first duty being considered is the duty of care, which in M&A transactions requires the directors to take sufficient time when making decisions regarding the sale or purchase of a company.³⁴² Directors should furthermore ensure that expert opinion, such as that of a financial advisor, is obtained in certain instances when deemed necessary.³⁴³ Prior to making final decisions, directors should inform themselves of alternatives to selling or purchasing a company.³⁴⁴ If the director acted in a manner which is consistent with the aforementioned, he will be protected by the rule.³⁴⁵ However, if the director was grossly negligent he will lose the protection of the rule.³⁴⁶ 'Gross negligence' is the standard applied by Delaware courts in order to determine whether the directors have failed to fulfil their duty of care.³⁴⁷ If a director has engaged in misconduct which is more culpable than simple inattention or failure to be informed of all facts, the court will view the directors' actions as grossly negligent.³⁴⁸

The second duty is the duty of loyalty which requires the directors to avoid acting for a personal or non-corporate purpose.³⁴⁹ Directors should thus not profit from the sale of the company in a manner which will not benefit the shareholders.³⁵⁰ In other words, a director

³⁴² Bruner R *Applied Mergers and Acquisitions* (2004) 715 (hereafter referred to as Bruner (2004)).

³⁴³ Bruner 2004 715.

³⁴⁴ Lajoux A 'Role of the Board in M&A' available at <https://corpgov.law.harvard.edu/2015/09/07/role-of-the-board-in-ma/> (accessed on 05 August 2016).

³⁴⁵ Lajoux A 'Role of the Board in M&A' available at <https://corpgov.law.harvard.edu/2015/09/07/role-of-the-board-in-ma/> (accessed on 05 August 2016).

³⁴⁶ Emanuel S *emanuelCrunchTime: Your Exam Study Partner* (2009) 65.

³⁴⁷ Potter, Anderson and Carroon LLP 'Disney Affirmed: The Delaware Supreme Court Clarifies The Duty of Directors To Act In Good Faith' available at <http://www.potteranderson.com/newsroom-news-90.html> (accessed on 1 August 2016).

³⁴⁸ Potter, Anderson and Carroon LLP 'Disney Affirmed: The Delaware Supreme Court Clarifies The Duty of Directors To Act In Good Faith' available at <http://www.potteranderson.com/newsroom-news-90.html> (accessed on 1 August 2016).

³⁴⁹ Brown R *The Concise Guide to Mergers, Acquisitions and Divestitures: Business, Legal Finance, Accounting, Tax and Process Aspects* 1ed (2007) 48.

³⁵⁰ Morgan G 'Fiduciary Duties of Directors – Generally and in the Context of Mergers and Acquisitions' available at <http://www.michaelbest.com/files/upload/Fiduciary%20Duties%20of%20Directors%20-%20Compliance%20Workshop%20for%20Community%20Bank%20Directors%20CBW%20Presentation%20Pack%20et.pdf> (accessed on 05 August 2016).

should recuse himself from the board if he is aware that a conflict of interest is present.³⁵¹ However, in instances where a director is interested in the transaction, directors and shareholders who are disinterested and fully informed may permit interested director transactions.³⁵² In the case of *Parnes v Bally Entertainment Corp*, the plaintiff challenged the merger of Bally with Hilton Hotels.³⁵³ The court was of the opinion that the plaintiff needed to prove that,

‘a majority of directors will receive a personal benefit from the transaction that is not equally shared by the shareholders....or where a corporate decision will have a materially detrimental impact on a director but not on the corporation and shareholders or that a majority of the directors were ‘beholden’ to an interested party or so under the influence of an interested party that the directors discretion would be sterilised’.³⁵⁴

As far as the duty of good faith is concerned, challenges to a director’s duty of good faith were initially included in the courts inquiry into the director’s satisfaction of his duties of care and loyalty.³⁵⁵ Delaware courts began separating the duty of good faith and it began existing independently of the duties of care and loyalty.³⁵⁶ Thus in instances where the directors ‘consciously and intentionally disregarded their responsibilities’ they will be considered to have breached their duty of good faith.³⁵⁷

The duties discussed above illustrates that even in M&A transactions, directors are expected to perform their fiduciary duties and as a result, they should be entitled to the protection of the BJR. Below is a discussion on the application of the traditional BJR in M&A transactions. It should be borne in mind that, as mentioned in chapter 2, the BJR prevents directors from

³⁵¹ Frankle D ‘Fiduciary Duties of Directors Considering a Proposal for an Acquisition of a Privately Held Company’ available at http://files.dlapiper.com/files/upload/Fiduciary_Duties_of_Directors.pdf (accessed on 05 August 2016).

³⁵² Hearn C & Friend A ‘Feeling Conflicted? Identifying and Resolving Conflicts of Interests’ available at <https://www.acc.com/chapters/houst/upload/N2658084.pdf> (accessed on 05 August 2016).

³⁵³ *Parnes v Bally Entertainment Corp*, No 15192, 2001 Del. Ch. LEXIS 34 (Del. Ch. Feb. 20, 2001) at 30 (quoting *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993)).

³⁵⁴ *Parnes v Bally Entertainment Corp*, No 15192, 2001 Del. Ch. LEXIS 34 (Del. Ch. Feb. 20, 2001) at 30 (quoting *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993)).

³⁵⁵ Fleischer A & Sussman A ‘Directors’ Fiduciary Duties in Takeovers and Mergers’ available at http://www.friedfrank.com/siteFiles/ffFiles/sri_directors_duties.pdf (accessed on 05 August 2016).

³⁵⁶ Fleischer A & Sussman A ‘Directors’ Fiduciary Duties in Takeovers and Mergers’ available at http://www.friedfrank.com/siteFiles/ffFiles/sri_directors_duties.pdf (accessed on 05 August 2016).

³⁵⁷ *In re the Walt Disney Company Derivative Litigation* 825 A.2d 275 (Del. Ch. 2003) 37-38.

incurring personal liability for the harm suffered by a company as a result of the directors' decision.³⁵⁸

3.3 APPLICATION OF THE TRADITIONAL BUSINESS JUDGMENT RULE

In instances where directors fulfil the above mentioned fiduciary duties in M&A transactions, Delaware courts will apply the traditional BJR. As discussed at the beginning of this chapter, the traditional BJR is a straightforward rule. In Delaware, the courts will presume that the directors have acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company.³⁵⁹

Although courts apply the traditional rule in the aforementioned instances, there have been cases in which Delaware courts have deviated from the application of the rule by applying an enhanced standard of judicial scrutiny.³⁶⁰ These standards were created after Delaware courts realised that plaintiff shareholders needed protection from directors who were not acting in the company's best interests during M&A transactions.³⁶¹ Delaware courts began realising that plaintiff shareholders experience an uphill battle when having to rebut the presumption of the traditional rule.³⁶² Furthermore, only in instances where a plaintiff can *prima facie* prove that the directors violated a fiduciary duty will the presumption be rebutted.³⁶³ This has proven to be difficult and as a result thereof, Delaware courts found it necessary to provide shareholders with more protection and this protection was provided by way of deviating from the traditional rule.³⁶⁴ It should however be borne in mind that the concern to protect shareholders is coupled with the fact that certain transactions, specifically M&A transactions, usually contain conflicts of interest on behalf of the directors.³⁶⁵ The standards consist of the Entire Fairness Doctrine (EFD), the Unocal Standard and the Revlon Standard.³⁶⁶ The next step of this chapter is to critically discuss each of the enhanced standards applied by Delaware courts to certain M&A transactions. The discussion will illustrate that in certain

³⁵⁸ Black J 'Tightening the Reigns of Corporate Governance' available at <https://www.irmi.com/articles/expert-commentary/the-increasing-judicial-scrutiny-of-director-care-and-independence> (accessed on 19 August 2016).

³⁵⁹ Shultz S *The Board Book: Making Your Corporate Board a Strategic Force in Your Company's Success* (2001) 226.

³⁶⁰ Jarrett T (1995) 677.

³⁶¹ Jarrett T (1995) 677.

³⁶² Siegel M 'The Problems and Promise of "Enhanced Business Judgment"' (2015) 17 *University of Pennsylvania Journal of Business Law* 50 (hereafter referred to as Siegel M (2015)).

³⁶³ Siegel M (2015) 50.

³⁶⁴ Siegel M (2015) 50.

³⁶⁵ Siegel M (2015) 50.

³⁶⁶ Siegel M 'The Illusion of Enhanced Review of Board Actions' (2013) 15 *University of Pennsylvania Journal of Business Law* 600.

cases the courts will first apply an enhanced standard of review prior to deciding whether the BJR should be invoked in order to protect the director.

3.4 ENHANCED STANDARDS OF JUDICIAL SCRUTINY

3.4.1 The Entire Fairness Doctrine

The EFD is applied by Delaware courts in instances where the BJR is relied upon by directors but the presumption of the rule has been rebutted by the plaintiff shareholders.³⁶⁷ This means that the shareholders have managed to prove that the directors have failed to act in a manner which is fair to the company and its stockholders.³⁶⁸ This doctrine is the most onerous standard which is applied in instances 'where a majority of directors approving the transaction were interested or where a majority stockholder stands on both sides of the transaction'.³⁶⁹ If the directors appear on both sides of the transaction or they expect to obtain a personal financial benefit, the directors can be referred to as interested directors for the purpose of the application of the EFD.³⁷⁰

The effect of the EFD is that the burden of proof is shifted from the plaintiff shareholders to the directors, provided that the shareholders have rebutted the presumption created by the BJR.³⁷¹ The directors are thus required to prove that both the process that was followed in reaching a decision as well as the costs involved in the business transaction was fair to the stockholders of a corporation.³⁷² In order to determine whether fair dealing took place the court will question the process followed in reaching a decision.³⁷³ The courts will question how the transaction was timed, initiated, structured, negotiated and disclosed and it will furthermore consider how the approvals of directors and the stockholders are obtained.³⁷⁴ Fair

³⁶⁷ Haims J & Beha J 'n re MFW Shareholders Litigation: Controlling Shareholder in Going-Private Transaction May Gain the Benefit of the Business Judgment Rule' available at <https://media2.mofo.com/documents/130816-in-the-courts.pdf> (accessed 19 August 2016).

³⁶⁸ Haims J & Beha J 'n re MFW Shareholders Litigation: Controlling Shareholder in Going-Private Transaction May Gain the Benefit of the Business Judgment Rule' available at <https://media2.mofo.com/documents/130816-in-the-courts.pdf> (accessed 19 August 2016).

³⁶⁹ *Golden Cycle, LLC v. Allan*, No. CIV.A. 16301, 1998 WL 892631 (Del. Ch. Dec. 10, 1998) 11.

³⁷⁰ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

³⁷¹ Pileggi F 'Chancery Applies Entire Fairness to Sale of Assets Just Before Bankruptcy Filing' available at <http://www.delawarelitigation.com/2011/12/articles/chancery-court-updates/chancery-applies-entire-fairness-standard-to-sale-of-assets-just-before-company-bankruptcy/> (accessed on 25 July 2016).

³⁷² Tuch A 'Delaware Supreme Court Orders Entire Fairness Review' available at <https://corp.gov.law.harvard.edu/2009/02/28/delaware-supreme-court-orders-entire-fairness-review-in-gantler-v-stephens/> (accessed 27 July 2016).

³⁷³ Chalian S & Bandura K 'The Business Judgment Rule and the Entire Fairness Doctrine' available at <http://www.rc.com/documents/Primer%20on%20Business%20Judgment%20Rule.pdf> (accessed on 29 June 2016).

³⁷⁴ *Weinberger v UOP, Inc.*, 457 A.2d 710-711 (Del. 1983).

price on the other hand relates to the economic and financial aspects of the transaction and in determining whether the price was fair, courts will consider the market value and assets of the company as well as other valuation metrics and a fairness opinion.³⁷⁵ Courts will thus always analyse fair price and fair dealing in conjunction as the EFD requires courts to scrutinise all aspects of the business transaction to ensure fairness.³⁷⁶ In essence, unlike the BJR, the EFD enables the full judicial review of whether directors have satisfied their fiduciary duties, specifically the duty of loyalty.³⁷⁷

The case of *Gantler v Stephens*, which concerns the takeover of First Niles Company, perfectly illustrates the application of the EFD by the Delaware Supreme Court.³⁷⁸ The court was of the opinion that the plaintiff shareholders met their burden of proof by pleading facts ‘sufficient to establish that three directors were disloyal and this was sufficient to rebut the business judgment presumption’.³⁷⁹ In conducting a director-specific analysis the court found that the majority members of the board were conflicted.³⁸⁰ One of the instances in which the court found conflict was the failure of the Chairman and CEO to respond to a due diligence as requested by a bidder and the court was thus of the view that in failing to respond, the Chairman acted in his own personal financial interest, as opposed to the interests of the shareholders.³⁸¹ The fact that two of the directors owned businesses which provided services to First Niles is another instance in which the court found conflict.³⁸² The occurrence of the takeover would cause the business owned by the directors to suffer and the services they provide to First Niles would be in jeopardy thereby causing the directors to be interested in the matter.³⁸³ The court thus held that the Chancery court should have applied the EFD as it was satisfied that the plaintiff shareholders proved the disloyalty of directors.³⁸⁴ The court

³⁷⁵ Borden M & Yunis J *Going Private* (2006) 4-14 (hereafter referred to as Borden M & Yunis J).

³⁷⁶ *Cinerama Inc. v Technicolor Inc.* 663 A.2d 1156, 1163 (Del. 1995).

³⁷⁷ Tuch A ‘Delaware Supreme Court Orders Entire Fairness Review’ available at <https://corpgov.law.harvard.edu/2009/02/28/delaware-supreme-court-orders-entire-fairness-review-in-gantler-v-stephens/> (accessed 27 July 2016).

³⁷⁸ *Gantler v Stephens* 965 A.2d 695, *707 (Del. 2009) 24.

³⁷⁹ *Gantler v Stephens* 965 A.2d 695, *707 (Del. 2009) 24.

³⁸⁰ Tuch A ‘Delaware Supreme Court Orders Entire Fairness Review’ available at <https://corpgov.law.harvard.edu/2009/02/28/delaware-supreme-court-orders-entire-fairness-review-in-gantler-v-stephens/> (accessed 27 July 2016).

³⁸¹ Tuch A ‘Delaware Supreme Court Orders Entire Fairness Review’ available at <https://corpgov.law.harvard.edu/2009/02/28/delaware-supreme-court-orders-entire-fairness-review-in-gantler-v-stephens/> (accessed 27 July 2016).

³⁸² Tuch A ‘Delaware Supreme Court Orders Entire Fairness Review’ available at <https://corpgov.law.harvard.edu/2009/02/28/delaware-supreme-court-orders-entire-fairness-review-in-gantler-v-stephens/> (accessed 27 July 2016).

³⁸³ *Gantler v Stephens* 965 A.2d 695, *707 (Del. 2009) 24.

³⁸⁴ *Gantler v Stephens* 965 A.2d 695, *707 (Del. 2009) 24.

further noted that although the transaction was not complete and it would be difficult to determine the fair price of the transaction, the EFD can be applied in a non-transaction context.³⁸⁵ In instances where the EFD is applied and directors fail to prove fair price and fair dealing, they will be held personally liable for the harm suffered by the company.³⁸⁶

It should however be borne in mind that if directors succeed in proving that the transaction was fair to the entire corporation, the court will apply the BJR and the directors will be exculpated from liability.³⁸⁷ Having discussed the EFD, which is the most onerous standard of them all it is necessary to consider the Unocal standard. As will be illustrated below, this standard bridges the gap between the BJR and the EFD.

3.4.2 The Unocal Standard

In 1985, Delaware courts were faced with numerous cases pertaining to corporate takeover activity in America, many of which were hostile.³⁸⁸ As touched on earlier in the chapter, a hostile takeover is an acquisition in which the target company does not want to be purchased or does not want to be purchased by a particular buyer making an offer.³⁸⁹ The *Unocal Corp. v. Mesa Petroleum Co* case introduced what is now referred to as the Unocal standard and often best described as ‘the conditional business judgment rule’.³⁹⁰ The rule introduced an intermediate form of judicial review as it bridges the gap between the BJR and the EFD.³⁹¹ The BJR was not stringent enough to apply to hostile takeover cases as conflict of interest is inherent in these types of transactions.³⁹² Plaintiff shareholders would have to rebut the rule by proving that the directors’ decision involved fraud, illegality or self-dealing and doing so has proven to be difficult.³⁹³ On the other hand, the application of the EFD is too stringent in hostile takeover cases as directors are required to show that the defensive measure taken was

³⁸⁵ *Gantler v Stephens* 965 A.2d 695, *707 (Del. 2009) 24.

³⁸⁶ Blomberg J ‘The lurking danger in insider-led financings’ available at <https://apps.americanbar.org/buslaw/blt/2003-05-06/blomberg.html> (accessed on 08 September 2016).

³⁸⁷ Hecker W ‘Controlling Shareholder Duty of Loyalty: Entire Fairness or Business Judgment’ available at [https://law.ku.edu/sites/law.ku.edu/files/docs/recent-developments/\(2\)HeckerControllingShareholderDutyofLoyalty.pdf](https://law.ku.edu/sites/law.ku.edu/files/docs/recent-developments/(2)HeckerControllingShareholderDutyofLoyalty.pdf) (accessed on 19 August 2016).

³⁸⁸ Phillips C & Krishnamurthy P ‘The Landscape of U.S Hostile Takeover Litigation’ available at <https://www.cov.com/~media/files/corporate/publications/2001/12/oid6533.pdf> (accessed on 21 November 2016).

³⁸⁹ Grabianowski E ‘How Hostile Takeovers Work’ available at <http://money.howstuffworks.com/hostile-takeover1.htm> (accessed on 11 August 2016).

³⁹⁰ *Unocal Corp. v. Mesa Petroleum Co* 493 A.2d 946 (Del. 1985).

³⁹¹ Cahill D & Wink S (1990) 169.

³⁹² Bainbridge S ‘The Geography of *Revlon-Land*’ (2013) 81 *Fordham Law Review* 3294 (hereafter referred to as Bainbridge S (2013)).

³⁹³ Bainbridge S (2013) 3294.

objectively fair to the corporation.³⁹⁴ This is an exceedingly difficult burden to bear and it was extremely difficult for directors to satisfy the burden thus resulting in increased director liability.³⁹⁵ As a result of the above mentioned concerns, the Delaware Supreme Court developed the Unocal standard.

This standard allows for enhanced judicial scrutiny to take place in that it requires the court to assess, among other things, the substantive reasonableness of the boards' decisions.³⁹⁶ This takes place without the plaintiff shareholder proving that the board breached its duty of loyalty or was grossly negligent in making the business decision.³⁹⁷ The Delaware Supreme Court in the *Unocal* case has observed that conflict of interest is inherent in takeover bids.

‘Because of the omnipresent spectre that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protection of the business judgment rule may be conferred.’³⁹⁸

Therefore, when courts apply the Unocal test, there are two aspects of the test which directors need to satisfy in order to be protected by the BJR.³⁹⁹ The first aspect of the test requires the board to prove that the defensive measures taken in response to the hostile takeover were taken in good faith.⁴⁰⁰ The board furthermore needs to prove that a reasonable investigation was conducted which established that the corporate policy and effectiveness of the corporation was in danger.⁴⁰¹ The second aspect of the test will be satisfied if the board can prove that the action taken was reasonable in relation to the threat posed by the unwanted bidder.⁴⁰² Should directors satisfy the Unocal test, they will be protected by the BJR.⁴⁰³ However, in cases where they fail to meet the Unocal test, the directors' defensive measures

³⁹⁴ Bainbridge S (2013) 3293.

³⁹⁵ Bainbridge S (2013) 3293.

³⁹⁶ Regan P (2001) 948.

³⁹⁷ Regan P (2001) 948.

³⁹⁸ *Unocal Corp. v. Mesa Petroleum Co* 493 A.2d 946 (Del. 1985) at 942.

³⁹⁹ Cahill D & Wink S ‘Time and Time Again the Board is Paramount: The Evolution of the Unocal Standard and the Revlon Trigger through *Paramount v. Time*’ (1990) 66 *Notra Dame Law Review* 166 (hereafter referred to as Cahill D & Wink S (1990)).

⁴⁰⁰ Cahill D & Wink S (1990) 166.

⁴⁰¹ Cahill D & Wink S (1990) 166.

⁴⁰² Cahill D & Wink S (1990) 166.

⁴⁰³ Warren I & Aronstam B ‘Delaware’s Business Judgment Rule and Varying Standards of Judicial Review for Assessing Director Conduct in M&A Transactions’ available at http://www.ramllp.com/media/article/12_Canadian%20Institute%20Article.pdf (accessed on 13 August 2016).

will be invalidated and the courts will require the directors to show that their actions were entirely fair.⁴⁰⁴

Having considered what the Unocal standard is and why courts created it, it is necessary to look at when and how Delaware courts apply Unocal. Although the manner in which courts apply the standard was briefly mentioned above, this section will look at it in detail.

3.4.2.1 The application of the Unocal standard

The Delaware courts have applied Unocal to hostile takeovers which consist of directors having taken defensive measures.⁴⁰⁵ In essence, defensive measures are taken by directors when trying to prevent a hostile bidder from succeeding in his or her bid for the company.⁴⁰⁶ There is an array of defensive measures which the board of directors can take and an example of these defensive measures is referred to as the 'poison pill'.⁴⁰⁷ The term poison pill is almost always subject to takeover litigation and the term refers to a group of shareholder rights which are triggered by an event such as a hostile takeover.⁴⁰⁸ Poison pill thus provides certain shareholders, except the hostile bidder, with rights to purchase additional shares or to sell shares on very attractive terms.⁴⁰⁹ This places the hostile bidder at a disadvantage as he or she faces severe economic penalties.⁴¹⁰

As previously mentioned, when courts apply Unocal, a burden is placed on directors to satisfy two aspects to the Unocal test.⁴¹¹ The first aspect requires directors to prove that a good faith and reasonable investigation was conducted of the perceived threat and the defences available to the corporation.⁴¹² Directors will satisfy this burden if they can prove that no misconduct

⁴⁰⁴ Warren I & Aronstam B 'Delaware's Business Judgment Rule and Varying Standards of Judicial Review for Assessing Director Conduct in M&A Transactions' available at http://www.ramllp.com/media/article/12_Canadian%20Institute%20Article.pdf (accessed on 13 August 2016).

⁴⁰⁵ Smadja C *Hostile Takeovers and Directors Duties: From Delaware to Brussels, What's Best for Shareholders?* (published LLM thesis, McGill University, 2008) 12 (hereafter referred to as Smadja C (2008)).

⁴⁰⁶ Smadja C (2008) 12.

⁴⁰⁷ Jarrell G 'Takeovers and Leveraged Buyouts' available at <http://www.econlib.org/library/Enc1/TakeoversandLeveragedBuyouts.html> (accessed on 12 August 2016).

⁴⁰⁸ Jarrell G 'Takeovers and Leveraged Buyouts' available at <http://www.econlib.org/library/Enc1/TakeoversandLeveragedBuyouts.html> (accessed on 12 August 2016).

⁴⁰⁹ Smadja C (2008) 12.

⁴¹⁰ Jarrell G 'Takeovers and Leveraged Buyouts' available at <http://www.econlib.org/library/Enc1/TakeoversandLeveragedBuyouts.html> (accessed on 12 August 2016).

⁴¹¹ Bradford S 'Mergers and Acquisitions' available at <http://www.unl.edu/bradford/Mergers%20Exam%20Answers%202006.doc> (accessed on 12 August 2016).

⁴¹² Bradford S 'Mergers and Acquisitions' available at <http://www.unl.edu/bradford/Mergers%20Exam%20Answers%202006.doc> (accessed on 12 August 2016).

was committed in reaching an informed decision.⁴¹³ If the directors can prove that a lengthy and detailed discussion took place regarding the proposed defensive measures, the Delaware courts will be satisfied that the directors made an informed decision.⁴¹⁴ There has been an instance whereby the directors' determination of the company's value was sufficient enough to qualify as an informed decision.⁴¹⁵ As a result thereof, it has been argued that the first aspect of the Unocal test is rather easy for directors to satisfy.⁴¹⁶

The second aspect of the test requires the directors' response to have been reasonable in relation to the threat posed.⁴¹⁷ This aspect of the test is also referred to as the proportionality test.⁴¹⁸ The reasonableness of the response is evaluated by considering the nature of the takeover bid and its effect on the corporation. In instances where the board's response is coercive and not within a range of reasonable responses, the board will fail to satisfy the second aspect of the Unocal test.⁴¹⁹ The effect thereof is that the protection afforded by the BJR will be lost.⁴²⁰ Delaware courts have thus accepted a comprehensive defensive strategy used to maintain the company's independence, as a reasonable defensive measure.⁴²¹

3.4.2.2 Success of the Unocal Standard

There have been contrasting views regarding the effectiveness of the Unocal standard. Various commentators have viewed it as a failure and academics such as Johnson and Siegel have called it a 'toothless standard' and dismissed it as 'fairly inconsequential'.⁴²² According to academics, the only difference between the BJR and the Unocal test is that Unocal places the burden of proof on the directors while the BJR protects the directors instead of placing a burden on them.⁴²³ The aforementioned distinction serves little purpose because when

⁴¹³ Cara F & Lane P 'The Business Judgment Rule and Unocal: Twin Barriers to Shareholder Welfare' (1989) 5 *Journal of Civil Rights and Economic Development* 208-209 (hereafter referred to as Cara F & Lane P (1989)).

⁴¹⁴ Cara F & Lane P (1989) 208-209.

⁴¹⁵ Cara F & Lane P (1989) 208-209.

⁴¹⁶ Cara F & Lane P (1989) 208-209.

⁴¹⁷ Smith R & Atwood E 'Conflicts of interest in complex investment structures – the evolution of the business judgment rule' available at <http://www.lexology.com/library/detail.aspx?g=afb8c0ba-52e6-48ee-a31f-53bfbcb4f7f7> (accessed on 12 August 2016).

⁴¹⁸ *Unitrin, Inc. v. American General Corporation* 651 A.2d 1361 (1995).

⁴¹⁹ Smith A 'Fairness Compendium' available at https://books.google.co.za/books?id=r-6-BX2mVpoC&dq=second+aspect+of+the+Unocal+test+requires+the+directors%E2%80%99+response+to+h+ave+been+reasonable+in+relation+to+the+threat+posed.&source=gbs_navlinks_s (accessed on 08 September 2016).

⁴²⁰ Palm C 'A Primer on the Basics of Directors' Duties in Delaware: The Rules of the Game (Part II) (1997) 42 *Villanova Law Review* 1065.

⁴²¹ Cara F & Lane P (1989) 211.

⁴²² Bainbridge S 'Unocal at 20: Director Primacy in Corporate Takeovers' (2006) 31 *Delaware Journal of Corporation Law* 4.

⁴²³ Cara F & Lane P (1989) 211.

directors are required to satisfy the Unocal test they are basically satisfying the elements of the BJR.⁴²⁴ At the moment, by placing the initial burden on the directors under the Unocal standard, no effective and proper scrutiny of the boards' decision takes place.⁴²⁵ This has an adverse effect on the shareholders as they are not receiving sufficient protection.⁴²⁶

It has been argued by various states that Delaware courts should focus on placing the initial burden on plaintiff shareholders thereby requiring them to prove the presence of fraud, bad faith or self-dealing in the defensive measures taken by the directors.⁴²⁷ In doing so, the courts will technically be applying an aspect of the EFD. However, instead of requiring directors to satisfy the elements of the EFD, the directors will have to prove the aspects of the Unocal test in order to be protected by the BJR.⁴²⁸

The Delaware courts later created a modified version of the Unocal standard which is referred to as the Revlon Doctrine. This Doctrine will be discussed below as it is another method of enhanced scrutiny introduced by Delaware courts.

3.4.3 The Revlon Doctrine

In *Revlon Inc v MacAndrews & Forbes Holdings Inc*, the court introduced the Revlon standard which deals with a particular problem, namely, the use of takeover defences to prevent a hostile bidder from succeeding in his bid for the corporation and control thereof.⁴²⁹ Thus in certain sale or change of control transactions, the court will have to deviate from the traditional BJR and apply what has come to be known as the 'Revlon Doctrine'.⁴³⁰ It is important to note that change of control refers to the acquirer (the person or company purchasing the target company) becoming the majority or sole shareholder of the target company.⁴³¹

⁴²⁴ Cara F & Lane P (1989) 212.

⁴²⁵ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) at 68-71.

⁴²⁶ Cara F & Lane P (1989) 213.

⁴²⁷ Cara F & Lane P (1989) 213.

⁴²⁸ Cara F & Lane P (1989) 213.

⁴²⁹ Bainbridge S 'Lost in Revlon-land: An acquisition by a public corporation should not trigger Revlon' available at <http://www.professorbainbridge.com/professorbainbridge.com/2011/05/lost-in-revlon-land-an-acquisition-by-a-public-corporation-should-not-trigger-revlon.html> (accessed on 19 August 2016).

⁴³⁰ Cappucci V 'Diminishing Significance of the Revlon Doctrine' available at <http://www.law360.com/articles/769424/diminishing-significance-of-the-revlon-doctrine> (accessed on 08 August 2016).

⁴³¹ Gevurtz F 'Removing Revlon' (2013) 70 *Washington and Lee Law Review* 1014.

There are two ways in which the Revlon Doctrine changes the manner in which board decisions are made.⁴³² The first change comes about when the court requires the directors to no longer exercise their fiduciary duties for the long-term well-being of the company.⁴³³ Instead, in cases where it is apparent that the break-up of the company is inevitable, directors are expected to exercise their duties in a manner, which will maximise the value of the company at a sale, for the stockholders to benefit.⁴³⁴ This is referred to as ‘Revlon Duties’ or ‘Revlon Standard’ and in the aforementioned instances directors change from being defenders of the corporation to becoming ‘auctioneers charged with getting the best price for the stockholders at a sale of the company’.⁴³⁵

It is important to note that the Delaware Chancery Court held that ‘rather than changing the duties directors owe to stockholders, Revlon changes the level of scrutiny under which the court reviews sale or change of control transactions’.⁴³⁶ This simply means that the ‘Revlon Duties’ are not distinctive board duties but it is rather a changed standard of judicial review.⁴³⁷ This then brings about the second change caused by the Revlon Doctrine. When courts apply the Doctrine it will review the decision of directors with an enhanced level of scrutiny.⁴³⁸ This level of scrutiny requires the independent, disinterested directors to prove that their decision making process took place with adequate care and that their decision, both in substance and procedure, was reasonable under the circumstances.⁴³⁹ Emphasis should be placed on the word ‘reasonable’ as it creates a higher standard in comparison to the ‘rationality’ standard created by the BJR.⁴⁴⁰

⁴³² Famulari D ‘The Revlon Doctrine – The Fiduciary Duties of Directors when Targets of Corporate Takeovers and Mergers’ available at http://www.americanbar.org/content/dam/aba/administrative/young_lawyers/publications/101/fiduciary_duties_of_directors_coporate_takeover.authcheckdam.pdf(accessed on 08 August 2016).

⁴³³ Furlow C (2009) 524.

⁴³⁴ Furlow C (2009) 524.

⁴³⁵ *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d at 182 (stating that when the break-up of a company is inevitable, the board’s duty changes from preserving the company “to the maximization of the company’s value at a sale for the stockholders’ benefit”).

⁴³⁶ Lida H ‘The Fiduciary Duties of Directors of the Company Facing M&As in Delaware and Japan’ (2015) 11 *Public Policy Review* 487 (hereafter referred to as Lida H (2015)).

⁴³⁷ Lida H (2015) 487.

⁴³⁸ Lida H (2015) 487.

⁴³⁹ Famulari D ‘The Revlon Doctrine – The Fiduciary Duties of Directors when Targets of Corporate Takeovers and Mergers’ available at http://www.americanbar.org/content/dam/aba/administrative/young_lawyers/publications/101/fiduciary_duties_of_directors_coporate_takeover.authcheckdam.pdf(accessed on 08 August 2016).

⁴⁴⁰ Johnson L ‘The reconfiguring of Revlon’ available at <http://poseidon01.ssrn.com/delivery.php?ID=27309910410308708206409608808307402303507100902002104509600200309808211106709908007502800109712204812603706411310711901010511304604503308902906902610508811209911002905005211302403109906509207203106509401110200009910109808400210806610>

Subsequent to the *Revlon* decision, there has been much litigation and academic discussion regarding the circumstances which trigger the Revlon standard and those which do not.⁴⁴¹ It has been argued that Revlon is not as clear as it should be and Delaware courts have not been consistent in dealing with the standard.⁴⁴² The next section will delve deeper into determining the situations to which the Revlon standard is applied by Delaware courts.

3.4.3.1 The Application of the Revlon Standard

As generally accepted by Delaware courts, the Revlon standard applies to sale of a company or change of control transactions. The Delaware Supreme Court in the case of *Arnold v. Socy for Sav. Bancorp, Inc* has highlighted three situations to which the Revlon standard is applied. The court observed that:

‘The directors of a corporation have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders, in at least the following three scenarios: (1) when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganisation involving a clear break-up of the company; (2) where, in response to a bidders offer, a company abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company; or (3) when approval of a transaction results in a sale or change of control. In the latter situation, there is no sale or change in control when [c]ontrol of both [companies] remain[s] in a large, fluid, changeable and changing market’.⁴⁴³

In simple terms the Revlon standard applies to certain situations involving auctioning of the company, the breakup of a company as well as transfers of control.⁴⁴⁴ As far as the sale or transfer of control is concerned, Delaware courts have initially held that Revlon will not be

[5125008010122026&EXT=pdf](#) (accessed on 10 August 2016) (As noted in the *Visser Citrus (Pty) Ltd v Goede Hoop Citrus (Pty) Ltd and Others* on page 25, Although the rationality requirement as provided in section 76(4) of the Companies Act of 2008 is objective, it is more easily met in comparison to the reasonable requirement. The requirement of rationality has been held to concern the relationship between the decision and the purpose for which the power is given to directors. The reasonable director test on the other hand, focuses on answering a factual question which is whether the directors were acting in what they bona fide believed to be in the best interest of the company).

⁴⁴¹ Terrell J ‘Revlon in Review’ available at

<http://www.pillsburylaw.com/siteFiles/Publications/RevlonInReview.pdf> (accessed on 09 August 2016).

⁴⁴² Terrell J ‘Revlon in Review’ available at

<http://www.pillsburylaw.com/siteFiles/Publications/RevlonInReview.pdf> (accessed on 09 August 2016).

⁴⁴³ *Arnold v. Soc’y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1290 (Del. 1994).

⁴⁴⁴ Gevurtz F ‘Removing Revlon’ (2013) 70 *Washington and Lee Law Review* 1487.

applicable in sale transactions which involve an exchange of stock.⁴⁴⁵ The reason for this is that no change of control has taken place and as previously mentioned the Revlon standard will only apply if a change of control has occurred.⁴⁴⁶ The standard will only be applied if the sale or change of control of a company involved cash.⁴⁴⁷ In other words, only in instances where shareholders receive cash for their shares when a company is being sold, will the Revlon standard be relevant.⁴⁴⁸ The reason for this is that the transaction is the final opportunity for stockholders of the target company to maximise the value of their investment before being barred from obtaining any future benefit from the company after the sale has taken place.⁴⁴⁹

However, in 2011 this view changed as the court in *Smurfit-Stone* was of the opinion that the Revlon standard should be applied to mixed stock and cash mergers.⁴⁵⁰ In essence, if the sale or change of control takes place with a portion of the payment being stock whilst the rest is cash, the Revlon standard will be applicable.⁴⁵¹ It is important to note that in mixed stock and cash mergers, the Revlon standard will only apply provided that the cash component of the sale is equal to or above 50 percent.⁴⁵² If the cash component is equal to or below 33 percent the directors' decision will be reviewed under the BJR.⁴⁵³ The question then arises as to what happens when the cash component of the transaction falls between 33 and 50 percent.⁴⁵⁴

⁴⁴⁵ Klein S & Granata E 'Delaware Chancery Court Provides New Data Point for Application of Revlon Standard to Mixed Stock and Cash Mergers' available at www.media.mofo.com/files/Uploads/Images/110712-Delaware-Application-of-Revlon-Standard.pdf (accessed on 09 August 2016).

⁴⁴⁶ Chadbourne&Parke LLP 'Delaware Chancery Court Addresses Application of Revlon Standard to 50/50 Cash and Stock Merger' available at http://www.chadbourne.com/sites/default/files/publications/mandaclientalert_june23_11_smurfit-stone.pdf (accessed on 09 August 2016).

⁴⁴⁷ Klein S & Granata E 'Delaware Chancery Court Provides New Data Point for Application of Revlon Standard to Mixed Stock and Cash Mergers' available at www.media.mofo.com/files/Uploads/Images/110712-Delaware-Application-of-Revlon-Standard.pdf (accessed on 09 August 2016).

⁴⁴⁸ Klein S & Granata E 'Delaware Chancery Court Provides New Data Point for Application of Revlon Standard to Mixed Stock and Cash Mergers' available at www.media.mofo.com/files/Uploads/Images/110712-Delaware-Application-of-Revlon-Standard.pdf (accessed on 09 August 2016).

⁴⁴⁹ Chadbourne&Parke LLP 'Delaware Chancery Court Addresses Application of Revlon Standard to 50/50 Cash and Stock Merger' available at http://www.chadbourne.com/sites/default/files/publications/mandaclientalert_june23_11_smurfit-stone.pdf (accessed on 09 August 2016).

⁴⁵⁰ *In re Smurfit-Stone Container Corp. Shareholder Litigation* C.A No. 6164-VCP (May 20, 2011).

⁴⁵¹ Tennyson P & Herriott J 'Delaware Court Applies Revlon To "Hybrid" Merger and Provides Guidance' available at <https://www.paulhastings.com/docs/default-source/PDFs/1929.pdf> (accessed on 09 August 2016).

⁴⁵² Tennyson P & Herriott J 'Delaware Court Applies Revlon To "Hybrid" Merger and Provides Guidance' available at <https://www.paulhastings.com/docs/default-source/PDFs/1929.pdf> (accessed on 09 August 2016).

⁴⁵³ Brauerman S 'Exploring the Boundaries of Revlon: Mixed Cash/Stock Transactions Under Heightened Scrutiny' available at <http://www.bayardlaw.com/publications/mixed-cash-stock-transactions-under-heightened-scrutiny> (accessed on 08 August 2016).

⁴⁵⁴ Brauerman S 'Exploring the Boundaries of Revlon: Mixed Cash/Stock Transactions Under Heightened Scrutiny' available at <http://www.bayardlaw.com/publications/mixed-cash-stock-transactions-under-heightened-scrutiny> (accessed on 08 August 2016).

There is still uncertainty lingering in the air as to whether the court will apply the BJR or the Revlon standard in the aforementioned instance.⁴⁵⁵

3.4.3.2 Success of the Revlon Standard

Based on arguments provided by academics, it is clear that there is still much controversy surrounding the Revlon standard.⁴⁵⁶ In Delaware, there is uncertainty as to when to apply the Revlon Standard. As previously mentioned, Delaware courts have not dealt with the application of Revlon to mixed stock-cash payments which fall between 33-50 percent.⁴⁵⁷ The question as to whether the BJR or the Revlon standard would be applicable is yet to be answered. There is furthermore no judicial blueprint for Delaware directors to properly perform their Revlon duties in a sale of control transaction.⁴⁵⁸ Directors can discharge their Revlon duties by way of:

‘a formal auction, a more limited pre-sign canvass of prospective financial and strategic buyer candidates, a limited exclusive negotiation, a passive post-sign market check or, in some instances, an affirmative “go shop” period (with a subsequent “window shop” period) may be appropriate or inappropriate, depending on the totality of facts and circumstances.’⁴⁵⁹

Based on the aforementioned, there is no set manner in which directors are expected to achieve the best value for the shareholder and some commentators find this to be rather problematic as it contributes to the uncertainty.⁴⁶⁰ Some academics are of the opinion that the Revlon Doctrine should be abolished.⁴⁶¹ Authors such as Gevurtz find the Doctrine to be unnecessary in that the Unocal standard or the duty of loyalty is sufficient to deal with

⁴⁵⁵ Alpert M, Smith K & Cankorel T ‘Delaware Chancery Court addresses application of Revlon standard to 50/50 cash and stock merger’ available at http://www.chadbourn.com/sites/default/files/publications/alpert_smith%20_cankorel_vcexpertsarticle_aug11.pdf (accessed on 09 August 2016).

⁴⁵⁶ Johnson L & Ricca R ‘The Still-Dwindled Revlon’ (2014) 71 *Washington and Lee Law Review* 150.

⁴⁵⁷ Thompson G, Haas S & Kehoe G ‘Delaware Court Addresses Duties in Mixed Consideration Mergers’ available at <https://www.hunton.com/files/News/2ca577b2-b751-4acc-ac16-7e9bcec5f724/Presentation/NewsAttachment/495ee8f5-a21e-4001-b0a1-846583a66c48/DelawareCourtAddressesRevlon.pdf> (accessed on 10 August 2016).

⁴⁵⁸ Mills W ‘2 Del. Decisions Offer Nuanced Guidance on Revlon Duties’ available at <http://www.law360.com/articles/614587/2-del-decisions-offer-nuanced-guidance-on-revlon-duties> (accessed on 10 August 2016).

⁴⁵⁹ Carpanini F & Stott A ‘Delaware Supreme Court Provides Comfort to Directors Regarding Process of Selling Company and Reverses Decision of Delaware Court’ (2009) 1 *The GT M&A Report* 6 (hereafter referred to as Carpanini F & Stott A (2009)).

⁴⁶⁰ Carpanini F & Stott A (2009) 6.

⁴⁶¹ Lida H (2015) 492.

directors when a conflict of interest is present.⁴⁶² However, the debate regarding Revlon is still on-going and research has indicated that Delaware courts have continued applying the Doctrine.⁴⁶³ Whether the Doctrine will be abolished in the future or whether courts will merely refine it in order to reduce or remove uncertainties remains unanswered. It is however an interesting matter to look into but the purpose of this dissertation is not to focus on this aspect too much as this has successfully been done elsewhere. It is merely important to understand the rule, how it is applied and that Delaware courts have continued to apply it.

The aforementioned makes it clear that there are various standards created by Delaware courts and in certain instances either one of the standards will be applied. However, it should be borne in mind that in instances where the director has satisfied the requirements of the enhanced standard being applied, he will be protected by the BJR. Having considered the approaches adopted by Delaware courts in M&A transactions, it is necessary to look at how Delaware courts have dealt with the liability of directors' of insolvent or near insolvent corporations.

3.5 INSOLVENT TRANSACTIONS

There are two instances in which Delaware courts have applied the BJR, namely, when a corporation is insolvent and when the corporation is in the zone of insolvency. This section of the dissertation will define each term and thereafter the duties of the board of directors will be discussed. The focus will be on the fiduciary duties of directors of an insolvent corporation as well as a corporation in the zone of insolvency. Subsequently, the rule and its application to insolvent transactions in Delaware will be analysed.

3.5.1 Defining the Term 'Insolvent'

The Delaware's Fraudulent Transfers Act, Title 6, Delaware Code §§ 1302(a)-(b) provides two definitions for the term 'insolvent'.⁴⁶⁴ The first definition provided by the Fraudulent Transfer's Act states that insolvency refers to the inability of the corporation to pay its debts as they become due.⁴⁶⁵ In determining this, Delaware courts have applied the 'cash flow test'

⁴⁶² Lida H (2015) 492.

⁴⁶³ Johnson L 'The Dwindling of Revlon' available at <http://clsbluesky.law.columbia.edu/2014/01/30/the-dwindling-of-revlon/> (accessed on 11 August 2016).

⁴⁶⁴ Fraudulent Transfers Act, Title 6, Delaware Code §§ 1302(a)-(b).

⁴⁶⁵ Fraudulent Transfers Act, Title 6, Delaware Code §§ 1302(a)-(b).

in either a forward looking manner or a present manner.⁴⁶⁶ The forward looking version looks at whether the company will be able to pay its debts as they become due in the near future whereas the present version of the test analyses whether the corporation is currently paying its debts.⁴⁶⁷ The second definition of the term ‘insolvency’ refers to the corporations liabilities’ exceeding the fair market value of its assets.⁴⁶⁸ The *Gheewalla* case however extended the latter definition by observing that in instances where a company has a deficiency of assets which is less than its liabilities and no prospect exists of the corporation successfully continuing to operate, the corporation will be considered insolvent.⁴⁶⁹ In these instances some Delaware courts will apply the ‘balance sheet test’ in order to determine whether the corporations’ liabilities exceed the reasonable market value of its assets.⁴⁷⁰ Other courts have applied a narrower version of the test by looking at whether a company has a ‘deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof’.⁴⁷¹ Research has illustrated that the traditional balance sheet test, which is the broader version of the test, is the preferred test used by Delaware courts.⁴⁷²

3.5.2 Defining the Term ‘Zone of Insolvency’

Another common term which will be mentioned later in this chapter is ‘zone of insolvency’. When a corporation is said to be in the zone of insolvency it means that there is uncertainty as to whether the corporation is experiencing financial difficulties or not.⁴⁷³ There is thus no certainty as to whether the corporation can be declared insolvent as it moves back and forth between solvency and insolvency and this continues for quite some time thereby resulting in uncertainty.⁴⁷⁴ Courts have accepted that in instances where corporations’ financial conditions

⁴⁶⁶ Stearn R & Kandestin C ‘Delaware’s Solvency Test: What is it and does it make sense? A Comparison of Solvency Tests under the Bankruptcy Code and Delaware Law’ (2011) 36 *Delaware Journal of Corporate Law* 165 (hereafter referred to as Stearn R & Kandestin C (2011)).

⁴⁶⁷ Stearn R & Knadestin C (2011) 166.

⁴⁶⁸ Fraudulent Transfers Act, Title 6, Delaware Code §§ 1302(a)-(b).

⁴⁶⁹ *North American Catholic Educ. Programming Found., Inc. v. Gheewalla* 2007 WL 1453705 (Del. May 18, 2007) (hereafter referred to as *Gheewalla* (2007)).

⁴⁷⁰ Stearn R & Knadestin C (2011) 166.

⁴⁷¹ *Prod. Res. Grp., L.L.C. v. NCT Grp., Inc.*, 863 A.2d 772, 782 (Del. Ch. 2004) (quoting *Siple v. S & K Plumbing & Heating, Inc.*, 1982 WL 8789, at 2 (Del. Ch. Apr. 13, 1982)).

⁴⁷² *Gevurtz F Corporation Law, 2d (Hornbook Series)* 2ed (2010) 158.

⁴⁷³ Nemeroff M, Prezant E & Lewis A ‘Director’s Duties in the Zone of Insolvency: A Practical Guide’ available at <http://www.vedderprice.com/files/Publication/79f488ef-d725-4b12-b3b3-77147b34172d/Presentation/PublicationAttachment/2ed41bda-b06e-4031-85db-edf3e36434d6/Directors%E2%80%99Duties%20in%20the%20Zone%20of%20Insolvency%20-%20A%20Practical%20Guide.pdf> (accessed on 15 August 2016).

⁴⁷⁴ Nemeroff M, Prezant E & Lewis A ‘Director’s Duties in the Zone of Insolvency: A Practical Guide’ available at <http://www.vedderprice.com/files/Publication/79f488ef-d725-4b12-b3b3-77147b34172d/Presentation/PublicationAttachment/2ed41bda-b06e-4031-85db->

are deteriorating such as having minimal cash reserves, only having a marginal surplus, increasing debt and the inability to invest in future operations, a corporation might be deemed to be in the zone of insolvency'.⁴⁷⁵ For instance, in the *In re Healthco International, Inc* case, the court was of the opinion that a company is in the zone of insolvency if the company has 'unreasonably small capital' which indicates financial weakness and makes the occurrence of insolvency reasonably foreseeable.⁴⁷⁶ This may take place when a board of directors approves a transaction which causes the company to have insufficient funds.⁴⁷⁷

Having considered the aforementioned essential terms, it is necessary to consider whether a corporation being insolvent or operating in the zone of insolvency, has any impact on the directors' fiduciary duties. The fiduciary duties will not be discussed in too much detail as this has been done in chapter 2 but the most important aspects of the duties as it pertains to insolvency and zone of insolvency will be focused on.

3.6 DIRECTORS' FIDUCIARY DUTIES DURING INSOLVENCY OR NEAR INSOLVENCY

As previously noted, directors owe fiduciary duties to the corporation and in turn the stockholders ultimately benefit. As discussed in chapter 2, directors' duties consist of the duty of loyalty, duty of care and the duty to act in good faith.⁴⁷⁸ Initially the duty of good faith was considered in conjunction with the duties of loyalty and care as they are interrelated.⁴⁷⁹ However, the Delaware Supreme Court in *Cede & Co. Technicolor Inc* made the duty of good faith a separate fiduciary duty thereby creating a triad of fiduciary duties.⁴⁸⁰ When a corporation is insolvent or in the zone of insolvency, the directors are still expected to act in accordance with their fiduciary duties.⁴⁸¹ Directors of financially distressed corporations are

[edf3e36434d6/Directors%E2%80%99%20Duties%20in%20the%20Zone%20of%20Insolvency%20-%20A%20Practical%20Guide.pdf](http://www.hkmlaw.com/publications/The-Zone-Of-Insolvency-A-Trap-for-the-Unwary-03-14-2008/) (accessed on 15 August 2016).

⁴⁷⁵ Rutherford B. Campbell, Jr. & Christopher W. Frost, Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere) (2007) 32 *Journal of Corporation Law* 491, 493.

⁴⁷⁶ *In re Healthco International Inc* No. 97-1381 (1998) at 302.

⁴⁷⁷ Parlin B 'The Zone Of Insolvency: A Trap for the Unwary' available at <https://www.hkmlaw.com/publications/The-Zone-Of-Insolvency-A-Trap-for-the-Unwary-03-14-2008/> (accessed on 15 August 2016).

⁴⁷⁸ *Cede & Co and Cinerama Inc v Technicolor Inc* (Del. 1990).

⁴⁷⁹ Strine L, Hamermesh L, Balotti R et al 'Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law' available at http://www.law.uchicago.edu/files/file/strine_duty_of_good_faith.pdf (accessed on 21 June 2016).

⁴⁸⁰ *Cede & Co and Cinerama Inc v Technicolor Inc* (Del. 1990).

⁴⁸¹ Boelter J 'Fiduciary Duties and the Zone of Insolvency' available at http://www.navigant.com/~media/WWW/Site/Insights/Disputes%20Investigations/Fiduciary_Duties_Zone_Insoolvency.pdf (accessed on 15 August 2016).

often faced with complicated and high pressure decisions in fulfilling their fiduciary duties.⁴⁸² These directors often take big risks by entering into questionable deals which could save the corporation but also carries a high risk of failure.⁴⁸³ Although they face complicated and high pressure decisions, which could in turn have a huge impact on whether the company could either move away from the zone of insolvency or move out of insolvency, directors are still required to exercise their fiduciary duties in the same manner as they would have exercised it if the corporation was solvent.⁴⁸⁴

Therefore, just to touch on the duties which were discussed in detail in chapter 2, it is important to note that when a director exercises his duty of loyalty he is required to avoid conflict of interest between the director's interests and the interests of the corporation.⁴⁸⁵ The duty of care, on the other hand, requires the director to inform himself of all material information reasonably available to him before making a business decision.⁴⁸⁶ Not only should the director be loyal or act with care, he is also expected to act in good faith thereby ensuring that he acts in a manner that will be in the best interests of the corporation.⁴⁸⁷ For some time, courts have been grappling with who the fiduciary duties are owed to and there have been competing views, some finding that the duties shift from the corporation and shareholders to the creditors whilst others have held that directors continue owing their duties to the corporation.⁴⁸⁸

It should be borne in mind that this does not mean that directors owe their fiduciary duties to the creditors although the creditors can bring a derivative claim against the director for

⁴⁸² Huebner M & Klein D 'The Fiduciary Duties of Directors of Troubled Companies' available at https://www.davispolk.com/sites/default/files/mhuebner.dklein.ABI_article.feb15.PDF (accessed on 15 August 2016).

⁴⁸³ Hamilton B 'Does Recent Delaware Case put Final Nail in Coffin of "Zone of Insolvency" Claims?' available at <https://bradhamilton.wordpress.com/tag/zone-of-insolvency/> (accessed on 16 August 2016).

⁴⁸⁴ LaCroix K 'Insolvent Company Directors' Duties to Creditors Under Delaware Law' available at <http://www.dandodiary.com/2014/12/articles/director-and-officer-liability/insolvent-company-directors-duties-to-creditors-under-delaware-law/> (accessed on 17 August 2016).

⁴⁸⁵ Waksman T 'Insolvency and Fiduciary Duties: Advising Directors and Officers when the Company Cannot Pay Bills' available at <http://www.americanbar.org/content/dam/aba/publications/blt/2010/09/inside-buslaw-insolvency-201009.authcheckdam.pdf> (accessed on 15 August 2016).

⁴⁸⁶ Waksman T 'Insolvency and Fiduciary Duties: Advising Directors and Officers when the Company Cannot Pay Bills' available at <http://www.americanbar.org/content/dam/aba/publications/blt/2010/09/inside-buslaw-insolvency-201009.authcheckdam.pdf> (accessed on 15 August 2016).

⁴⁸⁷ Waksman T 'Insolvency and Fiduciary Duties: Advising Directors and Officers when the Company Cannot Pay Bills' available at <http://www.americanbar.org/content/dam/aba/publications/blt/2010/09/inside-buslaw-insolvency-201009.authcheckdam.pdf> (accessed on 15 August 2016).

⁴⁸⁸ Blain P 'Insolvent Corporations and Director Fiduciary Duties to Creditors: A Review of the Standards in Delaware and Wisconsin' available at <http://www.reinhartlaw.com/knowledge/insolvent-corporations-and-director-fiduciary-duties-to-creditors-a-review-of-the-standards-in-delaware-and-wisconsin/> (accessed on 08 September 2016).

breaching a fiduciary duty.⁴⁸⁹ The directors continue owing their duties to the corporation, however, instead of it being for the benefit of the shareholders the focus shifts to benefiting the creditors.⁴⁹⁰ The court in *Gheewalla* held that ‘when a corporation is insolvent its creditors take the position of the shareholders as the residual beneficiaries of any increase in value’.⁴⁹¹ Something similar was stated in the *Quadrant Structured Prods. Co* case, when the court observed that even when a company is insolvent;

‘directors are free to pursue value maximising strategies, while recognising that the firm’s creditors have become the residual claimants and the advancement of their best interests has become the firm’s principal objective’.⁴⁹²

As illustrated above, it is clear that if the corporation is insolvent, the directors are expected to maximise the value of the corporation for the creditors’ benefit but the question arises as to whether the same applies when a corporation is in the zone of insolvency. There have been contrasting views regarding the aforementioned as some courts were of the opinion that when a corporation is operating in the zone of insolvency, directors owe their duties to both the shareholders and the creditors.⁴⁹³ Bankruptcy courts agreed with this view thereby supporting creditor fiduciary claims where the corporation is operating in the zone of insolvency.⁴⁹⁴ However, when the concept of ‘zone of insolvency’ began expanding it brought about great concern.⁴⁹⁵ Vice Chancellor Shrine was of the opinion that the directors already owe their fiduciary duties to the shareholders.⁴⁹⁶ While being in the zone of insolvency, directors are being expected to exercise their fiduciary duties in favour of two different stakeholders, namely, the creditors and shareholders.⁴⁹⁷ The issue here is that shareholders and creditors

⁴⁸⁹ Oberwetter E ‘Nearing the End Zone: Developments in The ‘Zone of Insolvency’’ (2016) 13 *Westlaw Journal* 1 (hereafter referred to as Oberwetter E (2016)).

⁴⁹⁰ Boelter J ‘Fiduciary Duties and the Zone of Insolvency’ available at http://www.navigant.com/~media/WWW/Site/Insights/Disputes%20Investigations/Fiduciary_Duties_Zone_Insolvency.pdf (accessed on 15 August 2016).

⁴⁹¹ *Gheewalla* (2007) 101.

⁴⁹² *Quadrant Structured Products Co. v Vertin et al*, 102 A.3d at 172 (hereafter referred to as *Quadrant*).

⁴⁹³ Gavin E, Goldstein S & Gutfeld D et al ‘The Creeping Business Judgment Rule’ available at <http://www.polsinelli.com/~media/TheCreepingBusinessJudgmentRule> (accessed on 15 August 2016).

⁴⁹⁴ Gavin E, Goldstein S & Gutfeld D et al ‘The Creeping Business Judgment Rule’ available at <http://www.polsinelli.com/~media/TheCreepingBusinessJudgmentRule> (accessed on 15 August 2016).

⁴⁹⁵ Gavin E, Goldstein S & Gutfeld D et al ‘The Creeping Business Judgment Rule’ available at <http://www.polsinelli.com/~media/TheCreepingBusinessJudgmentRule> (accessed on 15 August 2016).

⁴⁹⁶ *In re Prod. Resources Grp., LLC*, 863 A.2d 772, 789 (Del. Ch. 2004).

⁴⁹⁷ Reed J & Ridgely H ‘Delaware court of chancery issues significant ruling on the ability of creditors to assert fiduciary duty claims against directors: key takeaways’ available at <https://www.dlapiper.com/en/us/insights/publications/2015/05/delaware-court--chancery-issues-significant-ruling/> (accessed on 17 August 2016).

have disparate interests.⁴⁹⁸ Shareholders are interested in the success and well-being of the corporation as this would ultimately benefit them whereas creditors are more concerned with receiving the money owed to them.⁴⁹⁹

Although the Delaware courts have agreed that when a corporation is insolvent the directors are expected to exercise their duties for the benefit of the shareholders as well as the creditors, this view differs when a corporation is operating in the zone of insolvency. Delaware courts have disagreed with the view that when a company is merely operating in the zone of insolvency but has not been declared insolvent, the directors owe their duties to the creditors.⁵⁰⁰ The court in *Gheewalla* provided that:

‘If a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.’⁵⁰¹

Recently, the Delaware court addressed the aforementioned issue again in an attempt to provide clarity on the situation. In *Quadrant Structured Products Company* the court makes it clear that although the creditors are in a position to take derivative action against the directors when the company is in the zone of insolvency, no shift of fiduciary duties from the company to the creditors take place.⁵⁰² This means that by no means do the directors begin owing their duties to the creditors merely because the company is possibly on the brink of insolvency.⁵⁰³

⁴⁹⁸ Pernick N, Bonkowski M & Stickle J et al ‘The latest news from Delaware courts: decisions of interest to insolvency and restructuring professionals’ available at <http://www.coleschotz.com/2B7963/assets/files/News/91.pdf>(accessed on 17 August 2016).

⁴⁹⁹ Pernick N, Bonkowski M & Stickle J et al ‘The latest news from Delaware courts: decisions of interest to insolvency and restructuring professionals’ available at <http://www.coleschotz.com/2B7963/assets/files/News/91.pdf>(accessed on 17 August 2016).

⁵⁰⁰ Hamilton B ‘Does Recent Delaware Case put Final Nail in Coffin of “Zone of Insolvency” Claims?’ available at <https://bradhamilton.wordpress.com/tag/zone-of-insolvency/> (accessed on 16 August 2016).

⁵⁰¹ *Gheewalla* (2007) 13.

⁵⁰² Stark L ‘Chancery Court Reaffirms Delaware’s Deferential Approach to Evaluating Fiduciary Claims Brought by Creditors of Distressed Corporations’ available at http://www.americanbar.org/publications/blt/2014/11/delaware_insider.html (accessed on 17 August 2016).

⁵⁰³ Stark L ‘Chancery Court Reaffirms Delaware’s Deferential Approach to Evaluating Fiduciary Claims Brought by Creditors of Distressed Corporations’ available at http://www.americanbar.org/publications/blt/2014/11/delaware_insider.html (accessed on 17 August 2016).

3.7 LIABILITY OF DELAWARE DIRECTORS

As mentioned previously in this chapter, directors of insolvent corporations and corporations moving towards insolvency are faced with making high risk business decisions which have a high failure rate.⁵⁰⁴ It is thus necessary to consider the actions taken against directors of corporations operating in the vicinity of insolvency and insolvent corporations. In doing so, this section of the dissertation will indicate the type of action to be taken for the breach of fiduciary duties as well as who can institute the action. Prior to discussing the BJR it is important to have an understanding of why and how directors of insolvent and near insolvent corporations can be held liable.

As mentioned earlier in this dissertation, there is a difference regarding who can institute a derivative action. This difference occurs when a corporation is insolvent and when it is operating in the vicinity of insolvency. Therefore, prior to discussing this issue, it is necessary to go back to the brief discussion provided on derivative action in chapter 2. For purposes of having a better understanding the important aspects of derivative action will be highlighted in this chapter.

Derivative action is instituted on behalf of the corporation, in order to hold directors personally liable for harm suffered by the corporation as a result of their failure to fulfil certain fiduciary duties. It is generally accepted that a shareholder may sue on behalf of the corporation but certain circumstances will warrant the institution of derivative action by the creditors of the corporation.⁵⁰⁵ The discussion below will clearly indicate when shareholders and creditors have the right to take derivative action.

The aim of the derivative action is to redress harm suffered by the corporation as a result of the directors' business decision.⁵⁰⁶ In doing so, the interests of the corporation are being protected as the claim is being instituted for the benefit of the corporation.⁵⁰⁷ Furthermore, in instances where the claim is successful and the court requires the defendant directors to pay

⁵⁰⁴ Hamilton B 'Does Recent Delaware Case put Final Nail in Coffin of "Zone of Insolvency" Claims?' available at <https://bradhamilton.wordpress.com/tag/zone-of-insolvency/> (accessed on 16 August 2016).

⁵⁰⁵ McGaughey R 'Derivative Lawsuits' available at <http://www.law7555.com/wp-content/uploads/2015/08/derivativelawsuits4-5-10.pdf> (accessed on 18 August 2016).

⁵⁰⁶ Kleinberger D 'Direct versus Derivative and the Law of Limited Liability Companies' available at <http://open.mitchellhamline.edu/cgi/viewcontent.cgi?article=1233&context=facsch> (accessed on 18 August 2016).

⁵⁰⁷ Aronson S, Escobar A & Hassi T et al 'United States: Shareholder Derivative Actions: From Cradle To Grave' available at <http://www.mondaq.com/unitedstates/x/87654/Directors+Officers/Shareholder+Derivative+Actions+From+Cradle+To+Grave> (accessed on 18 August 2016).

compensation, the compensation received goes to the corporation and not the stockholders who instituted the claim.⁵⁰⁸

3.7.1 Instituting a Derivative Action when a Corporation is in the Zone of Insolvency

It was noted that when a corporation is operating in the zone of insolvency, no shift occurs as far as fiduciary duties are concerned.⁵⁰⁹ As a result thereof, directors continue owing their duties to the corporation at the benefit of the shareholders.⁵¹⁰ Therefore, when directors have breached their fiduciary duties in these instances, only the shareholders are allowed to bring derivative actions against the directors.⁵¹¹ Delaware law prohibits the creditors from taking action against the directors as the corporation is still technically solvent.⁵¹² It should further be noted that a shareholder cannot bring an action in an individual capacity in order to claim on behalf of the corporation regardless if the shareholder substantially owns all the corporations' stock.⁵¹³ The aforementioned makes it clear that Delaware courts have accepted that when a corporation is operating in the vicinity of insolvency, shareholders retain the right to institute derivative claims. A change however, comes about when a corporation has been declared insolvent.

3.7.2 Instituting a Derivative Action when a Corporation is Insolvent

When a corporation is insolvent a slight change takes place as far as derivative actions are concerned. As discussed earlier in this chapter, in these instances creditors are given the right to institute derivative action.⁵¹⁴ One core factor to pay attention to is that in no way does this mean that the shareholders lose their right to bring a derivative claim against the directors.⁵¹⁵

⁵⁰⁸ Aronson S, Escobar A & Hassi T et al 'United States: Shareholder Derivative Actions: From Cradle To Grave' available at <http://www.mondaq.com/unitedstates/x/87654/Directors+Officers/Shareholder+Derivative+Actions+From+Cradle+To+Grave>(accessed on 18 August 2016).

⁵⁰⁹ Engert A, Feldman R & Huff P 'Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies – Comparative and International Perspectives' (2007) 1 *Journal of Business and Technology Law* 331.

⁵¹⁰ LaCroix K 'Creditors' Right to Pursue Derivative Claims against Company Directors Under Delaware Law' available at <http://www.dandodiary.com/2015/05/articles/shareholders-derivative-litigation/creditors-rights-to-pursue-derivative-claims-against-company-directors-under-delaware-law/> (accessed on 18 August 2016).

⁵¹¹ Oberwetter E (2016) 1.

⁵¹² Oberwetter E (2016) 1.

⁵¹³ McGaughey R 'Derivative Lawsuits' available at <http://www.law7555.com/wp-content/uploads/2015/08/derivativelawsuits4-5-10.pdf>(accessed on 18 August 2016).

⁵¹⁴ LaCroix K 'Insolvent Company Directors' Duties to Creditors Under Delaware Law' available at <http://www.dandodiary.com/2014/12/articles/director-and-officer-liability/insolvent-company-directors-duties-to-creditors-under-delaware-law/>(accessed on 17 August 2016).

⁵¹⁵ LaCroix K 'Insolvent Company Directors' Duties to Creditors Under Delaware Law' available at <http://www.dandodiary.com/2014/12/articles/director-and-officer-liability/insolvent-company-directors-duties-to-creditors-under-delaware-law/>(accessed on 17 August 2016).

Insolvency only expands the pool of potential plaintiffs to include both shareholders and creditors.⁵¹⁶ Although both shareholders and creditors can claim, the court in *Quadrant* with reference to *Gheewalla* stipulated that creditors fall within a principal class injured by any breaches of fiduciary duties.⁵¹⁷ Therefore, shareholders can only benefit from increases in the corporations value once the creditors' claims have been satisfied.⁵¹⁸ Like shareholders, creditors are not entitled to bring direct claims against the directors for breach of fiduciary duties, as Delaware courts have rejected this view.⁵¹⁹ When shareholders institute derivative claims, Delaware courts have made it clear that what matters is that the corporation is insolvent when the claim is instituted.⁵²⁰ Therefore, should the corporation regain solvency after a derivative action has commenced, it will not affect the creditors' claims.⁵²¹

Having discussed director liability, it is necessary to consider whether directors are entitled to rely on the protection of the BJR when a corporation is insolvent or operating in the vicinity of insolvency. The Delaware Chancery Court has repeatedly held that directors of an insolvent corporation should participate in business activities provided that they believe that it will be in the best interest of the corporation, even though they may have an increased risk of failure.⁵²² It is for this very reason that directors of insolvent corporations or corporations near insolvency should be protected from incurring personal liability.⁵²³ The next section of this chapter will deal with the application of the BJR to protect the directors of both insolvent corporations as well as those operating within the zone of insolvency.

⁵¹⁶ Kilpatrick D, Mirick C & Baskin L 'Delaware Offers New Guidance on Enforcing Fiduciary Duties Owed to Insolvent Corporations' available at <http://www.pillsburylaw.com/publications/delaware-offers-new-guidance-fiduciary-duties-insolvent-corporations> (accessed on 18 August 2016).

⁵¹⁷ *Gheewalla* (2007) 13.

⁵¹⁸ *Gheewalla* (2007) 13.

⁵¹⁹ Evergreen R, Bernstein M & Varner A et al 'Delaware Court of Chancery Addresses Derivative Standing, Solvency Issues, and the Law Governing Breach of Fiduciary Duty Claims' available at <http://www.arnoldporter.com/en/perspectives/publications/2015/05/delaware-court-of-chancery-addresses-derivative-> (accessed on 18 August 2016).

⁵²⁰ Douglas M 'In Brief: Delaware Chancery Court Rules That Creditor Does Not Forfeit Standing to Bring Derivative Suit if Corporation Becomes Solvent' available at <http://www.jonesday.com/in-brief-delaware-chancery-court-rules-that-creditor-does-not-forfeit-standing-to-bring-derivative-suit-if-corporation-becomes-solvent-07-31-2015/> (accessed on 18 August 2016).

⁵²¹ Douglas M 'In Brief: Delaware Chancery Court Rules That Creditor Does Not Forfeit Standing to Bring Derivative Suit if Corporation Becomes Solvent' available at <http://www.jonesday.com/in-brief-delaware-chancery-court-rules-that-creditor-does-not-forfeit-standing-to-bring-derivative-suit-if-corporation-becomes-solvent-07-31-2015/> (accessed on 18 August 2016).

⁵²² Martin S 'Management Responsibilities in Insolvency Situations: United States and Canada' available at [https://www.iiiglobal.org/sites/default/files/18487762v1%20-%20Management%20Responsibilities%20in%20Insolvency%20Situations%20\(Samantha%20Martin\).PDF](https://www.iiiglobal.org/sites/default/files/18487762v1%20-%20Management%20Responsibilities%20in%20Insolvency%20Situations%20(Samantha%20Martin).PDF) (accessed on 18 August 2016).

⁵²³ Martin S 'Management Responsibilities in Insolvency Situations: United States and Canada' available at [https://www.iiiglobal.org/sites/default/files/18487762v1%20-%20Management%20Responsibilities%20in%20Insolvency%20Situations%20\(Samantha%20Martin\).PDF](https://www.iiiglobal.org/sites/default/files/18487762v1%20-%20Management%20Responsibilities%20in%20Insolvency%20Situations%20(Samantha%20Martin).PDF) (accessed on 18 August 2016).

3.8 THE APPLICATION OF THE BUSINESS JUDGMENT RULE

Initially, it was uncertain as to whether the BJR would protect directors of insolvent and near insolvent corporations.⁵²⁴ Some courts have suggested that a higher level of judicial scrutiny is necessary in these instances.⁵²⁵ Directors were thus required to proceed on the assumption that the rule would not apply and that they would have to defend their actions under the stricter, EFD.⁵²⁶ In order to provide clarity on this situation, this section of the dissertation will first look at the application of the BJR to directors of corporations operating in the vicinity of insolvency. Thereafter, the application of the BJR to directors of insolvent corporations will be analysed with specific reference to the *Quadrant* case as it had a huge impact on directors of insolvent corporations.

3.8.1 The Business Judgment Rule and Directors of Near Insolvent Corporations

It is important to note that when a corporation is operating in the vicinity of insolvency, it does not mean that the corporation is insolvent, in actual fact it is most likely still solvent.⁵²⁷ The effect thereof is that the BJR applies in the same manner it would in ordinary situations involving a corporation which is clearly solvent. Directors of these corporations are thus expected to exercise their fiduciary duties in the best interest of the corporation.⁵²⁸ Directors will be protected by the rule provided that they acted in good faith, with loyalty and care.⁵²⁹ Although in these instances the application of the BJR appears to be straight forward, there are certain additional requirements which need to be satisfied when a corporation is insolvent.

3.8.2 The Business Judgment Rule and Directors of Insolvent Corporations

As previously mentioned, there has been uncertainty as to whether the BJR or EFD should apply in instances where a corporation is insolvent. The recent *Quadrant* case has provided some clarity on the situation. The discussion below will illustrate when the BJR applies and when the EFD applies.

⁵²⁴ Cieri R & Riela M 'Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions' (2004) 2 DePaul *Business and Commercial Law Journal* 304 (hereafter referred to as Cieri R & Riela M (2004)).

⁵²⁵ Cieri R & Riela M (2004) 304.

⁵²⁶ Cieri R & Riela M (2004) 304.

⁵²⁷ Walawender R 'Directors' Duties of Corporations Near Insolvency' available at <https://www.millercanfield.com/resources-alerts-514.html> (accessed on 18 August 2016).

⁵²⁸ Walawender R 'Directors' Duties of Corporations Near Insolvency' available at <https://www.millercanfield.com/resources-alerts-514.html> (accessed on 18 August 2016).

⁵²⁹ Walawender R 'Directors' Duties of Corporations Near Insolvency' available at <https://www.millercanfield.com/resources-alerts-514.html> (accessed on 18 August 2016).

The *Quadrant* case involved a derivative claim instituted by the creditors of an insolvent corporation.⁵³⁰ The plaintiff creditors argued that the directors had improperly taken on more risk to benefit the corporation at the expense of the creditors.⁵³¹ The court observed that directors are free to take strategic decisions which maximise the value of the corporation and these decisions are generally protected by the BJR.⁵³² However, in order to be protected directors are expected to justify that their strategies were intended to maximise the value of the corporation and when this is established the BJR presumption will apply.⁵³³ The court was of the opinion that *Quadrant* could not rebut the business judgment presumption by alleging that the board has opted for a more risky business strategy to benefit its sole common stockholder.⁵³⁴ It should however be noted that the BJR will not be applicable in all instances of technical insolvency.⁵³⁵ The court in *Quadrant* recognised that not all board decisions that appear to increase the value of the corporation in its entirety will be protected by the rule.⁵³⁶ There will be instances in which the liquidation of the corporation will be the method that maximises the value of the insolvent corporation.⁵³⁷ What differs with the application of the BJR in these instances is that even if majority of the board of directors are interested in the matter, the court will continue to apply the BJR.⁵³⁸ This will only be done provided that the directors adopted a strategy which will affect the entire business instead of one which confers

⁵³⁰ Phinney C & Walsh K 'Business Judgment Rule Protects Board's Decision to Maximize the Value of an Insolvent Delaware Corporation Even If It Puts Creditors at Risk; But It Does Not Protect Transfers of Value from the Corporation to a Controlling Shareholder or Related Party' available at <https://www.mintz.com/newsletter/2014/Advisories/4399-1014-NAT-LIT-BRC/index.html> (accessed on 18 August 2016).

⁵³¹ Bomba A, Epstein S & Fleischer A et al 'Quadrant v Vertin: Duty to Maximize Value of an Insolvent Enterprise – Business Judgment Rule Applies to Interested Directors' "Risky" Strategy Increase Value, Even Though Creditors Bear the Downside and the Controller Stands to Benefit' available at <http://www.friedfrank.com/siteFiles/Publications/Final%20-%202010-03-14-%20TOC%20Memo%20-%20Quadrant%20v%20Vertin.pdf>(accessed on 18 August 2016).

⁵³² Bomba A, Epstein S & Fleischer A et al 'Quadrant v Vertin: Duty to Maximize Value of an Insolvent Enterprise – Business Judgment Rule Applies to Interested Directors' "Risky" Strategy Increase Value, Even Though Creditors Bear the Downside and the Controller Stands to Benefit' available at <http://www.friedfrank.com/siteFiles/Publications/Final%20-%202010-03-14-%20TOC%20Memo%20-%20Quadrant%20v%20Vertin.pdf>(accessed on 18 August 2016).

⁵³³ Huebner M & Klein D 'The Fiduciary Duties of Directors of Troubled Companies' available at https://www.davispolk.com/sites/default/files/mhuebner.dklein.ABI_article.feb15.PDF (accessed on 15 August 2016).

⁵³⁴ *Quadrant* at 49.

⁵³⁵ Schwartz M 'Quadrant v Vertin: Creditors Beware – Fiduciary Duty Protections Not as Protective as Some May Think' available at <http://www.stroock.com/siteFiles/Pub1557.pdf> (accessed on 08 September 2016).

⁵³⁶ Schwartz M 'Quadrant v Vertin: Creditors Beware – Fiduciary Duty Protections Not as Protective as Some May Think' available at <http://www.stroock.com/siteFiles/Pub1557.pdf> (accessed on 08 September 2016).

⁵³⁷ Schwartz M 'Quadrant v Vertin: Creditors Beware – Fiduciary Duty Protections Not as Protective as Some May Think' available at <http://www.stroock.com/siteFiles/Pub1557.pdf>(accessed on 08 September 2016).

⁵³⁸ Huebner M & Klein D 'The Fiduciary Duties of Directors of Troubled Companies' available at https://www.davispolk.com/sites/default/files/mhuebner.dklein.ABI_article.feb15.PDF (accessed on 15 August 2016).

a ‘direct or specific benefit to a particular group’.⁵³⁹ The Court of Chancery has held that there are instances when preferential treatment is granted to a particular group which will constitute a self-interested transaction thereby removing the protection afforded by the BJR.⁵⁴⁰

Having observed when the BJR applies, the court went further to observe when the EFD will apply. It was held that when a claim pertains to transfers of value from the insolvent corporation to the controlling shareholder and its partners, it will be appropriate to apply the EFD.⁵⁴¹ The court opted for the application of the entire fairness as a result of directors usually having a conflict of interest when transfers of value take place.⁵⁴² As a result thereof, directors are expected to prove that the transfer of value was entirely fair to the corporation and its stockholders.⁵⁴³

3.9 CONCLUSION

This chapter analyses the application of the BJR in various transactions with the focus particularly being placed on M&A transactions and insolvent transactions. It illustrates that a trend has been set by Delaware courts as they began deviating from the traditional BJR and focused on the creation of the modern BJR. This modern BJR consists of heightened standards of judicial review which requires courts to shift away from the BJR in order to first apply more stringent standards as certain transactions warrant this. In a nutshell, Delaware courts have created the EFD, the Unocal standard and the Revlon standard. The EFD being the most onerous of them all is applied in instances where the director’s loyalty is being questioned. The Unocal standard on the other hand is applied in certain hostile takeover cases whilst the Revlon standard applies when a sale of control has occurred. The Unocal and Revlon standards have only been used as far as certain M&A transactions are concerned and there are no cases as of yet, in which the standards have been applied to the transactions involving insolvent corporations. Instead, the Delaware courts have continued relying on the BJR provided that the strategies adopted by the directors have benefited the corporation as a whole. The discussion above has further illustrated that when a transfer of value has taken place from the insolvent corporation to certain stockholders, the EFD will be applied.

⁵³⁹ *Quadrant* at 190.

⁵⁴⁰ Welch E, Saunders R & Land A et al *Folk on the Delaware General Corporation Law: Fundamentals*, 2016 Edition 6thed (2015) 379 (hereafter referred to as Welch E et al (2015)).

⁵⁴¹ Welch E et al (2015) 380.

⁵⁴² Welch E et al (2015) 380.

⁵⁴³ Ward C ‘Fiduciary Duties Owed By Boards of Directors to Both Solvent and Insolvent Companies by Polsinelli PC’ available at <https://www.linkedin.com/pulse/fiduciary-duties-owed-boards-directors-both-solvent-insolvent-ward> (accessed on 19 August 2016).

Ultimately, what should be noted from this chapter is that Delaware has not merely stuck to the use of the BJR. The courts have realised that sometimes it may be necessary to shift away from the initial application of the rule in order to first review the board's decision and thereafter deciding whether the decision is worthy of the protection of the BJR. The purpose of this is to ensure that there is a balance between the interests of the shareholders and that of the directors. In certain instances, if the courts were to apply the BJR it might place the shareholders in at an unfair disadvantage as directors could possibly be protected when they do not deserve the protection.

Research has shown that many other countries have not followed Delaware's trend and have chosen to continue applying the traditional BJR. This is of utmost importance to the subsequent chapter which will focus on the BJR in South Africa. As a result of the rule being relatively new in South Africa, recommendations will be made as to whether the South African company law should adopt the EFD, Unocal standard and Revlon standard in specific transactions where heightened scrutiny of directors' decisions may be warranted.



CHAPTER 4

THE BUSINESS JUDGMENT RULE IN SOUTH AFRICA

4.1 INTRODUCTION

Since the mid-1990s there has been a debate as to whether the American BJR should be incorporated into South African (hereafter referred to as ‘SA’) law. The debate continued until the BJR eventually passed through Canada and landed on South African shore thereby forming part of the South African corporate law.⁵⁴⁴ Prior to the incorporation of the New Act, South Africa’s corporate law was governed by the Companies Act 61 of 1973 which did not make provision for the BJR.⁵⁴⁵ However, when the New Act was enacted, it changed South Africa’s corporate landscape by developing the roles and duties of directors as well as the liabilities associated with it.⁵⁴⁶ Amongst these developments is the BJR which South Africa adopted from America.⁵⁴⁷ It should be noted, that although the New Act was enacted in 2008 it only came into effect in 2011 and as a result thereof, the BJR remains relatively new in South Africa and has thus only been considered in one case in 2014.⁵⁴⁸ This raises concerns as differences exist between the Delaware BJR and the BJR as it has been incorporated into the New Act. As noted in chapter 2, amongst these differences is the creation of the modern BJR by Delaware courts.⁵⁴⁹ This modern BJR consists of enhanced standards of judicial scrutiny, such as, the EFD, the Revlon standard and the Unocal standard. These standards are adopted in certain transactions such as mergers and acquisitions as well as insolvent trading. With the rule being relatively new in South Africa, it remains questionable as to whether the SA courts will adopt the aforementioned modern BJR. This chapter will further highlight that

⁵⁴⁴ Wafwana E ‘The Business Judgment Rule’ available at <http://www.lexology.com/library/detail.aspx?g=e532c90b-eddc-49ad-a461-6be2e72a9a0e>(accessed on 06 July 2016).

⁵⁴⁵ Companies Act 61 of 1973.

⁵⁴⁶ Pillay D & Natesan P ‘The Business Judgment Rule’ available at <http://financialmarketsjournal.co.za/oldsite/18thedition/printedarticles/judgementrule.html>(accessed on 22 August 2016).

⁵⁴⁷ Wafwana E ‘The Business Judgment Rule’ available at <http://www.lexology.com/library/detail.aspx?g=e532c90b-eddc-49ad-a461-6be2e72a9a0e>(accessed on 06 July 2016).

⁵⁴⁸ *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and others* (case no: 15854/2014).

⁵⁴⁹ Schoeman-Louw N ‘The business judgment rule: how the Companies Act of 2008 is impacting directors’ duties’ available at <http://www.polity.org.za/article/the-business-judgment-rule-how-the-companies-act-of-2008-is-impacting-on-directors-duties-2013-08-07> (accessed on 12 September 2016).

although the Delaware BJR contains good faith as a requirement for the BJR, the 2008 Act in South Africa, fails to expressly provide for this requirement in section 76(4).⁵⁵⁰

For purposes of a holistic approach, this chapter will thus examine the historical development of the BJR in SA and in doing so the debate surrounding the introduction of the rule into SA law will be considered. The chapter will furthermore analyse the directors' duties and liabilities, the formulation of the South African BJR as provided in section 76(4) of the Companies Act 71 of 2008 as well as the application of the rule to certain transactions, namely, mergers and acquisitions and insolvent trading. The differences between the SA rule and the Delaware rule will also be considered and essential concerns pertaining to the SA rule will be discussed.

4.2 HISTORICAL DEVELOPMENT

In the King Report on Corporate Governance of 1994 (King Report I), the King Committee, a Committee established by the Institute of Directors in Southern Africa, was of the opinion that the Companies Act 61 of 1973 needed to be amended to make provision for a statutory limitation on a director's duty of care and skill.⁵⁵¹ The King Report I, a ground-breaking code of corporate governance, was the first of its kind in South Africa and it was aimed at promoting the highest standards of corporate governance in South Africa.⁵⁵² The Report provides guidelines for the drawing up and implementation of corporate codes of conduct and it thus does not contain compulsory rules which companies are required to adhere to.⁵⁵³

In making the recommendation that a statutory limitation should be placed on a directors' duty of care and skill, the King Committee believed that there was a need to encourage entrepreneurship and to attract skilled persons to act as directors.⁵⁵⁴ King Report I furthermore recommended that directors should not incur liability for the breach of the duty of care and skill provided that they made a business judgment in good faith, the decision they

⁵⁵⁰ Holland R 'Delaware's Business Judgment Rule: International Variations' available at <http://global.blogs.delaware.gov/2015/04/09/delawares-business-judgment-rule-international-variations/> (accessed on 22 September 2016).

⁵⁵¹ The King Report on Corporate Governance, published by the Institute of Directors on 9 November 1994 (hereafter referred to as 'the King Report') (In 1992 the Institute of Directors formed a King Committee to review corporate governance and make recommendations to the corporate world, in order to improve corporate governance).

⁵⁵² Cliffe Dekker Attorneys 'King Report on Corporate Governance for South Africa 2002' available at http://www.mervynking.co.za/downloads/CD_King2.pdf (accessed on 30 July 2016).

⁵⁵³ Caliyurt K & Crowther D *Globalisation and Social Responsibility* (2006)153.

⁵⁵⁴ Paragraph 3.2 of the King Report.

made was an informed and rational decision and the directors had no personal interest in the business decision or transaction.⁵⁵⁵ In 2002, King Report II recommended that the Standing Advisory Committee on Company Law should conduct an investigation in order to determine whether it is desirable to incorporate the BJR into SA law.⁵⁵⁶ The recommendation came about as a result of a growing concern that in a new era of corporate governance there would be a greater tendency to impose stricter liability on directors for breaching their duties or where their conduct has caused the company to suffer harm.⁵⁵⁷

However, although the King Committee was of the opinion that the incorporation of the BJR into SA law should be considered, the committee was not alone in arguing that directors should be afforded more protection.⁵⁵⁸ In addition to the King Reports, early case law has made it clear that directors should not incur liability for mere error of judgment.⁵⁵⁹ Mere error of judgment lacks wrongful intent and as a result thereof, it does not qualify as misconduct.⁵⁶⁰ In *Levin v Felt and Tweeds Ltd*, the court held that:

‘In the absence of any allegations that the directors acted mala fide this amounts to asking the court to usurp the functions of the directors and to consider what is in the best interest for the company from a business point of view. This is not the function of the court of law as the court is not concerned with the commercial wisdom of the scheme’.⁵⁶¹

A similar statement was made by Lord Greene in the case of *In re Smith and Fawcett Ltd*, which provides that, ‘they [the directors] must exercise their discretion bona fide in what they consider – not what a court may consider – is in the best interest of the company’.⁵⁶²

The essence of the aforementioned statements is abundantly clear, which is that the court will not usurp the function of directors by substituting their decisions for the business decisions of

⁵⁵⁵ Paragraph 24.6 of the King Report.

⁵⁵⁶ The King Report on Corporate Governance, published by the Institute of Directors in March 2002 (hereafter referred to as ‘King II’).

⁵⁵⁷ Lee A ‘Business Judgment Rule: Should South African Corporate Law Follow the King Reports Recommendation?’ (2005) 1 *University of Botswana Law Journal* 51 (hereafter referred to as Lee A (2005)).

⁵⁵⁸ Deloitte ‘Directors Duties’ available at http://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_DutiesOfDirectors2013_16042014.pdf (accessed on 13 September 2016).

⁵⁵⁹ *Levin v Felt and Tweeds Ltd* 1951 (2) SA 401 (A) at 414-415.

⁵⁶⁰ Yu E ‘Error in Judgment’ available at <https://yueb.wordpress.com/2015/05/18/error-in-judgment/> (accessed on 30 July 2016).

⁵⁶¹ *Levin v Felt and Tweeds Ltd* 1951 (2) SA 401 (A) at 414-415.

⁵⁶² *In re Smith and Fawcett Ltd* (1942) Ch 304 (CA) at 306.

directors.⁵⁶³ In referring back to chapter 2, one of the reasons why the BJR was created was to ensure that courts would not interfere with the business decisions made by directors. It can thus be argued that the court in the *Levin* case provides an implied BJR.⁵⁶⁴ Although there had been a clear support for the incorporation of the rule into SA law, some have disagreed and were of the opinion that the rule should not be adopted.⁵⁶⁵ The Department of Trade and Industry (hereafter referred to as ‘the DTI’) forms part of the group who did not see a need for the rule in SA law.

Although the DTI did not deem it necessary for the BJR to be introduced into SA law, it did however argue that there was a need to make changes to the 1973 Companies Act.⁵⁶⁶ The DTI clearly stated that the company law at the time, needed to be altered as the environment within which companies were operating had continuously changed since the Companies Act of 1973 came into effect.⁵⁶⁷ The Report which was published by the DTI suggested that there was a lack of effective mechanisms for the enforcement of directors’ duties and that the duties required clarity.⁵⁶⁸ These duties required clarity because the principles governing the directors’ duties are largely found in case law and the exact content of the duties remain subject to various views.⁵⁶⁹ The Report suggested that the duties of directors’ be codified in legislation in order to create certainty in the law and to ensure that the duties were no longer subject to various views of the judiciary.⁵⁷⁰ Although the DTI report did not specifically deal with the introduction of the BJR into South African law, it recognised that the South African society is not litigious in nature and it was thus not necessary to exculpate directors against liability for the breach of their duties.⁵⁷¹ The report consequently implied that the introduction of a statutory BJR into South African law would be unnecessary.⁵⁷²

⁵⁶³ Muswaka L ‘Director’s Duties and the Business Judgment Rule in South African Company Law: An Analysis’ (2013) 3 *International Journal of Humanities and Social Science* 90 (hereafter referred to as Muswaka L (2013)).

⁵⁶⁴ *Levin v Felt and Tweeds Ltd* 1951 (2) SA 401 (A) at 414-415.

⁵⁶⁵ Durckheim L (2012)39

⁵⁶⁶ Durckheim L (2012) 32.

⁵⁶⁷ Barac K & Moloi T ‘Assessment of corporate governance reporting in the annual reports of South African listed companies’ available at

https://www.researchgate.net/profile/Tankiso_Moloi/publication/272477179_Assessment_of_corporate_governance_reporting_in_the_annual_report_of_South_African_listed_companies/links/55d5877e08ae1e6516637c02.pdf (accessed on 13 July 2016).

⁵⁶⁸ The Department of Trade and Industry in South Africa Report, May 2004 at 18.

⁵⁶⁹ The Department of Trade and Industry in South Africa Report, May 2004 at 39.

⁵⁷⁰ Kennedy-Good S & Coetzee L ‘The Business Judgment Rule (part 2)’ (2006) 27 *Obiter* 289.

⁵⁷¹ Durckheim L (2012) 33.

⁵⁷² Kennedy-Good S & Coetzee L ‘The Business Judgment Rule (part 2)’ (2006) 27 *Obiter* 289.

Commentators have criticised the above mentioned report for being contradictory because on the one hand, the report recommended the introduction of statutory provisions which could be relied upon in litigation in order to hold directors liable for misconduct.⁵⁷³ However, on the other hand it suggests that there is no need for provisions to be enacted which will excuse directors from liability for their alleged wrongful conduct.⁵⁷⁴

4.3 CONTRASTING VIEWS ON THE INTRODUCTION OF THE BJR

There had been much controversy surrounding the introduction of the BJR into South African law.⁵⁷⁵ The controversy lingers around the issue as to whether it is a good idea for South Africa to follow the BJR formulated in the State of Delaware.⁵⁷⁶

Those arguing in favour of the BJR were of the opinion that the rule would provide certainty to the laws governing directors' duties as it will clarify the steps directors ought to take when making business decisions, in order to be protected against claims brought against them by shareholders.⁵⁷⁷ The BJR will thus create an awareness of the duties owed by company directors and it will create a framework within which courts and directors can operate.⁵⁷⁸ The rule will simultaneously provide courts with a guideline as to what standard of care is expected of directors in order for the BJR to be invoked.⁵⁷⁹

These proponents further justified their argument by stating that the court is not sufficiently equipped to evaluate the decisions made by a director.⁵⁸⁰ In many instances, business decisions can be very complex and courts were not made to necessarily understand the complex business situations directors may find themselves in.⁵⁸¹ Therefore, by incorporating the BJR into South African law, the courts will be in a better position to apply the existing legal principle within a framework of rules and criteria which they are familiar with such as

⁵⁷³ Durckheim L (2012) 33.

⁵⁷⁴ Durckheim L (2012) 33.

⁵⁷⁵ Essop L 'A focus on directors' duties of care, skill and diligence in terms of the common law and the Companies Act 71 of 2008' available at https://researchspace.ukzn.ac.za/bitstream/handle/10413/13095/Essop_Luthfiya_2015.pdf?sequence=1&isAllowed=y (accessed on 11 July 2016).

⁵⁷⁶ Essop L 'A focus on directors' duties of care, skill and diligence in terms of the common law and the Companies Act 71 of 2008' available at https://researchspace.ukzn.ac.za/bitstream/handle/10413/13095/Essop_Luthfiya_2015.pdf?sequence=1&isAllowed=y (accessed on 11 July 2016).

⁵⁷⁷ Lee A (2005) 77.

⁵⁷⁸ Lee A (2005) 78.

⁵⁷⁹ Lee A (2005) 77.

⁵⁸⁰ Dyke M *The Business Judgment Rule - Its Application in South Africa* (published LLM thesis, The University of South Africa, 1995) 3.

⁵⁸¹ Lee A (2005) 77.

good faith, conflict of interests, reasonableness and rationality.⁵⁸² A further argument is that the BJR will strike a balance between the legal expectations of a reasonable person under the similar circumstances to that which a director may be in when making a business judgment.⁵⁸³ The BJR will make provision for a balanced objective-subjective approach as this is the desired position that the law needs to strive towards.⁵⁸⁴ Although the rule is usually described as objective, it is also largely subjective because the reasonable director is instilled with the knowledge and experience of a director whose business decision is in question.⁵⁸⁵

Although there were various arguments in favour of the codification of the BJR, most commentators felt that there was no need to incorporate the rule into legislation.⁵⁸⁶ These commentators felt that the Companies Act already provides sufficient protection to honest and reasonable company directors and there were barely any cases in which directors were sued for negligence.⁵⁸⁷ A further argument is that the BJR is derived from a foreign legal system and they are of the opinion that it is undesirable to transplant the aforementioned legal doctrine into South African law, as it is based on a completely different legal system.⁵⁸⁸ This argument has however been rebutted by proponents of the BJR as they argued that some aspects of the BJR have previously appeared in South African case law and the fundamental principles of the rule do not significantly differ from South African corporate law.⁵⁸⁹ Commentators feared that in adopting the BJR, the uncertainty that is currently attached to the rule in America, would occur in South Africa.⁵⁹⁰ Proponents of the rule appear to think that in instances where there is a breach of the directors' duty of care and skill, that the directors will immediately face litigation for the breach but this is not true.⁵⁹¹ The case of

⁵⁸² Lee A (2005) 77.

⁵⁸³ Jones E 'Directors' Duties: Negligence and the Business Judgment Rule' available at [http://www.repository.up.ac.za/dspace/bitstream/handle/2263/3893/Jones_Directors\(2007\).pdf?sequence=1](http://www.repository.up.ac.za/dspace/bitstream/handle/2263/3893/Jones_Directors(2007).pdf?sequence=1) (accessed on 11 July 2016).

⁵⁸⁴ Jones E 'Directors' Duties: Negligence and the Business Judgment Rule' available at [http://www.repository.up.ac.za/dspace/bitstream/handle/2263/3893/Jones_Directors\(2007\).pdf?sequence=1](http://www.repository.up.ac.za/dspace/bitstream/handle/2263/3893/Jones_Directors(2007).pdf?sequence=1) (accessed on 11 July 2016).

⁵⁸⁵ Jones E 'Directors' Duties: Negligence and the Business Judgment Rule' available at [http://www.repository.up.ac.za/dspace/bitstream/handle/2263/3893/Jones_Directors\(2007\).pdf?sequence=1](http://www.repository.up.ac.za/dspace/bitstream/handle/2263/3893/Jones_Directors(2007).pdf?sequence=1) (accessed on 11 July 2016).

⁵⁸⁶ Durckheim L (2012) 39.

⁵⁸⁷ Durckheim L (2012) 39.

⁵⁸⁸ Botha D & Jooste R 'A Critique of the recommendations in the King Report regarding the director's duty of care and skill' (1997) 114 *South Africa Law Journal* 73.

⁵⁸⁹ Lee A (2005) 78.

⁵⁹⁰ Leach J (2014) 25.

⁵⁹¹ Bouwman N 'An Appraisal of the Modification of the directors duty of care and skill' (2009) 21 (4) *South Africa Mercantile Law Journal* 526.

Niagara v Langerman & Others is one of the very few reported cases in which a director was held liable for breaching the standard of care and skill.⁵⁹²

Although the incorporation of the BJR has been extensively criticised, the BJR was incorporated into the 2008 Act. However, it should be noted that although the content of the BJR is incorporated into the New Act, the Act does not expressly provide the name of the rule. Legislature thus took into account the benefits of the BJR and made a decision to codify it in the aforementioned Act. Having considered the historical development of the BJR as well as the pros and cons of codifying the rule it is necessary to consider the purpose of the rule, as this coincides with the legislatures' decision to codify the rule.

4.4 PURPOSE OF INTRODUCING THE BJR

Upon drafting the Companies Act of 2008, common law duties were being partially codified and the duty of care, skill and diligence, as illustrated below, became more stringent.⁵⁹³ The New Act thereby increased the liabilities of directors and it was argued that directors' personal liability would increase dramatically if they fail to calculate and perform their business decisions correctly.⁵⁹⁴ The aforementioned statement is supported by the fact that, in recent years, directors have been stifled by various burdening legislation, such as the Protection of Personal Information Act and the Broad-Based Black Economic Empowerment Act, which brought about increased possibilities of personal liability for directors.⁵⁹⁵ Legislature thus acknowledged this and the BJR was introduced into the New Act.⁵⁹⁶

The rationale behind the BJR is to provide directors with relief as it aims to protect directors who have made an informed decision without any personal financial interest or alternatively disclosed such an interest and rationally believed the decision to be in the best interest of the

⁵⁹² *Niagara v Langerman & Others* 1913 WLD 188.

⁵⁹³ Kanamugire J & Chimuka T (2014) 73.

⁵⁹⁴ Pillay D & Natesan P 'The Business Judgment Rule' available at <http://financialmarketsjournal.co.za/oldsite/18thedition/printedarticles/judgementrule.html> (accessed on 12 September 2016).

⁵⁹⁵ Booysen T 'Business Judgment Rule: How you will be judged' available at <https://www.linkedin.com/pulse/business-judgement-rule-how-you-judged-terry-booysen> (accessed on 12 September 2016).

⁵⁹⁶ Booysen T 'Business Judgment Rule: How you will be judged' available at <https://www.linkedin.com/pulse/business-judgement-rule-how-you-judged-terry-booysen> (accessed on 12 September 2016).

company.⁵⁹⁷ The BJR thus acknowledges that risks are inherent in business decisions and it furthermore assumes that it is unfair to expect that directors will always make perfect business decisions.⁵⁹⁸ The BJR therefore encourages the directors to take business decisions which are risky as these decisions could ultimately be beneficial to the company.⁵⁹⁹

A further purpose of the BJR is to promote the objective of the Companies Act of 2008 which is described as:

‘Read as a whole, the 2008 Act promotes the objective that there should not be an over-regulation of company business. The Act grants directors the legal authority to run companies as they deem fit, provided that they act within the legislative framework. In other words, the Act tries to ensure that it is the board of directors, duly appointed, who run the business rather than regulators and judges, who are never best placed to balance the interests of shareholders, the firm and the larger society within the context of running a business’.⁶⁰⁰

In deciphering the aforementioned statement, it could be argued that the purpose of the New Act makes it clear that it is the role of the board of directors to manage the company and who in essence make business decisions. It goes further by indicating that it is not the role of regulators to manage the business by performing important duties such as making business decisions. This links back directly to the BJR in that one of the main rationales of the BJR is to prevent court interference in business decisions.⁶⁰¹

Having considered the history and the purpose of the BJR, it is necessary to consider the directors duties which are of particular relevance to the BJR. These duties include the duty to act in the best interest of the company, the duty to act in good faith and for proper purpose as well as the duty of care, skill and diligence.

⁵⁹⁷ Booyesen T ‘Business Judgment Rule: How you will be judged’ available at <https://www.linkedin.com/pulse/business-judgement-rule-how-you-judged-terry-booyesen> (accessed on 12 September 2016).

⁵⁹⁸ Pillay D & Natesan P ‘The Business Judgment Rule’ available at <http://financialmarketsjournal.co.za/oldsite/18thedition/printedarticles/judgementrule.html> (accessed on 12 September 2016).

⁵⁹⁹ Pillay D & Natesan P ‘The Business Judgment Rule’ available at <http://financialmarketsjournal.co.za/oldsite/18thedition/printedarticles/judgementrule.html> (accessed on 12 September 2016).

⁶⁰⁰ Muswaka L ‘A Critical Analysis of the Protection of Stakeholders’ Interests under the South African Companies Act: (Part 2)’ (2014) 5 *Mediterranean Journal of Social Sciences* 67.

⁶⁰¹ Llewellyn L ‘Breaking Down the Business-Judgment Rule’ available at <http://www.winston.com/images/content/1/5/1535.pdf> (accessed on 15 September 2016).

4.5 DIRECTORS' DUTIES

In South Africa, the duties of directors have often been uncertain because it had initially been governed by South African common law.⁶⁰² The Companies Act 61 of 1973 followed the English law to a large extent and it left most of the law pertaining to directors' duties uncodified and in doing so the duties were to be developed by courts.⁶⁰³ The concern at the time was that directors' duties were being dealt with inconsistently by the courts of law.⁶⁰⁴ The duties imposed on directors are essential to ensuring the success and proper operation of a company which is exactly why there had been an urgent need for certainty and consistency as far as their duties are concerned.⁶⁰⁵

As mentioned under the previous section of this chapter, the King Committee called for the reform of the South African company law and in 2011 the New Act came into force. The New Act partially codifies the common law duties but it should be borne in mind that the partial codification of the duties did not render the common law invalid.⁶⁰⁶ The common law remains valid but in cases where inconsistency is present, the statutory duties will override the common law duties.⁶⁰⁷ It is important to note that the purpose of this section of the chapter is not to critically analyse the common law and how it differs from the statutory duties. Instead, this section will focus the lens on the current position of the directors' duties as per the New Act. The duties which are of particular relevance to the BJR will be analysed, namely, the duty to act in the best interests of the company, the duty to act in good faith and for proper purpose as well as the duty to act with a degree of care, skill and diligence.

⁶⁰² Werksmans Attorneys 'Companies Act No.71 of 2008: Duties and Liabilities of Directors' available at <http://www.werksmans.com/wp-content/uploads/2013/04/Director-duties-and-liabilities-FINAL-updated-electronic.pdf> (accessed on 15 September 2016).

⁶⁰³ Jacobs W, Brewis T & Thompson D et al 'Corporate Governance: A Guide for Directors' available at <https://www.cliffedekkerhofmeyr.com/export/sites/cdh/en/sectors/downloads/Corporate-governance-A-directors-guide.pdf> (accessed on 30 July 2016).

⁶⁰⁴ Jacobs W, Brewis T & Thompson D et al 'Corporate Governance: A Guide for Directors' available at <https://www.cliffedekkerhofmeyr.com/export/sites/cdh/en/sectors/downloads/Corporate-governance-A-directors-guide.pdf> (accessed on 30 July 2016).

⁶⁰⁵ Jacobs W, Brewis T & Thompson D et al 'Corporate Governance: A Guide for Directors' available at <https://www.cliffedekkerhofmeyr.com/export/sites/cdh/en/sectors/downloads/Corporate-governance-A-directors-guide.pdf> (accessed on 30 July 2016).

⁶⁰⁶ Stein C & Westbrook D 'Directors and Officers Liability Insurance' available at <http://services.bowman.co.za/Brochures/DutiesAndLiabilities/DutiesAndLiabilitiesBrochure-lr.pdf> (accessed on 30 July 2016) (Partial codification adopts the general principles of law but it allows room for the development of the common law).

⁶⁰⁷ Stein C & Westbrook D 'Directors and Officers Liability Insurance' available at <http://services.bowman.co.za/Brochures/DutiesAndLiabilities/DutiesAndLiabilitiesBrochure-lr.pdf> (accessed on 30 July 2016).

4.5.1 The Duty to Act in the Best Interest of the Company

The common-law principle that a director must act in the best interest of the company is codified in s 76(3)(b) of the New Act.⁶⁰⁸ According to s 76(3)(b) a director of a company, when acting in his capacity as a director, must exercise the powers and perform the functions of director ‘in the best interests of the company’.⁶⁰⁹ In essence, when the director participates in the management of the company, the duty to act in the best interests of the company attaches to the director.⁶¹⁰ This duty requires a director to act in a manner which he perceives to be for the benefit of the company as a whole.⁶¹¹ In the case of *Visser Citrus*, it was held that section 76(4) of the New Act makes it clear that the duty to act in the best interest of the company is not an objective duty.⁶¹² In essence, a director is required to subjectively believe that his decision was in the best interest of the company.⁶¹³

The phrase ‘best interests of the company’ is an indefinite phrase as different meanings are attached to it in different contexts.⁶¹⁴ The wording implies that the directors are expected to act in the best interests of the company and not the shareholders.⁶¹⁵ However, the general rule is that the interests of the company are the interests of the shareholders, as a general body.⁶¹⁶

Directors will be in breach of the duty to act in the best interest of the company if they exercise their powers in a manner which defeats or harms the interests of their company.⁶¹⁷

The duty will furthermore be breached if directors perform their powers in a manner which furthers their own interests or the interests of persons other than the shareholders of the

⁶⁰⁸ Strydom E *Company Legislation Handbook* 25ed (2012) 97 (hereafter referred to as Strydom E (2012)).

⁶⁰⁹ Strydom E (2012) 97.

⁶¹⁰ Joubert W ‘Companies: Part 2, Duties of Directors and Officers, Fiduciary Duties, Duties to exercise powers for proper purpose’ available at <https://www-mylexisnexis-co-za.ezproxy.uct.ac.za/Index.aspx#> (accessed on 10 September 2016).

⁶¹¹ van Tonder J ‘An Analysis of the Directors’ Duty to Act in the Best Interests of the Company, through the Lens of the Business Judgment Rule’ (2015) 3 *Obiter* 712 (hereafter referred to as van Tonder (2015)).

⁶¹² *Visser Citrus (Pty) Ltd v Goede Hoop Citrus (Pty) Ltd and others* (case no: 15854/2014) 25.

⁶¹³ Klein E ‘Corporate Donations, the Best Interest of the Company and the Proper Purpose Doctrine’ available at <http://www.austlii.edu.au/au/journals/UNSWLawJl/2005/5.html> (accessed on 23 October 2016).

⁶¹⁴ van Tonder (2015) 712.

⁶¹⁵ Leach J (2014) 24.

⁶¹⁶ Joubert W ‘Companies: Part 2, Duties of Directors and Officers, Fiduciary Duties, Duties to exercise powers for proper purpose’ available at <https://www-mylexisnexis-co-za.ezproxy.uct.ac.za/Index.aspx#> (accessed on 10 September 2016).

⁶¹⁷ Joubert W ‘Companies: Part 2, Duties of Directors and Officers, Fiduciary Duties, Duties to exercise powers for proper purpose’ available at <https://www-mylexisnexis-co-za.ezproxy.uct.ac.za/Index.aspx#> (accessed on 10 September 2016).

company.⁶¹⁸ In the case of *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd*, the court highlights the point that the court does not determine what the best interest of the company is.⁶¹⁹ Instead, the test applied by the court is to determine whether a reasonable man would have considered the act to be in the best interest of the company.⁶²⁰ The court in *Treck Corp Ltd v Millar* further reiterated the aforementioned when the court held that reasonable grounds need to exist on which the director in question believed that he was acting in the best interest of the company.⁶²¹ In order to determine whether the director complied with the best interest fiduciary duty, the court in *Charterbridge Corporation Ltd v Lloyd's Bank* formulated a test.⁶²² This test requires the court to determine:

‘whether an intelligent and honest person in the position of the director could under the same circumstances have reasonably come to find that he or she was in fact acting in the best interest of the company’.⁶²³

The case of *Neptune (Vehicle washing equipment) Ltd v Fitzgerald* provides an illustration of the aforementioned test.⁶²⁴ The court held that the sole director of the company had not acted in the best interest of the company by arranging for the company to make generous donations to him on the termination of his employment with the company.⁶²⁵ The court was of the opinion that the director was acting in his own interests and in doing so he breached his duty to act in the best interest of the company.⁶²⁶

4.5.2 The Duty to act in good faith and for a proper purpose

4.5.2.1 Good faith

The common law principle of good faith has been partially codified in section 76(3)(a) of the New Act.⁶²⁷ This duty is seen as the principal, overarching duty from which all other duties

⁶¹⁸ Joubert W ‘Companies: Part 2, Duties of Directors and Officers, Fiduciary Duties, Duties to exercise powers for proper purpose’ available at <https://www.mylexisnexis-co-za.ezproxy.uct.ac.za/Index.aspx#> (accessed on 10 September 2016).

⁶¹⁹ *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd* 1927 2 KB 9 (hereafter referred to as *Shuttleworth v Cox*).

⁶²⁰ *Shuttleworth v Cox* at 23.

⁶²¹ *Treck Corp Ltd v Millar* 1972 33 DLR (3d) 288 (BCSC).

⁶²² *Charterbridge Corporation Ltd v Lloyd's Bank* 1970 Ch2 at 74 (hereafter referred to as *Charterbridge Corporation Ltd v Lloyd's Bank*).

⁶²³ *Charterbridge Corporation Ltd v Lloyd's Bank* at 74.

⁶²⁴ *Neptune (Vehicle washing equipment) Ltd v Fitzgerald* 1995 1 BCLC 325 (ChD) (hereafter referred to as *Neptune (Vehicle washing equipment) Ltd v Fitzgerald*).

⁶²⁵ *Neptune (Vehicle washing equipment) Ltd v Fitzgerald*.

⁶²⁶ *Neptune (Vehicle washing equipment) Ltd v Fitzgerald*.

⁶²⁷ Companies Act 71 of 2008.

emerge.⁶²⁸ The reason for this is that the duty is always present and it is attached to all other fiduciary duties which directors owe to the company.⁶²⁹ However, the New Act fails to provide a detailed definition of ‘good faith’ and as a result thereof academics were left to turn to court decisions and common law in order to decipher the true meaning of the term.⁶³⁰

In *Da Silva and others v C H Chemicals (Pty)* the court held that ‘it is a well-established rule of common law that directors have a fiduciary duty to exercise their powers in good faith and in the best interests of the company’.⁶³¹ The duty to act in good faith and in the best interest of the company is interrelated.⁶³² However, when the New Act linked the duty to act in good faith and for proper purpose, the expectation of directors increased.⁶³³ Thus, it is not enough for a director to act according to what he believes to be in the best interest of the company but he also has to act for proper purpose.⁶³⁴ The common law views the good faith duty as a fundamental duty as it is rooted in honesty and it requires that the director apply his mind to the decision and thereafter he has to perform his duties in a manner which he honestly believes to be in the best interests of the company.⁶³⁵ The court in *Visser Sitrus* further stresses the importance of a director acting *bona fide* which translates to good faith.⁶³⁶

When directors are expected to act in good faith they are required to have reasonable grounds for having a specific belief and for acting according to that belief.⁶³⁷ In instances where the director acted in good faith, the court in *Hogg v Cramphorn Ltd* makes it clear that courts will not review the decision that the directors arrived at in honesty.⁶³⁸ Should there be an absence of reasonable grounds the courts are likely to be of the opinion that the director lacked good faith.⁶³⁹ The test to determine whether directors acted in good faith is a subjective test as the

⁶²⁸ Naicker M *A critical exploration of the fiduciary duties of a director to act in good faith and for proper purpose in respect of a company and an evaluation of the developments from common law to statute* (published LLM thesis, 2015, University of KwaZulu-Natal)30 (hereafter referred to as Naicker M (2015)).

⁶²⁹ Cassim et al (2012) 523.

⁶³⁰ Naicker M (2015) 31.

⁶³¹ *Da Silva and others v C H Chemicals (Pty)* 2008 (6) SA 620 (SCA).

⁶³² Naicker M (2015) 3.

⁶³³ Naicker M (2015) 3.

⁶³⁴ Naicker M (2015) 3.

⁶³⁵ Naicker M (2015) 32.

⁶³⁶ *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and others* (case no: 15854/2014).

⁶³⁷ Lesofe I *Implications of the Partial Codification of the Directors’ Duties under the New Companies Act* (published LLM thesis, 2015, University of Pretoria) 16 (hereafter referred to as Lesofe I (2015)).

⁶³⁸ *Hogg v Cramphorn Ltd* [1967] Ch 254 at 268.

⁶³⁹ Grove A (2012) 27.

focus is on the director's state of mind instead of focusing on what it is the court believes to have been in good faith.⁶⁴⁰

4.5.2.2 Proper purpose

The duty to act for proper purpose is also found in section 76(3)(a) of the New Act and although the Act does not define the term 'proper purpose', the common law meaning is relied upon.⁶⁴¹ According to the common law meaning, the duty to act for proper purpose requires the directors to ensure that they do not exercise their powers for purposes which it was not allocated for.⁶⁴² In essence, directors should not act beyond their powers by acting illegally or dishonestly.⁶⁴³ An example of this would be a director using the company assets, especially the funds, for his own purposes. A further example can be found in the case of *S v Hepker* in which the court held that:

'Directors are not allowed knowingly to bind their companies to transactions which are unprofitable to the company and are intended to serve the directors' own ends. That is so even when they all hold the shares and even when all the members of the board agree with full knowledge of the facts. The basis of this proposition is that the company is a person in law and that directors stand in a fiduciary relationship towards it.'⁶⁴⁴

The court in *Howard Smith v Ampel Petroleum Ltd* held that a director's duty to use his powers for a proper purpose serves as a test to determine if the director's act was for the benefit of the company.⁶⁴⁵ In order to determine whether directors have utilised their powers for a proper purpose, the court in *Extrasure Travel Insurance Ltd v Scattergood* identified a four-step approach. The court noted that the law pertaining to improper purpose does not require evidence that a director was dishonest or that he knew he was trying to achieve an alternative purpose.⁶⁴⁶ The court emphasised that when determining whether there had been an improper purpose the court will:

'identify the power being challenged, as well as the proper purpose for which the power was given to the director, the substantial purpose for which the power

⁶⁴⁰ Naicker M (2015) 32.

⁶⁴¹ Grove A (2012) 28.

⁶⁴² Lesofe I (2015) 15.

⁶⁴³ Pretorius J et al *Hahlo's South African Company law through the cases* 6ed (1999) 279.

⁶⁴⁴ *S v Hepker* 1973 1 SA 472 (W).

⁶⁴⁵ *Howard Smith v Ampel Petroleum Ltd* [1974]1 All ER 1126 (PC).

⁶⁴⁶ *Extrasure Travel Insurance Ltd v Scattergood* 2003 1 BCLC 598.

was in fact exercised should be investigated by the court and the court needs to decide whether the purpose was proper.’⁶⁴⁷

In the case of *Visser Sitrus*, the court held that the test for proper purpose is an objective one, in the sense that the court has to ascertain whether the actual purpose falls within the purpose for which the power was conferred.⁶⁴⁸ The court further highlighted that there is a relationship between the requirement that the power should be exercised for proper purpose and the requirement that directors should act in what they consider to be in the best interests of the company.⁶⁴⁹

4.5.3 The Duty to Act with Care, Skill and Diligence

Before commencing the discussion on the duty of care, skill and diligence, it is important to note that this duty is not a fiduciary duty.⁶⁵⁰ The purpose behind this duty is to prevent directors of the company from acting in a manner that could harm the company.⁶⁵¹ The importance between the distinction of fiduciary duties and the duty of care, skill and diligence lies in the basis of liability.⁶⁵² The liability in respect of the former is not based on fault whilst liability for breach of care, skill and diligence is purely based on fault which includes intentional or negligent conduct.⁶⁵³ In referring back to chapter 2 it is evident that this differs quite tremendously from the American approach to the duty as it classifies the duty as a fiduciary duty.⁶⁵⁴

For the first time in South Africa’s corporate law history, the duty to exercise reasonable care, skill and diligence has been statutorily defined in s76(3) of the Companies Act 71 of 2008.⁶⁵⁵ Although section 76(3) makes mention of other duties imposed on directors,

⁶⁴⁷ *Extrasure Travel Insurance Ltd v Scattergood* 2003 1 BCLC 598.

⁶⁴⁸ *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and others* (case no: 15854/2014) 28.

⁶⁴⁹ *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and others* (case no: 15854/2014) 28.

⁶⁵⁰ Stein C & Westbrook D ‘Directors and Officers Liability Insurance’ available at <http://services.bowman.co.za/Brochures/DutiesAndLiabilities/DutiesAndLiabilitiesBrochure-lr.pdf> (accessed on 31 July 2016).

⁶⁵¹ Stevens R & Beer P ‘The Duty of Care and Skill, and Reckless Trading: Remedies in Flux?’ (2016) 28 *South African Mercantile Law Journal* 250.

⁶⁵² Esser I & Delpont P ‘The Duty of Care, Skill and Diligence: The King Report and the 2008 Companies Act’ (2011) 74 *Journal of Contemporary Roman-Dutch Law* 453 (hereafter referred to as Esser I & Delpont P (2011)).

⁶⁵³ Esser I & Delpont P (2011) 453.

⁶⁵⁴ Jones E ‘Directors’ Duties: Negligence and the Business Judgment Rule’ (2007) 19 *South African Mercantile Law Journal* 327 (hereafter referred to as Jones E (2007)).

⁶⁵⁵ Barends R ‘Partial Codification of Directors Duty of Care and Skill in terms of the Companies Act 71 of 2008’ available at <http://www.stbb.co.za/blog/partial-codification-directors-duty-care-skill-terms-companies-act-71-2008/> (accessed on 31 July 2016).

paragraph (c) deals specifically with the duty being discussed in this section of the chapter.⁶⁵⁶

Section 76(3)(c) provides that:

‘Subject to subsection (4) and (5), a director of a company, when acting in the capacity, must exercise the powers and perform the functions of director –

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

- (i) carrying out the same functions in relation to the company as those carried out by that director;
- (ii) having the general knowledge, skill and experience of that director.’⁶⁵⁷

The aforementioned provision upgrades the director’s duty of care and skill as it imposes a less subjective and more demanding standard for directors.⁶⁵⁸ This differs from the common law version of the duty which is largely subjective and far less stringent.⁶⁵⁹ However, although the test is less subjective, it still focuses on the subjective element but included an objective element and in doing so, the provision created a two legged test for directors.⁶⁶⁰ The first leg which is stipulated in subsection (i) is objective as it requires directors to meet a threshold in order to avoid liability.⁶⁶¹ This leg requires courts to consider factors such as the size of the company, its nature, and whether the role of the director involves certain technical skills.⁶⁶² This was emphasised in the *Fisheries Development Corporation SA Ltd v Jorgensen* case. Margo J held that ‘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 or assigned to him’.⁶⁶³ The court will thus consider what would ordinarily and reasonably be expected from a director in the aforementioned position.⁶⁶⁴

⁶⁵⁶ Companies Act 71 of 2008.

⁶⁵⁷ Companies Act 71 of 2008.

⁶⁵⁸ Kanamugire J & Chimuka T (2014) 73.

⁶⁵⁹ Kanamugire J & Chimuka T (2014) 73.

⁶⁶⁰ McLennan J ‘Duties of Care and Skill of Company Directors and their Liability for Negligence’ (1996) 8 *South African Mercantile Law Journal* 101.

⁶⁶¹ DLA Cliffe Dekker Hofmeyr ‘The Company Director Checklist South Africa’ available at <http://www.ibanet.org> (accessed on 1 August 2016).

⁶⁶² DLA Cliffe Dekker Hofmeyr ‘The Company Director Checklist South Africa’ available at <http://www.ibanet.org> (accessed on 1 August 2016).

⁶⁶³ *Fisheries Development Corporation SA Ltd v Jorgensen* 1980 (4) SA 156 (W).

⁶⁶⁴ DLA Cliffe Dekker Hofmeyr ‘The Company Director Checklist South Africa’ available at <http://www.ibanet.org> (accessed on 1 August 2016).

Subsection (ii) on the other hand, provides the subjective aspect of the test as it focuses on the experience of the particular director in question.⁶⁶⁵ However, should the director have more skills and qualifications than expected for his position, he will be held to a higher standard.⁶⁶⁶ The cumulative effect of the two elements is that it creates a minimum standard which directors must adhere to irrespective of their particular skills, knowledge and experience.⁶⁶⁷

A notable difference between the common law and statutory versions of the duty is the inclusion of the term 'diligence' when the duty became partially codified.⁶⁶⁸ This thus raises questions as to whether it caused any tremendous change to the duty. It is however, important to note that the term 'diligence' relates quite close to the term 'due diligence' which is used frequently amongst attorneys.⁶⁶⁹ For example, when attorneys are going to do due diligence on a company, it means that they are going to conduct research on the company by meeting with the employees and management in order to assess the company, its operations and finances.⁶⁷⁰ Similarly, if one were to apply this term in the context of directors, it simply means that directors are required to thoroughly investigate the implications of their decisions, prior to making a final decision which could impact the company.⁶⁷¹

South Africa was largely influenced by Australia with the duty of care, skill and diligence. Australia included the statutory duty of diligence long before South Africa did.⁶⁷² South African commentators and courts barely refer to the term diligence despite it being included

⁶⁶⁵ Nethavhani K *The Business Judgment Rule: Undue Erosion of Director's Duty of Care, Skill and Diligence* (published LLM thesis, University of Pretoria, 2015) 14 (hereafter referred to as Nethavhani K (2015)).

⁶⁶⁶ Nethavhani K (2015) 14.

⁶⁶⁷ Nethavhani K (2015) 14.

⁶⁶⁸ Barends R 'Partial Codification of Directors Duty of Care and Skill in terms of the Companies Act 71 of 2008' available at <http://www.stbb.co.za/blog/partial-codification-directors-duty-care-skill-terms-companies-act-71-2008/> (accessed on 20 October 2016).

⁶⁶⁹ National Paralegal College 'The Duty of Care' available at http://nationalparalegal.edu/public_documents/courseware.asp_files/businessLaw/Directors&Officers/DutyOfCare.asp (accessed on 20 October 2016).

⁶⁷⁰ National Paralegal College 'The Duty of Care' available at http://nationalparalegal.edu/public_documents/courseware.asp_files/businessLaw/Directors&Officers/DutyOfCare.asp (accessed on 20 October 2016).

⁶⁷¹ National Paralegal College 'The Duty of Care' available at http://nationalparalegal.edu/public_documents/courseware.asp_files/businessLaw/Directors&Officers/DutyOfCare.asp (accessed on 20 October 2016).

⁶⁷² Du Plessis J 'A comparative analysis of directors' duty of care, skill and diligence in South Africa and in Australia' (2010) 2010 *ActaJuridica* 263 (hereafter referred to as Du Plessis J (2010)).

in section 76(3)(c) of the New Act.⁶⁷³ There is little doubt that the diligence aspect of the rule has been derived from the Australian Corporations Act of 2001 and as a result thereof, section 76(3)(c) of the New Act is viewed from the perspective of Australian law.⁶⁷⁴ It is important to note that care and diligence should be seen as a term rather than trying to distinguish between the terms.⁶⁷⁵ When directors exercise diligence they ensure that they become sufficiently informed about the situation at hand prior to taking action and in doing so they can be in compliance with the duty of care, provided that the manner in which they became informed is the same as the manner in which a reasonable person would have become informed.⁶⁷⁶ It could be assumed that diligence was added to the duty of care and skill to ensure that directors act diligently. The aforementioned statement can be supported by the judgment of the *Fisheries Development Corporation of SA Ltd v Jorgensen* case.⁶⁷⁷ The court was of the opinion that a director is ‘entitled to accept and rely on the judgment, information and advice of the management, unless there are proper reasons for querying such’.⁶⁷⁸ The court further indicated that a director exercising reasonable care would not accept information and advice blindly but in instances where he accepts it he should give it due consideration and exercise his own judgment in light of the information received.⁶⁷⁹

Having considered the essential duties imposed upon directors, it is necessary to analyse the potential liability faced by directors for the breach of their fiduciary duties as well as the duty of care, skill and diligence. In discussing their liability, it will become easier to understand why some commentators were of the opinion that the BJR should be introduced into SA corporate law.

4.6 DIRECTORS’ LIABILITY

The personal liability of directors became an important issue and it gained momentum when the Companies Act 71 of 2008 was drafted.⁶⁸⁰ Directors became aware of the fact that they were going to become more vulnerable and as a result thereof, they became concerned that it

⁶⁷³ Mongalo T *Modern Company Law for a Competitive South African Economy* (2010) 268 (hereafter referred to as Mongalo T (2010)).

⁶⁷⁴ Du Plessis J (2012) 263.

⁶⁷⁵ Mongalo T (2010) 268.

⁶⁷⁶ Kershaw D *Company Law in Context: Text and Materials* 2ed (2012) 444.

⁶⁷⁷ *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980 (4) SA 156 (W).

⁶⁷⁸ *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980 (4) SA 156 (W).

⁶⁷⁹ Pretorius J et al *Student Case Book on Business Entities* 3ed (2004) 113.

⁶⁸⁰ Levenstein E ‘Personal Liability of Directors’ available at http://www.saripa.co.za/downloads/AIPSAnews_200803.pdf (accessed on 12 September 2016).

would be easier for them to incur personal liability.⁶⁸¹ Section 77 of the New Act is quite a lengthy provision which focuses solely on the liability of directors.⁶⁸² As a result of section 77 being as lengthy as it is, this section of the dissertation will not quote section 77 in its entirety. Instead it will provide a broad outline pertaining to the important aspects in the section.

According to section 77 of the New Act, a company may recover losses, damages or costs which the company sustained as a result of the directors' actions.⁶⁸³ This can be done by the company in terms of the common law principles which relates to the breach of fiduciary duties as well as the law of delict when it comes to the breach of the duty of care, skill and diligence.⁶⁸⁴ Therefore, should the director breach any one or more of his fiduciary duties or the duty of care, skill and diligence as provided for in the New Act and the common law, he can be held personally liable.⁶⁸⁵ Common law is stated because it still remains relevant as the provisions in the New Act do not override the common law duties.⁶⁸⁶ Furthermore, if a director acted without the required authority, for example by signing documents he was not entitled to sign and the company is harmed, the director can incur personal liability.⁶⁸⁷

Section 77 further provides that if a director is involved in an act or omission with the purpose of defrauding a creditor, shareholder or employee, he can incur personal liability regardless as to whether he had knowledge that the purpose of the act or omission was to defraud one of the aforesaid parties.⁶⁸⁸ Moreover, if a director failed to comply with the provisions of the New Act or signed, authorised or consented to the publication of

⁶⁸¹ Levenstein E 'Personal Liability of Directors' available at http://www.saripa.co.za/downloads/AIPSAnews_200803.pdf (accessed on 12 September 2016).

⁶⁸² Companies Act 71 of 2008.

⁶⁸³ Companies Act 71 of 2008.

⁶⁸⁴ Smith W 'Companies Act 2008 – Directors' Responsibilities and Liability' available at <http://www.exceedinc.co.za/news/companies-act-2008-directors-responsibilities-and-liability/?id=8&entryId=13> (accessed on 13 September 2016).

⁶⁸⁵ Smith W 'Companies Act 2008 – Directors' Responsibilities and Liability' available at <http://www.exceedinc.co.za/news/companies-act-2008-directors-responsibilities-and-liability/?id=8&entryId=13> (accessed on 13 September 2016).

⁶⁸⁶ van Wyk J 'Expanding employees' duties under the new Companies Act' available at http://www.lib.uct.ac.za/usr/companylaw/downloads/legislation/WLB_2011-07_Cos_Act_Expanding_employee_duties_JvW_AvH.pdf (accessed on 15 September 2016).

⁶⁸⁷ KPMG 'The Companies Act 71 of 2008' available at <https://www.kpmg.com/ZA/en/IssuesAndInsights/ArticlesPublications/Tax-and-Legal-Publications/Documents/Companies%20Act%2071%20of%202008%20final.pdf> (accessed on 13 September 2016).

⁶⁸⁸ KPMG 'The Companies Act 71 of 2008' available at <https://www.kpmg.com/ZA/en/IssuesAndInsights/ArticlesPublications/Tax-and-Legal-Publications/Documents/Companies%20Act%2071%20of%202008%20final.pdf> (accessed on 13 September 2016).

misleading, false or untrue information, the company can institute a claim against the director(s).⁶⁸⁹

The above mentioned instances in which directors can incur personal liability are not exhaustive of the provisions in section 77 of the New Act. As mentioned previously, this section of the dissertation would focus on providing a broad outline on the liability of directors. What is important to note is that in comparing the New Act to the 1973 Act, it is very clear that in partially codifying the fiduciary duties, the duty of care, skill and diligence of the directors as well as the potential liability they can incur, the New Act became more specific thereby arguably, making it easier for directors to incur personal liability.⁶⁹⁰

It is important to bear in mind that prior to the introduction of the BJR the only protection afforded to the directors was indemnification and insurance.⁶⁹¹ As far as indemnity is concerned, a company can indemnify a director from any liability including liability arising from his negligence, default, breach of duty or breach of trust.⁶⁹² However, in order for this indemnification to be valid, the company must have taken out insurance and this insurance must have been kept as indemnification against any liability as stated above.⁶⁹³

The aforementioned makes it rather clear that directors were in need of more protection, as argued by some commentators, hence the introduction of the BJR into South African corporate law. The subsequent section will analyse the rule and its formulation as provided in section 76(4) of the Companies Act.

4.7 THE BUSINESS JUDGMENT RULE

As previously mentioned the BJR has been taken from America and incorporated into the South African company law.⁶⁹⁴ The BJR specifically covers the duty to act in the best interest of the company and the duty to act with care, skill and diligence which is contained

⁶⁸⁹ KPMG 'The Companies Act 71 of 2008' available at <https://www.kpmg.com/ZA/en/IssuesAndInsights/ArticlesPublications/Tax-and-Legal-Publications/Documents/Companies%20Act%2071%20of%202008%20final.pdf> (accessed on 13 September 2016).

⁶⁹⁰ South Africa *The Comparative Guide to the Old and New Companies Act* (2011) 382 (hereafter referred to as South Africa (2011)).

⁶⁹¹ South Africa (2011) 383.

⁶⁹² South Africa (2011) 383.

⁶⁹³ South Africa (2011) 383.

⁶⁹⁴ Muswaka L 'Shielding Directors against Liability Imputations: The Business Judgment Rule and Good Corporate Governance' available at <http://www.saflii.org/za/journals/SPECJU/2013/2.html> (accessed on 10 September 2016).

in the requirements provided in section 76(4) of the New Act.⁶⁹⁵ What stands out is the fact that it does not specifically deal with good faith as this is the most fundamental fiduciary duty.⁶⁹⁶ This aspect will be elaborated on later in this chapter.

The case of *Visser Sitrus* is the first South African case to make reference to the business judgment rule.⁶⁹⁷ The court stated that ‘a court should be wary of substituting its own judgment for that of the persons entrusted with that decision by the corporate constitution’.⁶⁹⁸ This statement serves as an indication of the BJR as it is one of the essential purposes of the rule. The court furthermore made mention of section 76(4) of the New Act which makes provision for the BJR.⁶⁹⁹ Although the court refers to the rule, it does not explain all the requirements of the rule and as a result thereof, there is still uncertainty pertaining to how courts will, in future, interpret each requirement.⁷⁰⁰ The courts might opt for the meanings provided by various academics and foreign case law.

The rule was codified in section 76(4) of the Companies Act 71 of 2008.⁷⁰¹ In stipulating the rule in the section, it also provides the requirements which directors are expected to satisfy prior to receiving the protection of the BJR. According to section 74(6)(a):

- ‘(4) In respect of any particular matter arising in the exercise of the powers or the performance of the functions of director, a particular director of a company-
- (a) will have satisfied the obligations of subsection (3) (b) and (c) if-
- (i) the director has taken reasonably diligent steps to become informed about the matter;
- (ii) either-

⁶⁹⁵ Muswaka L ‘Shielding Directors against Liability Imputations: The Business Judgment Rule and Good Corporate Governance’ available at <http://www.saflii.org/za/journals/SPECJU/2013/2.html> (accessed on 10 September 2016).

⁶⁹⁶ Muswaka L ‘Shielding Directors against Liability Imputations: The Business Judgment Rule and Good Corporate Governance’ available at <http://www.saflii.org/za/journals/SPECJU/2013/2.html> (accessed on 10 September 2016).

⁶⁹⁷ *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and others* (case no: 15854/2014) 28.

⁶⁹⁸ *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and others* (case no: 15854/2014) 28.

⁶⁹⁹ *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and others* (case no: 15854/2014) 28.

⁷⁰⁰ *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and others* (case no: 15854/2014) 28.

⁷⁰¹ Companies Act 71 of 2008.

- (aa) the director had no material personal financial interest in the subject matter of the decision, and had no reasonable basis to know that any related person had a personal financial interest in the matter; or
- (bb) the director complied with the requirements of section 75 with respect to any interest contemplated in subparagraph (aa); and
- (iii) the director made a decision, or supported the decision of a committee or the board, with regard to that matter, and the director had a rational basis for believing, and did believe, that the decision was in the best interests of the company;⁷⁰²

The most essential aspect to pay attention to in the aforementioned section is the cross-reference to section 76(3)(b)-(c). This serves as an indication that the BJR only applies to the statutory duty of care as well as the statutory duty to act in the best interest of the company.⁷⁰³ When reading the section in its entirety it is clear that a director will have satisfied his duty of care if he complied with the three requirements provided for in subsection (a)(i)-(iii).⁷⁰⁴ This means that if the director made an informed decision, has no personal financial interest in the matter or made full and proper disclosure of his financial interest and has a rational basis for believing that the decision was in the best interest of the company, the court will presume that he acted in accordance with his duty of care.⁷⁰⁵ These are the three fundamental requirements of the rule which directors are expected to satisfy in order to be protected by the rule.⁷⁰⁶ It is necessary to consider each of the three requirements in detail in order to grasp a better understanding as to what is expected of directors in South Africa, in order to be afforded the protection of the rule.

⁷⁰² Companies Act 71 of 2008.

⁷⁰³ Leach J (2014) 21.

⁷⁰⁴ Leach J (2014) 21.

⁷⁰⁵ Leach J (2014) 21.

⁷⁰⁶ Leach J (2014) 21.

4.7.1 Informed Decision

It should be noted that the New Act does not define the phrase ‘reasonably diligent steps to become informed about the matter’.⁷⁰⁷ However, it has been noted by various academics that directors will be in compliance with this element if they ensure that they have taken the necessary steps to inform themselves about the affairs of the company, including other details which are essential to the decision being taken.⁷⁰⁸ Directors are therefore expected to use various techniques, methods and concepts in order to become informed about the matter.⁷⁰⁹ These different techniques, methods and concepts consist of ensuring that they (directors) are self-informed, mutually informed, informed by auxiliary bodies, and obtaining information from the chairman of the board of directors as well as obtaining the opinion of experts such as accountants.⁷¹⁰ Directors should therefore actively find information regarding the matter rather than being ignorant.⁷¹¹ What should be noted is that the question of how much and what type of information is sufficient to satisfy this requirement is determined by directors rather than by the judgment of the court.⁷¹²

4.7.2 No personal material financial interest

This element requires the director not to have a ‘material personal financial interest’ in the subject matter of the decision. Section 1 of the New Act defines ‘a personal financial interest’ as a ‘direct material interest of that person, of a financial, monetary, or economic nature, or to which a monetary value can be attributed’.⁷¹³ This definition makes it clear that a director’s interest must be a ‘direct’ material interest and not an indirect one.⁷¹⁴ It can be deduced that this means that the interest should not be a trivial interest which will not impact

⁷⁰⁷ Muswaka L ‘Shielding Directors against Liability Imputations: The Business Judgment Rule and Good Corporate Governance’ available at <http://www.saflii.org/za/journals/SPECJU/2013/2.html> (accessed on 10 September 2016).

⁷⁰⁸ Holburn P ‘Business judgment rule offers better protection to Directors’ available at <http://www.moneymarketing.co.za/business-judgement-rule-offers-better-protection-to-directors/> (accessed on 23 October 2016).

⁷⁰⁹ Vasiljević M ‘Civil Law and Business Judgment Rule’ (2012) 3 *Belgrade Law Review* 19 (hereafter referred to as Vasiljević (2012)).

⁷¹⁰ Vasiljević 19-20.

⁷¹¹ PWC ‘The Business Judgment Rule’ available at http://c.ymcdn.com/sites/iodsa.site-ym.com/resource/collection/05E93ACB-10BE-4507-9601-307A66F34BD8/IOD_Business_JudgementEmail.pdf (accessed on 11 September 2016).

⁷¹² Vasiljević 19-20.

⁷¹³ Companies Act 71 of 2008.

⁷¹⁴ Cassim et al (2012) 568.

the outcome of the matter or business decision.⁷¹⁵ It is essential to note that the interest must not only be direct but it should also be material. Section 1 furthermore defines the term material by stating that:

‘material when used as an adjective, means significant in the particular circumstances to a degree that is –

(a) of consequence in determining the matter; or

(b) might reasonably affect a person’s judgment or decision-making in the matter.’⁷¹⁶

Therefore, in instances where a director has a personal financial interest or a person related to the director has such an interest, the director is expected to disclose this interest to the rest of the board in accordance with section 75(5) of the New Act.⁷¹⁷ It should however be borne in mind that a director can only disclose the interest of a relative provided that he has knowledge of such an interest.⁷¹⁸ Section 75(5) requires the director to disclose his interest and its general nature, as well as any material information pertaining to the matter.⁷¹⁹ Thus all that is required is for the director to disclose the interest held by him or his relative as well as its general nature which indicates that the director will not necessarily be expected to describe the extent of his interest.⁷²⁰

4.7.3 Rational Basis

The last requirement provided for in section 74(6) expects directors to have a rational basis for believing that the decision would be in the best interest of the company.⁷²¹ The term ‘rational’ is however, not defined by the New Act.⁷²² Directors are expected to subjectively have believed that their decision was in the best interest of the company and this belief needs

⁷¹⁵ PWC ‘The Business Judgment Rule’ available at http://c.ymcdn.com/sites/iodsa.site-ym.com/resource/collection/05E93ACB-10BE-4507-9601-307A66F34BD8/IOD_Business_JudgementEmail.pdf (accessed on 11 September 2016).

⁷¹⁶ Companies Act 71 of 2008

⁷¹⁷ Cassim et al (2012) 570.

⁷¹⁸ Cassim et al (2012) 570.

⁷¹⁹ Cassim et al (2012) 570.

⁷²⁰ Cassim et al (2012) 570.

⁷²¹ Companies Act 71 of 2008.

⁷²² Muswaka L (2013) 31.

Seeing that courts have accepted that the term rational as far as section 76(4)(a) is concerned receives the same meaning as the term as it is used when dealing with public power, reference can be made to the *Minister of Defence and Military Veterans v Motau and Others*.⁷³¹ The court looked at whether the Minister's decision was rational and in order to determine this, the court had to consider whether the Minister's exercise of dismissal power related rationally to the purpose of the power.⁷³² The court found the decision to be rational because there was a rational link between the power exercised by the Minister and the purpose of the power.⁷³³ This case makes it clear that when courts are faced with having to determine whether the rationality aspect of the BJR has been satisfied, the court will look at whether there is a rational connection between the purpose for which the power was conferred upon the directors and the manner in which the powers in question has been exercised.

The essential question which remains is whether the test for rationality is lower or equal to that of reasonableness.⁷³⁴ It is easy to get confused between the tests and the contrasting views concerning the matter do not help.⁷³⁵ Some commentators such as J Cassidy are of the view that the test for rationality is lower than that of reasonableness.⁷³⁶ Commentators such as FHI Cassim are of the opinion that the two tests are equal and the exact same.⁷³⁷ However, the supported view appears to be that of the tests being different.⁷³⁸ The court in the case of *ASIC v Rich* is of the opinion that if the test of rationality is the same as reasonableness, the provisions section 76(4)(a) would be rendered unnecessary.⁷³⁹ This view

⁷³¹ *Minister of Defence and Military Veterans v Motau and Others* 2014 (5) SA 69 (CC).

⁷³² Klein M 'Legal Notes'

https://www.google.com/search?q=Visser+Sitrus+v+Goede+Hoop+Sitrus+rationality+requirement&client=firefox-b&biw=1252&bih=604&noj=1&ei=VQkJWIK5OYzMgAaB_5mYBA&start=10&sa=N&gfe_rd=cr# (accessed on 20 October 2016).

⁷³³ Klein M 'Legal Notes'

https://www.google.com/search?q=Visser+Sitrus+v+Goede+Hoop+Sitrus+rationality+requirement&client=firefox-b&biw=1252&bih=604&noj=1&ei=VQkJWIK5OYzMgAaB_5mYBA&start=10&sa=N&gfe_rd=cr# (accessed on 20 October 2016).

⁷³⁴ Nethavhani K 24.

⁷³⁵ American Law Institute Principles at 136.

⁷³⁶ Cassidy J 'Models for Reform: the directors duty of care in a modern commercial world' (2009) 20 *Stellenbosch Law Review* 400.

⁷³⁷ See Cassim FHI et al 2ed (2012) 564.

⁷³⁸ See Nethavhani K at pages 24-25 in which the views are highlighted but it is evident that the supported view is that of the standards being different and the rationality test being lower. This view is further supported with reference to the statutory interpretation rule that statutory provisions need to be interpreted in a manner that make them operational instead of redundant. If the reasonableness and rationality test were the same, section 76(4)(a) would be superfluous.

⁷³⁹ Nethavhani K 24.

was further supported by the court in *Visser Sitrus*. The court made it clear that although the rationality requirement is objective its threshold is quite easily met in comparison to the determination as to whether the decision was objectively in the best interest of the company.⁷⁴⁰ The test for rationality does not assess whether the best decision was made or whether a different decision could have been made, which are considered when dealing with reasonableness.⁷⁴¹

Based on the aforementioned requirements, it is clear that directors will be afforded the protection of the BJR, provided that they make an informed and reasonable business decision which is in the best interest of the company.⁷⁴² The formulation of the rule as provided in section 76(4) of the New Act signifies the ‘traditional business judgment rule’ which exists in Delaware law. The rule in this sense is straightforward and will apply provided that the requirements mentioned in section 76(4) are met. However, the question which comes about pertains to whether South Africa should apply the traditional BJR to certain transactions or whether the modern BJR should be adopted. In considering the above stated requirements of the BJR it is evident that good faith is not included in section 76(4) as a requirement and this is rather concerning. The court in the case of *Visser Sitrus* continuously makes reference to good faith in its judgment.⁷⁴³ Throughout the case, the court reiterates the fiduciary duty of directors to act in a manner which they *bona fide* believe to be in the best interest of the company.⁷⁴⁴ This makes it questionable as to whether it was wise of the legislature to exclude good faith from section 76(4) of the New Act. This will however, be addressed later in this chapter.

⁷⁴⁰ *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and Others* 2014 (5) SA 179 (WCC) 27.

⁷⁴¹ *Minister of Defence and Military Veterans v Motau and Others* 2014 (5) SA 69 (CC) (Chapter 2 indicates that the terms rational and reasonable are often used interchangeably but they differ fundamentally. The reasonable standard is an objective test which requires the court to look at whether a third party would have acted in the same manner as the director. It is thus an aspirational standard of conduct. The rationality test is subjective as it focuses on the ability of the director to use his power and judgment prior to making the final business decision. Unlike reasonableness, rationality has no uniform criteria).

⁷⁴² Maharaj M ‘A thorough examination regarding the standard of skill and care to be exercised by a director in terms of the common and statutory laws and an overview of the business judgement rule: A company law perspective’ available at http://researchspace.ukzn.ac.za/xmlui/bitstream/handle/10413/12320/Maharaj_Manashya_2014.pdf?sequence=1 (accessed on 12 September 2016).

⁷⁴³ *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and Others* 2014 (5) SA 179 (WCC).

⁷⁴⁴ *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and Others* 2014 (5) SA 179 (WCC).

4.8 THE MODERN BUSINESS JUDGMENT RULE

The New Act does not make mention of the modern BJR which was created by Delaware courts. The modern BJR, as discussed in chapter 3, consist of the EFD, the Unocal Standard and the Revlon Standard. This version of the BJR was adopted by Delaware courts as they were of the opinion that shareholders needed more protection against the decisions of directors in certain transactions.⁷⁴⁵ However, there is no clarity as to whether South African courts will adopt the same approach in certain transactions, namely mergers and acquisitions as well as insolvent trading. This part of the chapter will consider the existing protection available in the New Act to shareholders in both M&A and insolvent trading transactions. In doing so, it will become easier to identify whether South Africa really needs to adopt the modern BJR or not.

As noted in chapter 3, conflict of interest is inherent in M&A transactions and as a result thereof, Delaware courts have deviated from the application of the traditional BJR and instead applied either one of the EFD, Revlon Standard or the Unocal standard, depending on the facts of the case. However, as previously noted, Delaware courts opted for this because they felt that shareholders needed more protection.⁷⁴⁶ This then brings the topic to the question as to whether shareholders need more protection in South Africa particularly as far as M&A transactions are concerned.

It is rather obvious that the first remedy available to the shareholders in M&A transactions would be section 77 which enables shareholders to hold directors liable for the breach of fiduciary duties or the duty of care, skill and diligence.⁷⁴⁷ However, section 163 of the New Act, furthermore provides that shareholders are entitled to relief from oppressive or prejudicial conduct or from the abuse of the separate juristic personality of the company.⁷⁴⁸ This section protects shareholders in instances where directors exercise their powers in a manner that is oppressive or unfairly prejudicial or that unfairly disregards the interests of the shareholders.⁷⁴⁹ The above stated section also makes reference to section 162 of the New

⁷⁴⁵ Jarrett T 'Surviving Enhanced Judicial Scrutiny of Directors' Decisions—Reaching the Protection of the Business Judgment Rule (1995) 60 *Missouri Law Review* 677.

⁷⁴⁶ Jarrett T 'Surviving Enhanced Judicial Scrutiny of Directors' Decisions—Reaching the Protection of the Business Judgment Rule (1995) 60 *Missouri Law Review* 677.

⁷⁴⁷ Companies Act 71 of 2008.

⁷⁴⁸ Abbey N *An Insightful Study of the Oppression Remedy under South African and Canadian Corporate Law* (published LLM thesis, University of Western Ontario, 2012) 94 (hereafter referred to as Abbey N (2012)).

⁷⁴⁹ Abbey N (2012) 94.

Act as it enables the court to declare a person delinquent or under probation if he or she acted contrary to section 163 mentioned above.⁷⁵⁰ This then provides clarity that shareholders are also entitled to rely on section 162 of the New Act in M&A transactions. Other than the aforementioned applicable remedies, the statutory merger procedure as provided in the New Act has inherent protective measures.⁷⁵¹ The first protective measure available is shareholder approval which requires shareholders to approve the merger agreement prior to the merger taking place.⁷⁵² This is a vital safeguard for shareholders.⁷⁵³ The second measure is provided in section 164 of the New Act which provides dissenting shareholders with appraisal rights thereby enabling them to have their shares bought out by the company in cash, at a price reflecting the fair value of the shares.⁷⁵⁴ In doing so, the dissenting shareholders opt out of the merger.⁷⁵⁵ The third measure available to shareholders is the requirement to obtain the court's approval.⁷⁵⁶ It should be noted that this measure is not a general requirement for statutory mergers as it is only required in certain circumstances. The court is able to prevent the merger from taking place.⁷⁵⁷ With all the protective measures available to shareholders in M&A transactions, it makes it questionable as to whether it is necessary to adopt the modern BJR in South Africa. This will be further addressed in the subsequent chapter.

Delaware courts made a decision to apply the traditional BJR or alternatively the EFD to insolvent trading. In Delaware, directors of insolvent companies can continue to trade and in instances where shareholders or creditors allege that directors have breached one or more of their fiduciary duties, the directors could rely on the BJR.⁷⁵⁸ This could be difficult to do in South Africa as section 22(2) of the New Act enables the Commission to prohibit a company

⁷⁵⁰ Abbey N (2012) 95.

⁷⁵¹ Cassim F et al (2012) 700.

⁷⁵² Cassim F et al (2012) 700.

⁷⁵³ Cassim F et al (2012) 700.

⁷⁵⁴ Coetzee W & Rankine T 'Minority Protection under the Companies Act 71 of 2008' available at <http://www.wylie.co.za/Newsletter/42> (accessed on 21 October 2016).

⁷⁵⁵ Coetzee W & Rankine T 'Minority Protection under the Companies Act 71 of 2008' available at <http://www.wylie.co.za/Newsletter/42> (accessed on 21 October 2016).

⁷⁵⁶ Lomax R 'Mergers and Acquisitions' available at <http://www.nortonrosefulbright.com/knowledge/publications/127038/mergers-and-acquisitions> (accessed on 21 October 2016).

⁷⁵⁷ Lomax R 'Mergers and Acquisitions' available at <http://www.nortonrosefulbright.com/knowledge/publications/127038/mergers-and-acquisitions> (accessed on 21 October 2016).

⁷⁵⁸ Kozlov H, Farber E & Levitan S 'Delaware Court Confirms the Applicability of Business Judgment Rule to Investment Decisions of Insolvent Corporations' available at <https://www.reedsmith.com/Delaware-Court-Confirms-Applicability-of-Business-Judgment-Rule-to-Investment-Decisions-of-Insolvent-Corporations-10-23-2014/> (accessed on 21 October 2016).

from trading, provided that the Commission has reason to believe that the company is unable to pay its debts as they become due and payable.⁷⁵⁹ Section 77(3)(b) of the New Act furthermore supports section 22(2) mentioned above, as it allows directors to incur liability if they carried on the company's business despite knowing that it was being conducted in a manner prohibited by section 22(2).⁷⁶⁰ This differs quite dramatically from the Delaware approach as companies are still allowed to trade in a manner which could potentially place the company in a position in which it can pay its debts as they become due.

Furthermore, section 162(5)(c)(iv) deals with the delinquency and probation of directors. In essence what it provides is that directors can be declared delinquent or placed on probation if they acted in a manner that amounted to gross negligence, wilful misconduct and breach of trust whilst performing their functions and duties as directors.⁷⁶¹ In considering this in relation to section 22(2) of the New Act, it is evident that if the director continued the operations of the company recklessly, with gross negligence or with the intent to defraud any person, it is highly likely that the director will be declared delinquent or alternatively be placed on probation depending on the grounds present in the case before the court.⁷⁶² The grounds will determine whether the court will deem delinquency or probation suitable for the matter at hand.⁷⁶³ For purposes of clarity, when a director is declared delinquent it means that he is disqualified from being a director and this disqualification could subsist for 7 years or more or it could last a lifetime.⁷⁶⁴ The probation order on the other hand, prohibits the person from serving as a director but this can be subject to certain conditions provided in the order.⁷⁶⁵

The aforementioned makes it clear that as far as insolvent trading is concerned, sections 22(2), 77(3)(b) as well as 162(5)(c)(iv) of the New Act, provides shareholders with sufficient protection in that they have various avenues with which they can hold directors

⁷⁵⁹ Roodt J & Cohen J 'The provisions of the Companies Act of 2008 in regard to trading whilst insolvent' available at <http://www.roodtinc.com/newsletter64.asp> (accessed on 19 September 2016).

⁷⁶⁰ Companies Act 71 of 2008.

⁷⁶¹ Companies Act 71 of 2008.

⁷⁶² Companies Act 71 of 2008.

⁷⁶³ Cassim R 'Delinquent Directors under the Companies Act 71 of 2008' available at <http://www.saflii.org/za/journals/DEREBUS/2013/14.html> (accessed on 21 October 2016).

⁷⁶⁴ Bouwman J McFie K 'Company directors face the wrath of stakeholders and regulators' available at <http://www.lexology.com/library/detail.aspx?g=5534b8d6-1a64-4f02-8a00-56b8dcf3d4f3> (accessed on 21 October 2016).

⁷⁶⁵ Cliffe Dekker Hofmeyr 'Corporate Governance: A guide for directors' available at <https://www.cliffedekkerhofmeyr.com/export/sites/cdh/en/sectors/downloads/Corporate-governance-A-directors-guide> (accessed on 21 October 2016).

liable. As a result thereof, it is clear that as far as insolvent trading is concerned, it will not be necessary to adopt enhanced standards of judicial scrutiny as shareholders are afforded sufficient protection by the three sections provided above.

As noted in chapter 3, the term ‘zone of insolvency’ is commonly used in Delaware as it refers to a company moving back and forth between solvency and insolvency.⁷⁶⁶ In these instances, the company is under financial distress but is on the brink of insolvency and not yet insolvent.⁷⁶⁷ In South Africa, business rescue could be seen as the equivalent to the zone of insolvency. The reason for this is that although the company is under financial distress, measures are taken in order to rescue the company from becoming insolvent.⁷⁶⁸ The difference with business rescue is that once the board of directors determine that the company begin business rescue, a practitioner will be appointed in order to oversee the company throughout the business rescue proceedings.⁷⁶⁹ Section 137 of the New Act makes it clear that directors continue to exercise their functions as directors but this is done subject to the authority of the practitioner.⁷⁷⁰ As long as this takes place, section 137(1)(d) provides that the directors will be relieved from the duties provided in section 76 as well as certain liabilities set out in section 77 of the New Act.⁷⁷¹ However, what if the board is aware that the company is under financial distress yet it fails to rely on business rescue proceedings? It would only make sense for directors to continue performing their duties as set out in section 76 of the New Act in order to ensure that the company is no longer on the brink of insolvency. In essence, directors will be entitled to rely on the BJR as they are still expected to perform their fiduciary duties in the aforementioned instance and will not be relieved from liability as provided in section 137(1)(d).

The following chapter will make recommendations as to how South African courts could deal with the aforementioned concerns. However, prior to moving on to chapter 5, it is

⁷⁶⁶ Rutherford B. Campbell, Jr. & Christopher W. Frost, Managers’ Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere) (2007) 32 *Journal of Corporation Law* 491, 493.

⁷⁶⁷ Nemeroff M, Prezant E & Lewis A ‘Director’s Duties in the Zone of Insolvency: A Practical Guide’ available at <http://www.vedderprice.com/files/Publication/79f488ef-d725-4b12-b3b3-77147b34172d/Presentation/PublicationAttachment/2ed41bda-b06e-4031-85db-edf3e36434d6/Directors%E2%80%99%20Duties%20in%20the%20Zone%20of%20Insolvency%20-%20A%20Practical%20Guide.pdf> (accessed on 15 August 2016).

⁷⁶⁸ Thulo L ‘All your big business rescue questions answered’ available at <http://www.smesouthafrica.co.za/15452/All-your-big-business-rescue-questions-answered/> (accessed on 22 November 2016).

⁷⁶⁹ Section 129 of the Companies Act 71 of 2008.

⁷⁷⁰ Companies Act 71 of 2008.

⁷⁷¹ Companies Act 71 of 2008.

necessary to consider the differences between the Delaware and South African BJR. In doing so, reference will be made to chapter 2 and 3 and important concerns will be highlighted.

4.9 DIFFERENCES BETWEEN THE DELAWARE AND SOUTH AFRICAN BUSINESS JUDGMENT RULE

It should be noted that the interpretation and application of the BJR has only been briefly addressed in one case, namely, the *Visser Citrus* case.⁷⁷² However, when South African courts begin dealing with the rule in further detail, there is no doubt that they will refer to foreign judgments in order to obtain an understanding of the rule and how it should be interpreted and applied.⁷⁷³ This section of the chapter will consider the main differences between the rule in Delaware and the rule in South Africa.

4.9.1 Exclusion of Good Faith

In referring back to chapter 2 of this dissertation, it is clear that the Delaware case law formulation of the BJR expressly includes good faith as a requirement to be met in order to be protected by the BJR. However, if reference is made to section 76(4) of the Companies Act 71 of 2008, it is evident that only three requirements are provided in the section in order for directors to receive the protection afforded by the rule.⁷⁷⁴ However, it is important to note that section 76(4) of the above stated Act, fails to expressly provide good faith as a requirement.⁷⁷⁵ In essence, as stated by academics, the BJR as provided in section 76(4) of the New Act, only provides for the duty of care, skill and diligence as well as the duty to act in the best interest of the company.⁷⁷⁶ Some might see the exclusion of the duty of good faith as a concern as the duty is referred to as the most fundamental duty which directors are expected to adhere to whilst others might adopt a contrasting view. Each potential view will be discussed below.

⁷⁷² *Visser Citrus (Pty) Ltd v Goede Hoop Citrus (Pty) Ltd and Others* 2014 (5) SA 179 (WCC) 28.

⁷⁷³ Schoeman-Louw N 'The business judgment rule: how the Companies Act of 2008 is impacting directors' duties' available at <http://www.polity.org.za/article/the-business-judgment-rule-how-the-companies-act-of-2008-is-impacting-on-directors-duties-2013-08-07> (accessed on 12 September 2016).

⁷⁷⁴ Companies Act 71 of 2008.

⁷⁷⁵ Companies Act 71 of 2008) (Section 76(4) provides three requirements which a director needs to satisfy in order to be protected by the rule. However, these requirements do not expressly include good faith as a requirement which directors need to satisfy.)

⁷⁷⁶ Muswaka L (2013) 89.

Although there are several reasons as to why the duty of good faith is desirable, it could be argued that there are reasons as to why the legislature did not include the duty as a BJR requirement. In referring back to chapter 2, it was stated that bad faith refers to ‘improper motives or personal gain as well as arbitrary actions or conscious disregard for the interests of the corporation including the rights of stockholders’.⁷⁷⁷ Although the statement defines bad faith, it is evident that the statement contains an aspect of the duty to act in the best interest of the company.⁷⁷⁸ Some commentators could argue that the duty of good faith and the duty to act in the best interest of the company are so interrelated, that it is not necessary to expressly include good faith as a requirement for the BJR. They could further argue that the expectation of directors to act in the best interest of the company can only be satisfied if the directors acted in good faith. The common law supports this argument as it furthermore links the duty of good faith to the duty to act in the best interest of the company.⁷⁷⁹

On the other hand, commentators could argue that the failure to include good faith as a requirement in section 76(4) of the New Act is alarming. In the *Visser Citrus* case, which is currently the only case addressing the section 76(4), the court continuously highlights the importance of good faith in order to be protected by the rule.⁷⁸⁰ The court in *Visser Citrus* remains adamant on the importance of good faith expected from directors.⁷⁸¹ Among these reasons is the failure of duties such as the duty of care and the duty of loyalty, to cover all types of improper conduct by directors.⁷⁸² Certain types of misconduct fall outside the sphere of the duty of care and the duty of loyalty whilst most types of misconduct fall within the duty of good faith.⁷⁸³ Furthermore, in certain instances, even if a director acted negligently or was interested in a transaction, there are rules which limit the director’s accountability.⁷⁸⁴ For example if a director has a personal interest in the matter, the New Act provides that if the interest is approved by the board, he will not incur liability.⁷⁸⁵

⁷⁷⁷ Rossi F ‘Making sense of the Delaware Supreme Court’s Triad of Fiduciary Duties’ available at <http://poseidon01.ssrn.com/delivery.php> (accessed on 23 June 2016).

⁷⁷⁸ Rossi F ‘Making sense of the Delaware Supreme Court’s Triad of Fiduciary Duties’ available at <http://poseidon01.ssrn.com/delivery.php> (accessed on 23 June 2016).

⁷⁷⁹ *Da Silva and others v C H Chemicals (Pty) 2008 (6) SA 620 (SCA)*.

⁷⁸⁰ *Visser Citrus (Pty) Ltd v Goede Hoop Citrus (Pty) Ltd and Others 2014 (5) SA 179 (WCC)*.

⁷⁸¹ *Visser Citrus (Pty) Ltd v Goede Hoop Citrus (Pty) Ltd and Others 2014 (5) SA 179 (WCC)*.

⁷⁸² Eisenberg M ‘The Duty of Good Faith in Corporate Law’ (2006) 31 *Delaware Journal of Corporate Law* 2 (hereafter referred to as Eisenberg M (2006)).

⁷⁸³ Eisenberg M (2006) 2.

⁷⁸⁴ Eisenberg M (2006) 29.

⁷⁸⁵ Companies Act 71 of 2008.

It has thus been argued that the limits applicable to duties such as the duty of care and the duty of loyalty should not be applicable to the duty of good faith as this duty plays a prominent role and if a director acted in bad faith, his conduct involves a high degree of wrongfulness and should not be excused from liability.⁷⁸⁶ Conduct that lacks good faith should not be protected by the BJR and should thus not be shielded from judicial review merely because it had been approved by the rest of the board.⁷⁸⁷

In Delaware, the focus on good faith has increased as a result of damages as a remedy against directors who have acted in bad faith.⁷⁸⁸ Delaware courts have referred to good faith as a potential avenue for plaintiffs seeking to take action against directors' decisions.⁷⁸⁹ In other words, plaintiffs can institute action based on an allegation that the directors lacked good faith when making a business decision.⁷⁹⁰ With the absence of the requirement of good faith in section 76(4) of the New Act, although shareholders have an avenue in which they can hold directors liable for the breach of fiduciary duties and the duty of care, skill and diligence, directors will not be able to rely on the BJR if shareholders allege that the directors have breached the duty of good faith.⁷⁹¹ This is because the BJR only emphasises the duty of care and skill as well as the duty to act in the best interest of the company.⁷⁹² Therefore the director could have acted in good faith and not be protected by the rule, or alternatively could have acted mala fide and still be protected. This is because the failure to include good faith does not necessarily require the court to question whether the director acted in good faith when applying the BJR. This is the potential risk of the failure to include good faith as a requirement to be met by directors in order to be protected by the rule.

Based on the aforementioned, it is evident that there could be contrasting views regarding the exclusion of good faith from the BJR as provided in the New Act. This will be touched on in

⁷⁸⁶ Eisenberg M (2006) 29.

⁷⁸⁷ Eisenberg M (2006) 29.

⁷⁸⁸ Tumas M et al 'The Omnipresent Specter of the Duty of Good Faith: *Do Directors Have Reason to Worry?*' available at <http://www.potteranderson.com/newsroom-publications-150.html> (accessed on 19 September 2016).

⁷⁸⁹ Tumas M et al 'The Omnipresent Specter of the Duty of Good Faith: *Do Directors Have Reason to Worry?*' available at <http://www.potteranderson.com/newsroom-publications-150.html> (accessed on 19 September 2016).

⁷⁹⁰ Tumas M et al 'The Omnipresent Specter of the Duty of Good Faith: *Do Directors Have Reason to Worry?*' available at <http://www.potteranderson.com/newsroom-publications-150.html> (accessed on 19 September 2016).

⁷⁹¹ *Grossbauer J & Waterman N 'The (No Longer) Overlooked Duty of Good Faith Under Delaware Law'* available at <http://www.potteranderson.com/newsroom-publications-159.html> (accessed on 19 September 2016).

⁷⁹² Muswaka L (2013) 89.

Chapter 5 and recommendations will be made as to what can and should be done regarding the exclusion

4.9.2 Duty of Care, Skill and Diligence

A further distinction concerns the duty of care and skill. Based on the previous discussions on the said duty in South Africa, it is clear that the duty has become far more stringent ever since it has been partially codified in the New Act.⁷⁹³ Furthermore, in South Africa, there is a clear distinction between a director's fiduciary duty and his duty of care and skill.⁷⁹⁴ On the other hand, in America, the distinction between the fiduciary duty and the duty of care and skill has been blurred upon the introduction of the BJR.⁷⁹⁵ Therefore, uncertainty exists as to whether the duty of care and skill in America, is a fiduciary duty or not.⁷⁹⁶ The aforementioned demonstrates that there is a tremendous difference between the American law on directors' duties and the South African law on directors' duties.⁷⁹⁷ Not only does the duty of care in America and South Africa differ in the aforementioned sense, it also differs in the sense that the South African duty of care consists of both subjective and objective elements whereas the duty in America, specifically Delaware, only consists of objective elements.⁷⁹⁸ South Africa's duty of care is subjective as it focuses on the skill and experience of the director in question.⁷⁹⁹ The objective aspect of the duty provides a minimum standard that all directors are expected to meet.⁸⁰⁰ However, in Delaware, the duty of care is only objective as it provides a minimum standard that the directors are required to satisfy.⁸⁰¹ This standard, as previously mentioned, enquires whether the director in question

⁷⁹³ Kanamugire J & Chimuka T (2014) 73.

⁷⁹⁴ Jones E (2007) 327.

⁷⁹⁵ Jones E (2007) 327.

⁷⁹⁶ Jones E (2007) 335.

⁷⁹⁷ Jones E (2007) 327.

⁷⁹⁸ Bradshaw G 'Duty of Care and Duty of Loyalty owed by Directors in Delaware' available at <http://bradshawlawgroup.com/duty-of-care-and-duty-of-loyalty-owed-by-directors-in-delaware/> (accessed on 12 September 2016).

⁷⁹⁹ Barends R 'Partial Codification of Directors Duty of Care and Skill in terms of the Companies Act 71 of 2008' available at <http://www.stbb.co.za/blog/partial-codification-directors-duty-care-skill-terms-companies-act-71-2008/> (accessed on 12 September 2016).

⁸⁰⁰ Barends R 'Partial Codification of Directors Duty of Care and Skill in terms of the Companies Act 71 of 2008' available at <http://www.stbb.co.za/blog/partial-codification-directors-duty-care-skill-terms-companies-act-71-2008/> (accessed on 12 September 2016).

⁸⁰¹ Bradshaw G 'Duty of Care and Duty of Loyalty owed by Directors in Delaware' available at <http://bradshawlawgroup.com/duty-of-care-and-duty-of-loyalty-owed-by-directors-in-delaware/> (accessed on 12 September 2016).

acted in the same manner as an ordinarily careful and prudent person in similar circumstances.⁸⁰²

4.9.3 The Modern Business Judgment Rule

As previously mentioned another difference between the rule in South Africa and in Delaware is the failure of South Africa to make provision for the modern BJR which consists of heightened judicial scrutiny of business decisions. Included in the modern rule are the EFD, the Unocal Standard as well as the Revlon Standard.⁸⁰³ These standards were adopted when Delaware courts realised that there are certain transactions in which it would be insufficient to merely apply the traditional, straightforward BJR.⁸⁰⁴ As discussed in chapter 3, these transactions include mergers and acquisitions as well as insolvent trading. Mergers and acquisitions in particular consist of inherent conflict of interest on behalf of the directors.⁸⁰⁵ Delaware courts went further to apply the BJR to insolvent trading. As mentioned earlier in this chapter, there is currently no certainty as to whether South African courts will opt for the modern BJR in certain transactions. Chapter 5 will consider whether and why it would be a good idea for South African courts to adopt the modern BJR.

4.10 CONCLUSION

The aspects covered in this chapter provide an understanding as to why and how the BJR was incorporated into South African law. It has been highlighted that the rule was introduced in order to afford directors with more protection in instances where they are expected to make risky business decisions which can ultimately be beneficial to the company. One of the alarming points highlighted is the fact that the rule is relatively new in South Africa and as a result thereof, more courts are yet to apply and interpret the BJR. This might be challenging considering the fact that Delaware courts have been applying a heightened standard of review in certain transactions, specifically

⁸⁰² Bradshaw G 'Duty of Care and Duty of Loyalty owed by Directors in Delaware' available at <http://bradshawlawgroup.com/duty-of-care-and-duty-of-loyalty-owed-by-directors-in-delaware/> (accessed on 12 September 2016).

⁸⁰³ Hill C & Solomon S *Research Handbook on Mergers and Acquisitions* (2016) 270 (hereafter referred to as Hill C & Solomon S (2016)).

⁸⁰⁴ Hill C & Solomon S (2016) 270.

⁸⁰⁵ Hill C & Solomon S (2016) 270.

mergers and acquisitions and insolvent trading. At the moment there is no clarity as to whether our courts will adopt the same approach in these transactions and whether doing so would be possible. A further concern is that the South African formulation of the rule fails to include good faith as a requirement to be satisfied in order to be protected by the rule. Delaware differs in this sense as good faith is clearly stipulated as a requirement.

There are always contrasting views amongst academics regarding a certain topic and in this instance, contrasting views are bound to arise regarding the failure to include 'good faith' in section 76(4) of the New Act. This chapter highlights the potential differing views and chapter 5 will delve deeper into this issue by providing recommendations as to whether the aforementioned failure should be remedied and how it can be remedied.

Another important concern is whether South African courts should adopt the modern BJR in certain transactions. Certain transactions might necessitate heightened judicial review prior to the application of the BJR. In chapter 5, recommendations will be made as to whether and why South African courts should or should not adopt the modern rule which consists of the EFD, the Unocal Standard and the Revlon Standard. In doing so, reference will be made to chapter 3's discussion on the role and success of the aforementioned standards.

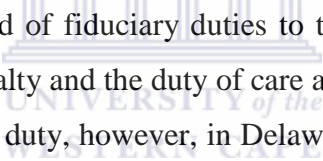
CHAPTER 5

CONCLUSIONS AND RECOMMENDATIONS

5.1 INTRODUCTION

The central focus of this dissertation is the interpretation and application of the BJR in SA law, with particular emphasis on its application to certain transactions which consist of mergers and acquisitions as well as insolvent trading. An analysis was conducted of the Delaware BJR as well as the South African formulation of the rule. This chapter will consist of two sections, namely, conclusions and recommendations. The conclusions will be based on the overall findings of the dissertation. The recommendations on the other hand will focus on three important concerns. Recommendations will be made regarding the interpretation of the BJR, the failure of the New Act to include 'good faith' in section 76(4) as well as whether the modern BJR should be incorporated into South African law.

5.2 CONCLUSIONS



In Delaware, directors owe a triad of fiduciary duties to the company which consist of the duty of good faith, the duty of loyalty and the duty of care and skill. At common law, the duty of care and skill is not a fiduciary duty, however, in Delaware the distinction became blurred and the duty now falls under fiduciary duties, hence Delaware courts referring to the fiduciary duties of directors as a 'triad of fiduciary duties'. This differs fundamentally from South African law as the duty of care, skill and diligence is not a fiduciary duty and the distinction is quite clear. In Delaware, the duty of good faith was not a fiduciary duty on its own until the courts and academics realised the importance of the duty and as a result thereof, it became part of the directors' fiduciary duties. Delaware courts found that in instances where these duties are breached, directors can incur personal liability but this changed when the traditional BJR was introduced. The purpose of the introduction of the BJR in Delaware was to promote risk taking, to ensure that competent directors are appointed, to prevent judicial encroachment and promote judicial efficiency and to achieve a compromise between the interests of the shareholders and directors.

Unlike the Delaware case law formulation of the BJR, the South African BJR is codified in the Companies Act 71 of 2008 and it is thus relatively new as it only came into effect in 2011. The BJR has only been addressed by one court in the case of *Visser Sitrus* and as a

result thereof, uncertainty remains as to how other courts will apply and interpret the rule. Further questions remain as to whether it is advisable for South African courts to adopt the modern BJR in certain merger and acquisition transactions, as mentioned above. The purpose of the introduction of the BJR is relatively the same as the Delaware purposes mentioned above. However, in South Africa, it was furthermore introduced to give effect to the objectives of the New Act. The Delaware and South African duties of directors are essentially the same however, they are phrased differently. In South Africa, the fiduciary duties consist of the duty to act in the best interest of the company, the duty to act in good faith and for proper purpose and the non-fiduciary duty is the duty to act with care, skill and diligence. Had directors allegedly breached one of the aforementioned duties in terms of common law, they could incur personal liability but this changed when the BJR was adopted from America and included in the New Act.

Although the author touches on the American BJR the lens is focused on the Delaware case law formulation of the rule. The reason for this is that Delaware courts initially relied solely on what is referred to as the traditional, straightforward BJR. This however changed when Delaware courts began expanding the rule thereby creating what is now referred to as the modern BJR and as this is the crux of the dissertation, it was necessary to focus on Delaware. It is for this very reason that the dissertation focuses on the Delaware case law formulation of the rule instead of the American Law Institute version. In deviating from the traditional BJR to the modern BJR, Delaware courts essentially deviated from the abstention doctrine approach of the rule to a standard of review approach. The reason for this is that Delaware courts felt that in certain transactions, judicial interference is necessary prior to the application of the traditional BJR as shareholders were in need of more protection against the actions of directors. These transactions consist of mergers and acquisitions, particularly hostile takeovers and sale of control transactions as well as insolvent trading.

The modern BJR adopted by Delaware courts consist of the Entire Fairness Standard, the Revlon Standard as well as the Unocal Standard. The purpose of the modern BJR was to have more stringent standards in place as it was warranted by the aforementioned transactions. There are instances in which the application of the traditional BJR could place shareholders at an unfair disadvantage as directors could possibly be protected when they do not deserve the protection. Each of the above mentioned standards is applied depending on the facts of the case at hand. The author illustrates in chapter 3 that in instances where the directors' loyalty

is being challenged, the Delaware courts would apply the EFD. If the case concerns a hostile takeover, the Unocal standard will find application and in instances where the case deals with a sale of control, the courts will apply the Revlon standard. Therefore, as far as mergers and acquisitions are concerned, the courts would opt for either one of the aforementioned standards which as previously mentioned, depends largely on the facts of the case at hand. This means that directors would need to meet certain requirements before the BJR can be applied by the court. In South Africa, uncertainty still lingers around the incorporation of the modern BJR but recommendations will later be made as to how this could be dealt with.

The research has further indicated that although the aforementioned standards are not applied to insolvent trading, instead, Delaware courts have decided to apply the traditional BJR in these instances. This is one of the concerns when looking at South African law. The difference in South Africa is that there are instances in which directors will be prohibited from continuing the business when the corporation is insolvent and cannot pay its debts as they become due. In Delaware on the other hand, directors are still entitled to make business decisions in instances where a company is unable to pay its debts provided that the aim of continuing business operations is to move away from insolvency. In order to rely on the BJR, directors need to prove that the business decision was made to benefit the corporation as a whole. It should however be borne in mind that directors of insolvent corporations still need to prove that they made an informed business decision, in good faith and in the honest belief that it would be in the best interest of the company.

The aforementioned requirements of the Delaware BJR clearly indicate that good faith is a requirement. Chapter 4 reiterates the failure of the Companies Act 71 of 2008 to include good faith as a requirement in section 76(4) which contains the statutory codification of the BJR. In South Africa, good faith is the core and overarching duty from which all the other duties flow and the *Visser Sitrus* case emphasises the importance of this duty when directors perform all other duties. Much emphasis is placed on the duty in South Africa as it is interrelated with the duty to act in the best interest of the company, the duty to act with proper purpose as well as the duty to act with care. The author highlights opposing views pertaining to the exclusion of good faith. On the one side, commentators could argue that the current requirements in the BJR as formulated in section 76(4) of the New Act are sufficiently linked to good faith and as a result thereof, it is not necessary to expressly include good faith. On the other hand, there

could be a group of commentators that disagree and feel that the absence of good faith is rather alarming as it is the most fundamental fiduciary duty in South Africa.

The aforementioned conclusions highlight all the main and important findings in the dissertation. It demonstrates that the dissertation focused on both the Delaware and South African formulation of the BJR. The author continuously focuses on what Delaware courts refer to as the modern BJR as it is questionable as to whether South Africa will follow the same approach when dealing with certain business transactions. Further emphasis is placed on the failure to include good faith as a requirement in section 76(4) of the Companies Act 71 of 2008. The next section of this chapter will thus focus on the recommendations pertaining to the interpretation of the BJR in SA law, the possible adoption of the modern BJR as well as the exclusion of good faith from section 76(4) of the above stated Act. In doing so, reference will be made to chapter 3 and 4 which contains arguments pertaining to the above concerns, respectively.

5.3 RECOMMENDATIONS

5.3.1 Interpretation of the traditional BJR

An important aspect which could attract attention in the near future is the interpretation of the term 'rational' in the BJR as provided in section 76(4). There has been a vast amount of uncertainty and difficulties regarding the interpretation of this term as a result of the contrasting views pertaining to it. These contrasting views have often blurred the difference between the term 'reasonable' and 'rational'. In some instances, commentators were of the view that the reasonable standards are not any different from the rational standards thereby implying that the two terms are exactly the same. However, the court in the *Visser Sitrus*, with reference to other cases, provided some clarity on the matter.

As discussed in chapter 4, the *Visser Sitrus* made it clear that when determining what is meant by rational as far as it relates to directors, it is necessary to look at how the term was defined in so far as it relates to public power. In doing so, the court found that when speaking about rational in the sense of company law, it is clear that the term refers to the link between the power exercised by the director and the purposes for which the power was given to the director. In instances where there is a sufficient link between the two as provided in the

Minister of Defence and Military Veterans v Motau and Others case, the court will find the directors' decision to have been rational.

Based on the aforementioned, it is advisable that in future, courts make specific reference to the *Visser Sitrus* case when interpreting the rational requirement provided in section 76(4) of the New Act. This case provides detailed guidelines as to how a court should determine whether a decision was rational or not. However, courts should not restrict themselves to this case alone, as they have the freedom to make reference to international cases such as *ASIC v Rich*. This should be done when dealing with the interpretation of the BJR in its entirety. Courts should make reference to international cases in order to effectively analyse and interpret the BJR. This is confirmed by section 39 of the 1996 Constitution of the Republic of South Africa as well as sections 5 and 7 of the new Companies Act itself.

5.3.2 Application of the modern BJR in certain transactions

As previously mentioned South Africa currently only has the traditional BJR codified in the New Act as the rule is still relatively new. In referring back to chapter 3 it is evident that Delaware courts felt that in certain transactions it would be necessary to take additional precautions to balance the interests between the shareholders and directors. Yes, the traditional BJR protects directors, but there are certain transactions which require a heightened standard of judicial review in order to provide shareholders with more protection. In mergers and acquisitions for example, conflict of interest is inherent in those transactions and if Delaware courts were to merely apply the traditional BJR, directors could easily escape liability. The same could be said for South African directors and M&A transactions. With the traditional BJR being so new in South Africa, it would be advisable for SA courts to focus on the application and interpretation of this version of the rule prior to considering the modern BJR. The reason for the aforementioned is that there is still no certainty as to how SA courts will deal with the rule and whether it will be successful in South Africa, especially considering the failure to include good faith as a requirement to be protected by the rule. Although the *Visser Sitrus* case has dealt with the BJR, it did not deal with it in sufficient detail to create clarity regarding the rule. It is still very possible that courts will encounter some problems with applying and interpreting the BJR, especially with having to refer to Delaware and other foreign judgments. It could still take years for the courts to resolve the uncertainties currently pertaining to the South African BJR but once these uncertainties have

been seen to and the success of the rule has been established, courts might begin looking at the modern BJR. Each standard, namely, the EFD, the Unocal Standard and the Revlon Standard plays an essential role and are effective depending on the circumstances of the case. In Delaware, courts have been successful in applying each of the above stated standards and it can be argued that this success only occurred upon Delaware courts mastering the application of the traditional BJR. This provides even more reason for SA courts to first focus on the rule as provided in section 76(4) prior to focusing on a heightened standard of judicial review. In the interim, SA courts should apply the traditional version of the rule as provided in the New Act, to M&A transactions.

The question which then arises is whether it is actually necessary for South African courts to adopt the modern BJR in M&A transactions. Based on the discussion provided in chapter 4 of this dissertation, it is evident that there are a number of protective remedies available to shareholders in M&A transactions. These remedies include section 77 and 163 of the New Act as well as other remedies which are inherent in the statutory M&A process, such as, shareholder approval, appraisal rights and court approval. With all these measures in place, it is clear that the legislature ensured that shareholders were afforded protection in M&A transactions. It could be assumed that the legislature was fully aware of the dangers inherent in these transaction hence the provision of the aforementioned remedies. This thus makes it questionable as to whether it is actually necessary for the modern BJR to be adopted. For example, if the shareholders approve the M&A transactions, with full knowledge of the risks involved, it would be unfair to expect a more onerous standard to be placed on the directors by relying on enhanced standards of judicial scrutiny. This would unfairly provide shareholders with extra protection which in essence could be defeating the purposes of the traditional BJR.

A further question revolves around the application of the modern BJR to insolvent trading. As mentioned in chapter 4, there are certain instances in which insolvent trading is prohibited by the New Act. Again, in order to determine whether it is necessary to adopt enhanced judicial scrutiny standards in cases dealing with insolvent trading transactions, it is necessary to consider the protection afforded to shareholders in these instances. Although in Delaware, directors of insolvent companies are still entitled to trade, the situation is slightly different in South Africa. Section 22(2) of the New Act is one of the protective measures available to the shareholders and creditors in these instances as it entitles the Commission to prohibit

directors from trading when a company is insolvent. A further protective measure provided to shareholders is contained in section 77(3)(b) of the New Act which makes provision for directors to be held liable if they continued to trade after being prohibited from doing so. However, in instances where the Commission does not prohibit trading and the company is insolvent, the directors will be in a position to continue trading and in essence, will be protected by the BJR. It should be borne in mind that this will only happen in exceptional instances in which the Commission fails to pick up that the company is not in a position to trade and thus fails to prohibit trading in terms of section 77(3)(b) of the New Act. Lastly, section 162(5)(c)(iv) of the New Act, furthermore entitles shareholders to have directors be declared delinquent or placed under probation. With these remedies in place protecting shareholders, it is evident that all odds are against directors and shareholders are provided with sufficient protection in instances which involve insolvent trading. Hence, in order to ensure equal protection amongst shareholders and directors, it will not be necessary to adopt the modern BJR in cases dealing with insolvent trading. Directors however, should be entitled to rely on the traditional BJR without any enhanced standards of judicial scrutiny brought about by the modern BJR.

Furthermore, as mentioned in chapter 4, business rescue in South Africa may be seen as the equivalent to the zone of insolvency in Delaware. As noted in chapter 4, if directors decided to place the company under business rescue and a practitioner is appointed, the directors will be relieved from their duties in terms of section 76 and certain liabilities as provided in the New Act. Although they are relieved from their duties and certain liabilities, if directors fail to perform in the required manner, the practitioner may apply for a court order to remove the directors from office. Furthermore, if the directors fail to place the company under business rescue proceedings they will be required to continue performing their duties as provided in section 76 of the New Act. This means that directors can incur liability and should thus be entitled to rely on the BJR. Based on the aforementioned, it is evident that the shareholders receive sufficient protection as the New Act provides shareholders with a number of remedies should directors fail to perform their duties. Furthermore, directors can be removed from office if they fail to act in the required manner. On the other hand, directors also receive sufficient protection as they are relieved from liabilities when a practitioner is appointed to oversee the business rescue proceedings and they are further protected by the BJR if they do not place the business under business rescue, but continue performing their duties in order to save the company. As a result of the aforementioned, it is thus not necessary to rely on

enhanced standards of judicial scrutiny in these instances as both the shareholders and directors are sufficiently protected.

5.3.3 Exclusion of Good Faith

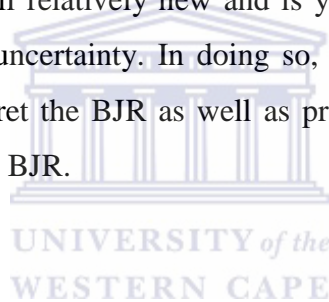
The exclusion of good faith is an issue of great concern and reference will be made to the arguments contained in the previous chapter. As mentioned, there are usually contrasting views by academics pertaining to a certain issue. In chapter 4 the author provided two differing perspectives but the perspective the author is in agreement with is that the failure to include good faith in section 76(4) is a concern. With good faith being the most fundamental and central fiduciary duty from which all other duties flow, it is only common sense that the duty be expressly included in the aforementioned provision. It is nonsensical for a director to be protected by the BJR without having acted in good faith. Although Delaware does not necessarily view the duty of good faith as the fundamental fiduciary duty and only later made it a separate fiduciary duty, it illustrates that the courts still thought that it is important to expressly provide for the rule in the formulation of the BJR. If Delaware included it, it is a concern that South Africa failed to include it. The *Visser Sitrus* case was discussed quite a few times in the previous chapter as it is currently an important case in South Africa regarding section 76(4) of the New Act. The fact that the court continuously reiterates the good faith duty of directors throughout its judgment removes any doubt that good faith plays an extremely important role in directors' duties and this importance cannot be overlooked. It thus makes no sense as to why good faith is not included as a requirement in section 76(4).

One way in which this can be remedied is by the court reading in the term 'good faith' or alternatively, legislature can amend the New Act in order to include compliance with the duty of good faith as a requirement for reliance on the BJR in section 76(4).⁸⁰⁶ This amendment is essential as the failure to include good faith as a requirement can lead to serious implications as directors could escape liability for decisions which, although meet the requirements of the BJR, are decisions which lack good faith. A further implication is that although shareholders have good faith available as an avenue to hold directors liable, directors could possibly incur liability although they acted in good faith as a result of it not being a requirement of the BJR

⁸⁰⁶ Mqoke R 'Legal Theory 2: Legal Interpretation' available at <https://www.ru.ac.za/media/rhodesuniversity/content/law/documents/10-students/2013courseoutlines/Legal%20Interpretation.pdf> (accessed on 23 September 2016).

as provided in section 76(4). Alternatively, directors will be protected by the rule although they acted *mala fide* as courts will not be obliged to enquire into whether directors acted in good faith in order to be protected by the BJR.

In conclusion, the research conducted in this dissertation brings to light a number of concerns and unanswered questions pertaining to the BJR as provided in the New Act. As previously stated, the focus of this dissertation is whether the modern BJR should be incorporated into South African law. The aforementioned recommendations clearly indicate that it is not advisable or necessary for South African courts to adopt the modern BJR in certain fundamental transactions, namely, M&A transactions as well as insolvent trading. The main reason for this is that directors as well as shareholders receive sufficient protection and the New Act creates a balance between the protection provided to shareholders and the protection provided to directors. Furthermore, the courts need to focus on the BJR as provided in section 76(4) of the New Act as it is still relatively new and is yet to be relied upon by a director thereby resulting in the current uncertainty. In doing so, the courts will in the foreseeable future, be in a position to interpret the BJR as well as provide clarity as to the absence of good faith as a requirement of the BJR.



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