



Guidance for Boards

EXERCISING BUSINESS JUDGEMENT

A legal and governance framework

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The Board Governance Forum (the “Forum”) is constituted as a forum of the Institute of Directors in South Africa (“IoDSA”), and is sponsored by PwC. The activities of the Forum have specific focus on advancing corporate governance practices in South Africa by producing guidance papers and/or events for directors who serve on governing bodies.

The objective of the Forum is to serve as a platform for discussion and dissemination of guidance to directors serving on governing bodies, either in the form of papers or events.

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Introduction

Directors, whether executive or non-executive, are required to exercise their judgement as to the best decisions or courses of action available to a company. However, sometimes even the best laid plans fail, and, in such instances, the assessment of the appropriateness of the decisions taken by the directors is not based solely on the manner in which the decision turned out but are also based on the process that the directors followed in arriving at their decision.

This is the essence of the ‘business judgement rule’¹ which entered the South African legal lexicon with the arrival of the Companies Act, 2008² (‘the Act’). It has been heralded by many as the key form of protection for directors and allows them to make informed, reasonable judgements without the threat of liability for a potential negative outcome hanging over their heads. Section 76(4) can be invoked by directors as a defence in legal proceedings in the event that errors in judgement or business decisions by the board turn out to not have been in the best interests of the company. This rule protects directors against liability for errors in judgement, but its existence also protects companies against directors who are fearful of making decisions that carry risk. Business is about taking risk for reward and directors are therefore expected to take reasonable and well-considered risks to display “entrepreneurial flair” in the best interests of the company.

The rule contained within South African law is considered to be broader than the equivalent rule in other countries, as it is not limited to only actual decisions made by directors. Instead, in South Africa it applies more broadly to the exercise of powers and duties of directors in all its forms, including for example, knowingly allowing management to take a certain course of action without there being an explicit decision to that effect.

Whilst there has been much debate about how it will be applied by the courts, this paper seeks to provide a high-level overview of the rule and some practical considerations.

“Even though this paper follows the legal framework in the Act prescribed for companies, following these requirements is considered good practice that should be adopted also by the governing bodies of other types of organisations other than companies to protect themselves against errors in judgement. For clarity of drafting, we use the terms as in the Act, namely: “company”, “director” and “board” in this paper. Other organisations should apply these provisions with the necessary adaptations..”

It is critical to note that the business judgement rule can only be invoked if all of the conditions discussed below, as set out in the Act, have been complied with.

¹ Refer also to the article by du Plessis and Meaney published in ‘The Company Lawyer’ Issue 9, 2012 titled ‘Directors liability for approving financial statements containing blatant incorrect items: lessons from Australia for all directors in all jurisdictions’

² Companies Act 71 of 2008

Elements of the definition

Section 76 of the Act discusses directors' duties, and includes the following provisions:

Section 76(3) states that directors must perform their duties: -

- (a) in good faith and for a proper purpose;
- (b) in the best interests of the company; and
- (c) with the degree of care, skill and diligence that may reasonably be expected of a person carrying out the same functions in relation to the company as those carried out by that director; and having the general knowledge, skill and experience of that director.

The duties described above are subject to Subsections (4) and (5), which set out the circumstances which indicate whether a director is considered to have carried out these responsibilities appropriately.

Section 76(4) states that a director is considered to have satisfied the obligations of acting in the best interests of the company; and with the degree of care, skill and diligence that may reasonably be expected of a person carrying out the same functions in relation to the company as those carried out by that director; and having the general knowledge, skill and experience of that director if the director has:

1. taken reasonably diligent steps to become informed about the matter;
2. either—
 - (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
3. the director made a decision or supported a recommendation/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.

The key elements outlined above are discussed in more detail in the paragraphs below. (Section 76(5) is dealt with under the heading "Reliance on Information Prepared by Others".)

Taking reasonably diligent steps to be informed

The director and the board have a responsibility to be reasonably informed about the affairs of the company and the environment within which it operates. The company secretary or governance services professional plays an important role in keeping directors informed about the latest developments, be these are from an industry, regulatory or business trends perspective.

The responsibility to be informed is one that rests with the individual director. There is therefore a responsibility on the director to actively seek out information rather than being passively ignorant.

Principle 1 of King IV, that speaks to ethical and effective leadership, introduces the notion that the members of the governing body should individually and collectively cultivate certain characteristics and exhibit them in their conduct. One of these characteristics is competence which supports directors' responsibility to become informed. Competence is encapsulated as follows under Principle 1:

- “
- i. Members of the governing body should take steps to ensure that they have sufficient working knowledge of the organisation, its industry, the triple context in which it operates, the capitals it uses and affects as well as of the key laws, rules, codes and standards applicable to the organisation.
 - ii. Members of the governing body must act with due care, skill and diligence, and take reasonably diligent steps to become informed about matters for decision.
 - iii. Members of the governing body should continuously develop their competence to lead effectively.”

The various elements of “competence”, as understood in King IV and set out above, are aligned to the requirements in the Act pertaining to the business judgement rule. **King IV is applicable to all organisations** and is further support for the position taken in this paper that heeding the conditions in the Act for the business judgement rule to apply, is good practice for the governing bodies of all organisations in the execution of their duties and not only boards of companies.

The 2015 NACD Blue Ribbon Commission report, titled *The Board and Long-term Value Creation*³ says the following with regards to the pro-active stance by directors in becoming informed:

“Directors need to be active students of the business, seeking out information from multiple sources in preparation for boardroom discussions rather than being passive recipients of data from management. And rather than being dominated by retrospective analysis of past performance, board agendas should provide adequate time for substantive discussion of long-term strategic choices, risks and opportunities.”⁴

The report further states: “In order to build and maintain a sufficiently thorough understanding of the company’s business model and industry context, including current conditions and emerging trends, directors need to factor substantial preparation time into their board duties.”

The result of becoming informed is that knowledge is attained. The Act defines “knowing”, “knowingly” or “knows”, when used with respect to a person, and in relation to a particular matter, to mean that the person either:

- (a) had actual knowledge of the matter; or
- (b) was in a position in which the person reasonably ought to have—
 1. had actual knowledge;
 2. investigated the matter to an extent that would have provided the person with actual knowledge; or
 3. taken other measures which, if taken, would reasonably be expected to have provided the person with actual knowledge of the matter.

This concept of considering not only the information before the directors but rather also the broader concept of what ought to have been considered was also discussed by Scrutton LJ in *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd 1927 2 KB 9 (CA) at 23 -24*.

The aforementioned NACD Blue Ribbon Commission report on long-term value creation⁵ refers to outside sources of information that are available to directors. This points to a broad scope of information that directors could and, depending on the decision and situation, should consider in exercising oversight and making decisions as per this extract from the report:

³ See the executive summary of the report on [nacdonline.org](https://www.nacdonline.org/files/NACD%20BRC%20Long-Term%20Value%20Creation%20Executive%20Summary.pdf), page 2 <https://www.nacdonline.org/files/NACD%20BRC%20Long-Term%20Value%20Creation%20Executive%20Summary.pdf>

⁴ See the executive summary of the report on [nacdonline.org](https://www.nacdonline.org/files/NACD%20BRC%20Long-Term%20Value%20Creation%20Executive%20Summary.pdf), page 2.

⁵ Report of the NACD Blue Ribbon Commission on The Board and Long-Term Value Creation, page 15, Extract used with permission, full report available to members only.

Outside Information Sources

In order to be fully prepared for ongoing strategy discussions with management, directors can leverage information from the following sources:

- industry analysts (including those with positive and negative recommendations on the company);
- the company's investors, including portfolio managers and members of the corporate governance team;
- publicly available data on peer companies, again including the views of leading analysts;
- board's existing advisors, including the external audit firm, compensation consultant, investment bankers, equity and debt analysts, and outside counsel;
- trade publications, government data, and reports from subject-matter experts;
- director education programs; and
- conferences, trade shows, and webinars, or in-boardroom briefings from third-party experts that focus on emerging regional and/or international industry trends.

Internal sources of information include the following: formal briefings/reports and discussions with management, tours of the business operations and internal literature and communications. It is recommended that optimal use is made of technology to enable directors to engage with all sources of information, whether internal or external.

All of this does not imply that the director is expected to be a subject matter expert on all matters, but rather that the director should be sufficiently informed to interrogate the information and proposed decision or course of action.

Subject to the conditions explained in the section titled 'Reliance on information prepared by others' below, in assessing the requirement to be reasonably informed, the director is entitled to rely on information provided by others.

An important part of the assessment of being informed is not simply accepting information presented at face value but probing and forming one's own point of view before meetings so that the board meeting serves as an arena for robust discussion around an issue rather than it being the first time that the director has considered the impact of the issue on the business of the company.

The board should also ensure that sufficient time is devoted to those matters that are the most significant and that warrant the attention of the board, rather than consuming copious amounts of time on administrative items. Similarly, directors should ensure that they are given an opportunity to debate matters to the extent required.

Not having a material personal financial interest

The term "material personal financial interest" is defined in the Act and is narrower in scope than the broader term "conflict of interest". However, directors would be well advised to deal with both material personal financial interests as discussed below and other conflicts of interest, be they actual or perceived, in a manner that errs on the side of caution. If there is doubt as to whether an interest falls under the ambit of material personal financial interest, the prudent approach would be to declare it.

Section 75 of the Act deals with directors' personal financial interests. The term director here includes alternate directors, prescribed officers and members of committees of the board. It also applies to persons both individual and juristic, related to the director.

WHAT IS A PERSONAL FINANCIAL INTEREST?

The Act defines personal financial interest, when used with respect to any person, to mean:

- (a) a direct material interest of that person, of a financial, monetary or economic nature, or to which a monetary value may be attributed; but
- (b) does not include any interest held by a person in a unit trust or collective investment scheme in terms of the Collective Schemes Act, 2002 (Act No. 45 of 2002), unless that person has direct control over the investment decisions of that fund or investment.

However, since the concept of materiality is an important part of the definition of personal financial interest, it is important that the director is aware of what the Act defines as material, namely “as significant in the circumstances to a degree that is (a) of consequence in determining the matter; or (b) might reasonably affect a person’s judgement or decision-making in the matter.” The Corporate Governance Network has released a paper, titled *Conflicts of Interest*⁶, that is available on the IoDSA website which further discusses this broader definition of materiality.

EXEMPTIONS FROM SECTION 75

Section 75 discussed above does not apply to a director of a company in respect of a decision that may generally affect all of the directors of the company in their capacity as directors; or a class of persons, despite the fact that the director is one member of that class of persons, unless the only members of the class are the director or persons related or inter-related to the director.

Section 75 also does not apply to a company, or its director, if one person holds all of the beneficial interests of all of the issued securities of the company; and is the only director of that company.

WHO ARE RELATED PERSONS AS IT RELATES TO PERSONAL FINANCIAL INTEREST?

Furthermore, the requirements of Section 75(5) also extend to persons, related to the director, who have a personal financial interest in the matter. This extends the circle of influence that the director must consider in making the assessment of whether he or she is conflicted.

“Related persons” means persons who are connected to one another in any manner contemplated in Sections 2(1)(a)-(c) which states that:

- (a) an individual is related to another individual if they:
 - 1) are married, or live together in a relationship similar to marriage, or
 - 2) are separated by no more than two degrees of natural consanguinity or affinity
- (b) an individual is related to a juristic person if the individual directly or indirectly controls the juristic person as determined in Subsection 2

Additionally, Section 75(1)(b) includes in the definition of a related person any company or close corporation of which the director (or a related person) is also a director or member respectively.

In practice the director may or may not be aware of the interests of related persons in matters that are before the board. The director should take every reasonable step to obtain this information. The assessment as to whether the director has taken reasonable steps in this regard must be performed on a case by case basis.

⁶ https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/05E93ACB-10BE-4507-9601-307A66F34BD8/CGN_Position_Paper_5_Conflict_of_Interest.pdf

ACTIONS REQUIRED WHERE A PERSONAL FINANCIAL INTEREST IS PRESENT

Section 75(5) of the Act states that if a director of a company has a personal financial interest in respect of a matter to be considered at a meeting of the board, or knows that a related person has a personal financial interest in the matter, the director—

- (a) must disclose the interest and its general nature before the matter is considered at the meeting;
- (b) must disclose to the meeting any material information relating to the matter, and known to the director;
- (c) may disclose any observations or pertinent insights relating to the matter if requested to do so by the other directors;
- (d) if present at the meeting, must leave the meeting immediately after making any disclosure contemplated in paragraph (b) or (c);
- (e) must not take part in the consideration of the matter, except to the extent contemplated in paragraphs (b) and (c).

It is important to note that the obligation of the director to disclose material information that he or she is aware of relating to the matter does not imply that the director should lobby the remainder of the board on a position that is of benefit to that director. The director in this situation should only provide the pertinent facts relevant to his or her fiduciary duty.

This section does not cover the wider discussion around conflicts of interest.⁷

Rational basis for believing the decision was in the best interest of the company

The Oxford dictionary defines rational as being based on or in accordance with reason or logic. In assessing whether a decision the director has made is considered to be reasonable and logical, there must be a link between the action or decision that the director took and the information available and circumstances at the time.

The Australian Securities and Investments Commission v Healey⁸ case, generally known as the Centro decision, highlighted the fact that the director must have an enquiring mind and has a responsibility for ensuring that errors have been identified by asking appropriate questions of those that are experts in the field. Furthermore, the court held that each director must have a general understanding of all aspects of the business and not only in regards to that aspect of the business in which he or she has specialised or has expert knowledge.

RISK AND OPPORTUNITY GOVERNANCE

A reasonable basis for decision-making can never be established without a proper consideration of the balance of risks and opportunities posed by a decision or course of action. Boards and directors should appreciate that the execution of all directors' duties takes place against the broader backdrop of risk and opportunity management and governance. Once a decision is made or an action embarked upon, robust risk management and governance significantly increases the probability of a positive outcome. It is important therefore, that boards ensure that sound risk governance is in place that supports it in the proper execution of their duties. In summary: Decisions by the board, the implementation of those decisions by

⁷ For more information on conflicts of interest in the broader context, the Corporate Governance Network has released a paper, titled 'Conflicts of Interest', https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/05E93ACB-10BE-4507-9601-307A66F34BD8/CGN_Position_Paper_5_Conflict_of_Interest.pdf.

⁸ Australian Securities and Investments Commission v Healey [2011] FCA 717

management and the oversight of implementation by the board rely on an effective risk system.

In the volatile and ever-changing environment that companies now operate, business continuity and building resilience that can be drawn on in times of difficulty should be an underpinning of an effective risk system. Diversification, agility, trust relationships with stakeholders and having a measure of redundancy as a fall-back option is some of the strategies that can be deployed to strengthen resilience and to lessen the effect of decisions and actions that have had negative outcomes.

As far as particular decisions and actions by the board are concerned, an important part of the risk consideration for a decision or action is how it will affect the creation of value in the short and longer terms. Reviewing the consequences of decisions and actions on key stakeholders' needs, interests and expectations is a valuable lens through which to review risks and opportunities. Potential longer term outcomes are important for directors to reflect on particularly in an environment when the pace of change is ever-increasing.

MEETING INFORMATION AND MINUTES

The board and committee packs and the minutes of meetings play an important part in showing what and how the matter was considered and that the decision taken was in the best interest of the company and that there was a rational basis for the decision. It is therefore essential that the board pack contains all the relevant information that indicates the different options or choices available to the directors. Often references are made to email and round robin approvals including other committee meetings without keeping proper record of these. Such other information considered should form part of the formal documentation that is retained by the company to substantiate the decision. With decisions that carry high risk, directors should consider consulting outside sources as those listed in the NACD Blue Ribbon Commission report referred to above.

The minutes of the meeting must also reflect the material points of the discussion that took place and explain why the decision was taken. These minutes must reflect an accurate view of the discussion at the time rather than simply being a justification for the decisions taken. It is also not sufficient to merely record the outcome, without the rationale for the decision being documented. Directors have a responsibility to ensure that minutes of meetings appropriately capture the discussions and points of view of both the board and individual directors. Where directors dissent, this should also be recorded. Lastly, directors should ensure that they have reviewed the minutes before they are approved.

Reliance on information prepared by others

An important part of making any decision is having the pertinent information available. For non-executive directors, in particular, it means that information considered is mostly prepared by other parties, such as management or an assurance provider including the internal and external auditors. This raises questions regarding the extent to which directors may rely on advice and information prepared by others.

These questions were the subject of the landmark judgment in the Centro case.⁹ The case concerned the Centro Group which failed to disclose current liabilities of almost AUD4 billion in the group's financial statements. This resulted in a considerably skewed picture of the financial position of the group and when the errors were discovered and announced the Centro Group collapsed. Even though the judge pointed out that the non-executive directors acted "honestly", on appeal it was held that directors and officers were liable for breach of their duty of care by not detecting that a company's financial statement incorrectly classified a large amount of current liabilities as non-current liabilities.

This case was decided in Australia, but it also has relevance in South Africa as the two countries share the same common law heritage that inform the nature and extent of company directors' duties. Furthermore, the South African Constitution allows for reliance upon relevant foreign judgments. The judgment in the Centro case is very helpful in clarifying when directors are entitled to rely on others' information and advice.

The Centro judgment emphasises that there is no general expectation that directors must scrutinise every

⁹ Australian Securities and Investments Commission v Healey (2011) FCA 717 (27 July 2011)

part of all submissions in great detail to detect incorrect or misleading information – reasonable reliance on other parties is acceptable and to be expected in the course of the board executing its duties. On the other hand, the court is clear that directors can also not be going through the motions” and blindly rely on others. The Centro case highlighted that ‘directors cannot substitute reliance upon the advice of management for their own attention and examination of an important matter that falls specifically within the board’s responsibilities...’

The case was also clear that the board also has the responsibility for controlling the flow of information to it and the manner in which the information is provided to it. This means that the board must satisfy itself that the information provided has integrity and has been prepared through a robust process that will withstand challenge. An important part of the integrity of this information is ensuring that the information has been through a process of combined assurance that involves the relevant services and functions as appropriate. These may include the risk and compliance functions, internal audit, external audit and review by senior management before it is presented to the board.

Section 76 of the Act provides for *who* directors may rely on for advice and information. It allows directors to rely on information provided to them by the company, and by individuals within the company. Directors will generally rely on the information contained within the board pack. However, as discussed above, it is important for directors to understand what controls are in place to ensure that they receive information that is of the appropriate quality and relevance. It is also important for directors to consider what they ought to have known, as discussed in the section titled ‘Taking reasonably diligent steps to be informed’ discussed above.

In considering what information to rely on, directors should consider both the quality and relevance of the information. The quality of the information refers to the robustness of the process that the information goes through before it reaches the board and speaks to its credibility. The relevance of the information refers to what information was considered necessary to present to the board and the process followed to determine what information was relevant to the board’s decision and what was not.

Where directors discover inconsistencies in the information presented to them, the directors have a responsibility to probe these inconsistencies and obtain appropriate answers and explanations. These inconsistencies may also be indicative of a lack of an appropriate process to ensure that directors receive the relevant information which is of a high quality.

Section 76(5) of the Act allows directors to rely on submissions by the following persons:

- (a) one or more employees of the company whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports or statements provided;
- (b) legal counsel, accountants, or other professional persons retained by the company, the board or a committee as to matters involving skills or expertise that the director reasonably believes are matters—
 - 1) within the particular person’s professional or expert competence; or
 - 2) as to which the particular person merits confidence; or
- (c) a committee of the board of which the director is not a member, unless the director has reason to believe that the actions of the committee do not merit confidence.

Directors are entitled to rely on these persons or committees for any information, opinions, recommendations, reports or statements, including financial statements and other financial data, prepared or presented by any of the persons specified above.

To the extent that directors still have doubt about the information provided by management, they may request independent advice to get a second opinion. The process to be followed for obtaining such independent opinions should be incorporated in the board Charter and committee Terms of References.

Conclusion

Business involves taking risk for reward and responsible risk-taking is necessary for companies and the economy to succeed. Directors in the execution of their duties weigh-up the risks against the potential rewards as well as the organisation's ability to absorb or exploit the consequences of a risk materialising. However, it is beyond directors' ability to see into the future. There is an element of judgement involved in the assessment of the potential risks and rewards involved in taking a certain course of action and such judgement remains, at best, a considered view of how the future could potentially turn out. The business judgement rule serves as an important defence to directors from liability for reasonable actions taken in a *bona fide* manner.

To avail themselves of this protection afforded by the Act, a director's conduct must conform with the requirements for the protection in that: -

- reasonably diligent steps were taken to become informed;
- the director must not have had a material personal financial interest in the matter, and;
- the director must have had a rational basis for believing that the decision was in the best interest of the company.

These are the legal requirements for directors of companies who may wish to avail themselves of the protection afforded by the business judgement rule in Section 76 of the Act. It is the position put forward in this paper that these requirements also constitute good practice to be adopted by members of governing bodies of all organisations, including those at state-owned entities and other non-profit organisations who wish to be able to demonstrate sound decision-making.



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