The Nature and Evolution of the Business Judgment Rule and its Transplantation to South Africa under the Companies Act of 2008

Friedrich Hamadziripi†
LLD Candidate, Nelson R Mandela School of Law, University of Fort Hare, South Africa

Patrick C Osode††
Professor, Department of Mercantile Law, Nelson R Mandela School of Law, University of Fort Hare

Abstract

The business judgment rule is a judge-made company law doctrine developed by American courts to protect company directors from civil liability for the decisions they make on behalf of the company. Essentially, the rule operates as a mechanism that shields directors from civil liability originating from corporate transactions concluded in good faith and upon an informed basis, for the best interests of the company, in circumstances where the decision-maker had no personal interest in the outcome. This article argues that the business judgment rule is a sound doctrine as it, inter alia, encourages entrepreneurial risk taking by company directors, protects them from hindsight bias and preserves corporate decision-making as the directors' prerogative. The rule manifests either as an abstention doctrine, standard of liability doctrine or as an immunity doctrine. It remains largely uncodified in those jurisdictions in which the doctrine has been adopted with the notable exceptions of Australia and South Africa. The focus of this article is the development, adoption and transplantation of the rule in the USA, Canada and South Africa, which has for the first time in its legal history, enacted the rule in its Companies Act 71 of 2008. Unlike the other manifestations of the business judgment rule, if a director claims immunity, s/he bears the burden of proving that s/he is entitled to such immunity. It is therefore recommended that South African courts should embrace the immunity version of the business judgment rule as it is the one most aligned to the purposes of the Companies Act.

† LLB; LLM (Fort Hare).
†† LLB (Jos), BL (Nig), LLM (Lagos), SJD (Toronto).

1 INTRODUCTION

The business judgment rule is an American case-law derived doctrine of corporate law[1] which was developed by the courts to protect company directors from civil liability for the decisions they make on behalf of the company.[2] The rule can be loosely described as a mechanism of protection of directors from civil liability in corporate transactions concluded in good faith and upon an informed basis, for the best interests of the company in circumstances where the decision-maker had no personal interest in the outcome.[3] In the United States of America (hereinafter, 'USA'), this rule has now been in existence for more than one hundred and fifty years.[4] However, it is submitted that in spite of its advanced age, the business judgment rule is still misunderstood by both the courts and company law commentators.[5] Since its inception in the USA, the business judgment rule has been transplanted and applied in most of the jurisdictions around the globe. This article will focus on the development, adoption and transplantation of the rule in the USA, Canada and South Africa which has for the very first time in its legal history legislated the rule in its Companies Act.[6]

The immediately following section presents a discussion on the policy foundations of the business judgment rule given that such policy underpinnings determine what the pertinent legal rules would look like. Most of the scholarly work done on the business judgment rule thus far has focused on legal arguments that justify the existence of the rule. In addition to that, this section will also highlight some business and economics-related claims that vindicate the rule. Thereafter, the three manifestations or theoretical bases of the business judgment rule, which are the abstention, standard of liability, and immunity doctrines, will be examined in detail. A comparative analysis will then be presented. Here, the business judgment rule will be discussed with respect to how it is interpreted and applied in the USA and Canada. The USA has been chosen because it is the birthplace of the business judgment rule.[7] Surprisingly, the UK has rejected the rule, besides being the place of origin for most company-law principles.[8] For that reason Canada, a federal state, which has produced some cutting-edge judicial decisions[9] is considered an appropriate choice. The next part will, by drawing conclusions from the preceding parts, suggest the scope and effect of the business judgment rule in South Africa. The last part will present the authors' final reflections.

1 Cassim *et al Contemporary Company Law* 2 ed (2012) 563; Muswaka "Directors' Duties and the Business Judgment Rule in South African Company Law: An Analysis" 2013 *International J of Humanities and Social Science* 89; Schoeman "How the Companies Act Impacts on Directors" 2013 *Without Prejudice* 11; and Bouwman "An Appraisal of the Modification of the Director's Duty of Care and Skill" 2009 *SA Merc LJ* 523.

2 Bainbridge "The Business Judgment Rule as Abstention Doctrine" 2004 *Vanderbilt LR* 89.

3 Black *Black's Law Dictionary* 5 ed (1979) 181.

4 Arsht "The Business Judgment Rule Revisited" 1979 *Hofstra LR* 93. See also Bouwman 2009 *SA Merc LJ* 523, arguing that the rule can be traced back to 1829.

5 McMillan "The Business Judgment Rule as an Immunity Doctrine" 2012 *William & Mary Business LR* 524.

6 71 of 2008.

7 Jones "Directors' Duties: Negligence and the Business Judgment Rule" 2007 *SA Merc LJ* 326; Bouwman 2009 *SA Merc LJ* 523; Cassim *et al Contemporary Company Law* 2 (2012) 563; Cassim *et al The Law of Business Structures* (2012) 310.

8 Cassim *et al Contemporary Company Law* (2012) 563; Cassim *et al The Law of Business Structures* (2012) 310.

9 See part 4 2 below.

2 POLICY FOUNDATIONS

There are several policy underpinnings that are advanced by both the courts and scholars as justifications of the business judgment rule. First, it is contended that the business judgment rule exists because of information asymmetry.[10] It is submitted that the information-asymmetry coin has two sides. On the one hand, Giraldo argues that the court is simply "ill-equipped to make business decisions and should not second-guess directors or substitute its judgment for that of the directors."[11] According to this scholar's reasoning, since directors are involved in the day-to-day running of the company, they are more experienced and knowledgeable about the company's internal affairs than the courts. Inevitably, directors have more information and experience about the businesses they manage than the courts. Therefore, it must be presumed that their decision is better.

On the other hand, it is also argued that directors themselves lack full information about the future, so whatever decision they make is laden with one or more inherent limitations.[12] Directors are not fortune-tellers or prophets of future events.[13] So, if their decision turns out to adversely affect the company, they must not be crucified for what a reasonable person placed in their position could not have foreseen.[14] Accordingly, what is required of directors by the courts is for them to make an informed decision.[15] However, if directors' decisions are to be respected merely because the courts do not have as much information as directors, it begs the question why unmarried judicial officers adjudicate on marriage and divorce matters.

Furthermore, it is important to protect directors from the risk of hindsight bias.[16] Hindsight refers to the knowledge or understanding of a situation or event only after it has happened.[17] In this case, it refers to judicial officers and other stakeholders who, with the knowledge of events that took place after the decision was made suggest that the directors were unreasonable, careless and negligent. It is therefore submitted that directors require the protection of the law, which in this case is provided via the business judgment rule since their decision had to be made in an uncertain business environment. Therefore, not every decision of directors that leads to undesired results should be penalised.[18]

In addition, there is also need to avoid "the risk of stifling innovation and venturesome business activity."[19] Competition creates innovation, which inherently carries some form of risk. By definition, innovation refers to implementing changes in something that already exists by introducing new concepts, designs, techniques or even products.[20] There is no guarantee that

10 McMillan 2012 *William & Mary Business LR* 529; and Giraldo "Factors Affecting the Application of the Business Judgment Rule: An Empirical Study of the US, UK, Australia and the EU" 2006 *Vicepresidencia Juridica* 121.

11 Giraldo 2006 *Vicepresidencia Juridica* 121–122. The same scholar further asserts that "the law supposes that it is the board [of directors] that is in charge of running the company. Justices are lawyers and not business managers and thus are incompetent to manage human and physical resources, financial portfolios or specific commercial transactions." See *In re Solera Holdings Inc Stockholder Litigation* 2017 WL 57839 Del (Ch) 16; *Dodge v Ford Motor Co* 1919 170 NW 668; Bainbridge "The Business Judgment Rule as Abstention Doctrine" 2004 *Vanderbilt Law Review* 128–129; Branson "The Rule that isn't a Rule — The Business Judgment Rule" 2002 *Val U LR* 637; Havenga "The Business Judgment Rule: Should we Follow the Australian Example?" 2000 *SA Merc LJ* 29; McLennan "Duties of Care and Skill of Company Directors and their Liability for Negligence" 1996 *SA Merc LJ* 94; and Bouwman 2009 *SA Merc LJ* 524. In *Brehm v Eisner* 746 A 2d 244 2000 Del, it was held that "if judges failed to respect the decisions of directors made in good faith, this would have the effect that the courts would become super directors measuring matters of degree in business decision making and executive compensation."

12 Bainbridge 2004 *Vanderbilt LR* 118.

13 However, this does not mean that directors can freely abuse the protection offered by the business judgment rule as irrational, illegal and fraudulent acts will be penalised. See Bainbridge "The Bishops and the Corporate Stakeholder Debate" 2002 *Villanova JL & Investment Management* 20. Bainbridge "Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions" 1990 *Minn LR* 264; Van Tonder "An Analysis of the Directors' Decision-Making Function through the Lens of the Business Judgment Rule" 2016 *Obiter* 563.

14 McLennan 1996 *SA Merc LJ* 95.

15 *Aronson v Lewis* 473 A 2d 805 812 (Del 1984) and; Branson 2002 *Val U LR* 635.

16 Giraldo 2006 *Vicepresidencia Juridica* 122.

17 Hornby *Oxford Advanced Learner's Dictionary of Current English* 9 ed (2015) 721.

18 Havenga 2000 *SA Merc LJ* 34; Bouwman 2009 *SA Merc LJ* 511; McLennan 1996 *SA Merc LJ* 97.

19 Section 7(b) of the South African Companies Act 71 of 2008 provides that one of the purposes of that legislation is to "promote innovation and investment in the South African markets." See also *Joy v North* 692 F 2d 880 (1982); Bainbridge 2004 *Vanderbilt LR* 112; Branson 2002 *Val U LR* 637; Havenga 2000 *SA Merc LJ* 29; Muswaka *International J of Humanities and Social Science* 91; Bouwman 2009 *SA Merc LJ* 524; and Cassim *et al Contemporary Company Law* (2012) 565.

20 Hornby *Oxford Advanced* (2015) 787.

every innovative idea will be successful because it is impossible to pre-judge fully how the customers or clients will respond to a company's product or change. But, at the same time, for businesses to stay alive, there is a need for new products and services to be introduced into the market because consumer tastes and choices constantly change.[21] McLennan opines that

> in the normal course of events no businessmen can avoid taking risks. One of the main differences between directors and trustees is that directors must, of necessity, take commercial risks. Even where the most careful investigations and research have been carried out in advance, there is still the element of risk.[22]

Therefore, if perfection is required in company decision-making, only angels would be willing to take up the office of director. By protecting directors' "honest mistakes", the business judgment rule therefore encourages flawed humans to aspire to become company directors.

It is further argued that the business judgment rule has something to do with "respecting shareholders' will."[23] In other words, there is a need to prevent shareholders from becoming managers of their company.[24] This view is supported by the fact that first, directors are appointed by shareholders and secondly, shareholders have a choice to invest or continue investing in the company that is being governed by those directors.[25] This argument seems to suggest that directors are agents of shareholders which is correct under the shareholder primacy model[26] according to which the directors' fiduciary duty to act in the best interests of the company is owed to shareholders. However, the argument is problematic in a number of respects. First, does it seek to suggest that directors are free to do whatever they deem necessary whilst the courts remain silent, and if the shareholders are unhappy about such decisions they should simply invoke the exit option? Additionally, what if the shareholders themselves are unhappy about the directors' decisions whose wishes will be honoured by applying the business judgment rule?

Moreover, directors need the protection of the business judgment rule according to the principle of bounded rationality.[27] This concept is defined by Bainbridge to mean "the natural limits on the ability of decision makers to gather and process information."[28] The same scholar further opines "all humans have inherently limited memories, computational skills, and other mental tools."[29] All these factors point to the imperfection and fallibility of human beings. Human fallibility, therefore, forms one of the core values, if not the major, underlying the business judgment rule.

21 See News24 "Blackberry Lesson: Adapt or Die in the Internet Age" http://www.fin24.com/tech/gadgets/blackberry-lesson-adapt-or-die-in-the-internet-age (accessed 29-09-2016) in which the opening statement to that article read: "Blackberry has joined Yahoo, Nokia and other technology industry stars felled by an internet age in which companies are forced to evolve quickly or perish." This article revealed how Yahoo, which was formed earlier than Google was overtaken by the latter. Nokia, the Finland based company, which was once a giant in the cell phone manufacturing industry also threw in the towel. Blackberry, the Canada based firm recently formally announced its decision to stop making cell phones. The sharp and sudden declines in the fortunes of these former giants were due to failure to adapt to the changing economic environment.

22 McLennan 1996 *SA Merc LJ* 95. Bouwman 2009 *SA Merc LJ* 524 argues that there is need to persuade competent persons to accept the office of director.

23 Giraldo 2006 *Vicepresidencia Juridica* 123.

24 Bouwman 2009 *SA Merc LJ* 524.

25 Giraldo 2006 *Vicepresidencia Juridica* 123 referring to *Joy v North* 692 F 2d 880 (1982).

26 Ajibo "A Critique of Enlightened Shareholder Value: Revisiting the Shareholder Primacy Theory" 2004 *Birkbeck LR* 44–47 and; Esser and Du Plessis "The Stakeholder Debate and Directors' Fiduciary Duties" 2007 *SA Merc LJ* 351.

27 Giraldo 2006 *Vicepresidencia Juridica* 123.

28 Bainbridge 2004 *Vanderbilt LR* 111.

29 *Ibid.*

3 THE BUSINESS JUDGMENT RULE

The business judgment rule, which remains mostly uncodified, with Australia[30] and South Africa,[31] as notable exceptions, is usually invoked in cases of derivative actions and reviews of management decisions pertaining to takeovers.[32] The rule manifests itself either as an abstention doctrine, as a standard of liability or as an immunity doctrine. While the first two manifestations of the rule are common, it can be argued that the immunity version is still in its formative stages. These three manifestations, which are also referred to as the bases of the business judgment rule, will be discussed *seriatim*.

3 1 The Business Judgment Rule as an Abstention Doctrine

According to this approach, the judiciary should refrain or be precluded from making business decisions.[33] According to Bainbridge,

> abstention [does not mean] judicial abnegation of its role. Abstention contemplates judicial reticence but leaves open the possibility of intervention in appropriate circumstances. The main challenge is to identify those circumstances in which intervention is necessary. Put another way, when do accountability concerns trump preservation of the board's authority.[34]

The business judgment rule therefore echoes the tension between the conflicting values of authority and responsibility.[35] In response to Bainbridge's concern about identifying circumstances where judicial intervention becomes vital, it is submitted that proof of fraud, personal interest and/or lack of good faith should be sufficient to justify judicial interference.[36]

According to McMillan,[37] the abstention doctrine was first developed in the case of *Railroad Commission of Texas v Pullman Co*.[38] The main issue in that case was the independence of state courts versus the exercise of authority by federal courts.[39] Frankfurter J concluded that the complaint "tendered a substantial constitutional issue [which touched] a sensitive area of social policy upon which the federal courts ought not to enter unless no alternative to its adjudication is open."[40] Against this background, it is submitted that the doctrine of abstention originated in the USA from the tension between state and federal courts in cases of concurrent jurisdiction. It was further held in *Railroad Commission of Texas v Pullman*[41] that according to the abstention doctrine "federal courts exercise a wise discretion [to] restrain their authority because of scrupulous regard for the rightful independence of the state governments and for the smooth working of the federal judiciary."[42] From this statement by Frankfurter J, it can be deductively concluded that the abstention doctrine was based on respect and efficiency. In this respect, the rule upholds the principle that efficient corporate governance requires centralisation of decision-making authority.[43] The case of *Railroad Commission of Texas v Pullman*[44] was followed in *Burford v Sun Oil Company*.[45] Here, the Sun Oil Company attacked the validity of an order of the Texas Railroad Commission granting Burford a permit to drill

30 See s 180(2) of the Australian Corporations Act 2001.

31 Branson 2002 *Val U LR* 633. See s 76(4) of the South African Companies Act 71 of 2008. It is a paradox that the rule is not codified in Delaware, which frequently deals with corporate-law issues relating to it but has been codified in South Africa where the rule has barely been tested by the courts. For more on the advantages and disadvantages of codification and non-codification see Bouwman 2009 *SA Merc LJ* 521–523.

32 Branson 2002 *Val U LR* 647.

33 Mongalo *Corporate Law and Corporate Governance: A Global Picture of Business Undertakings in South Africa* (2003) 159 and Mongalo *et al Forms of Business Enterprise: Theory, Structure and Operation* (2004) 217.

34 Bainbridge 2004 *Vanderbilt LR* 128–129.

35 Bainbridge "Director Primacy in Corporate Takeovers: Preliminary Reflections" 2002 *Stanford LR* 806.

36 Bainbridge 2004 *Vanderbilt LR* 98 and; Arsht 1979 *Hofstra LR* 127.

37 McMillan 2012 *William & Mary Business LR* 537.

38 312 US 496 498 (1941).

39 *Railroad Commission of Texas v Pullman Co* 312 US 496 498 (1941). It has to be noted that "a federal state is one that brings together a number of different political communities with a common government for common purposes, and separate 'state' or 'provincial' or 'cantonal' governments for the particular purposes of each community." Forsey "How Canadians Govern Themselves: A Federal State" http://www.lop.parl.gc.ca/About/Parliament/senatoreugeneforsey/book/chapter_2-e.html (accessed 09-11-2016).

40 *Railroad Commission of Texas v Pullman Co* 312 US 496 498 (1941).

41 312 US 496 498 (1941).

42 *Railroad Commission of Texas v Pullman Co* 312 US 496 498 (1941).

43 Bainbridge 2002 *Villanova JL & Investment Management* 20.

44 *Railroad Commission of Texas v Pullman Co* 312 US 496 498 (1941).

45 319 US 315 332 (1943).

some wells in the East Texas oil field. Again, the issue arose in the context of the jurisdiction of state and federal courts. It was held that "[it] is in the public interest that federal courts of equity should exercise their discretionary power with proper regard for the rightful independence of state governments in carrying out their domestic policy."[46]

Then followed the case of *Colorado River Water Conservation District v United States*.[47] This case was also about the tension between state and federal courts. Most importantly, the three circumstances in which adherence to the abstention doctrine was appropriate were examined. It was held that the doctrine is applicable

> in cases presenting a federal constitutional issue which might be mooted or presented in a different posture by a state court's determination of pertinent state law, where there have been presented difficult questions of state law bearing on policy problems of substantial public import whose importance transcends the result in the case then at bar, and absent bad faith, harassment, or a patently invalid state statute, federal jurisdiction has been invoked for the purpose of restraining [*inter alia*] state criminal proceedings.[48]

If one was to contextualise these circumstances and apply reasoning by analogy, the federal court will be "the court" exercising abstention and the state court will be the "board of directors." One would then expect the courts to apply the abstention doctrine at least in cases where the directors are more informed or experienced in complex commercial matters, and in the absence of bad faith. The above case law shows that the business judgment rule as an abstention doctrine continues to evolve. In *Railroad Commission of Texas v Pullman*,[49] the doctrine was presented as a basis for postponement of judicial intervention, in *Burford v Sun Oil Company*,[50] the court adopted a hands-off policy, while in *Colorado River Water Conservation District v United States*[51] the court highlighted the exceptional circumstances wherein the doctrine ought to apply.[52]

The courts[53] and scholars[54] agree that the business judgment rule as a doctrine of abstention functions as a rebuttable presumption. For the abstention doctrine to apply, certain conditions must be met. The director or board of directors must have made a conscious informed decision.[55] This connotes positive action or a commission. Failure to act is not covered by the business judgment rule because it is regarded as an omission[56] but a decision not to act falls within the ambit of the doctrine.[57] Also, it is one thing to merely make a decision but it is another thing to make an informed decision.[58] The latter presupposes that one commits oneself to diligently seek relevant information before making a decision. It is this type of conduct that is covered by the business judgment rule. Moreover, the decision-maker has to have acted in good faith[59] and the directors should be disinterested and independent.[60] The decision also needs to be

46 *Burford v Sun Oil Company* 319 US 315 332 (1943).

47 424 US 80 817 (1976).

48 *Colorado River Water Conservation District v United States* 424 US 800 817 (1976) and; McMillan 2012 *William & Mary Business LR* 539.

49 312 US 496 498 (1941).

50 319 US 315 332 (1943).

51 424 US 800 817 (1976).

52 McMillan 2012 *William & Mary Business LR* 538.

53 *Gimbel v The Signal Companies Inc* 316 A 2d 599 (1974); *Aronson v Lewis* 473 A 2d 805 812 (Del 1984).

54 Cabrelli "Presentation for Universita' Bocconi on the Reform of the Law of Directors' Duties in UK Company Law" 2008 *Edinburgh Research Explorer* 27–28; Branson 2002 *Val U LR* 645 fn 51; Arsht 1979 *Hofstra LR* 109; Schoeman "How the Companies Act Impacts on Directors" 2013 *Without Prejudice* 11; and Furlow "Good Faith, Fiduciary Duties, and the Business Judgment Rule in Delaware" 2009 *Utah LR* 1084–1087.

55 Section 76 of the South African Companies Act 71 of 2008; s 180(2) of the Australian Corporations Act 2001; *Brehm v Eisner* 746 A 2d 244 2000 Del fn 100; Bainbridge 2004 *Vanderbilt LR* 101; Branson 2002 *Val U LR* 639–640; Davies *et al Companies and other Business Structures in South Africa* 3 ed (2013) 124; Cassim *et al Contemporary Company Law* (2012) 564; Havenga 2000 *SA Merc LJ* 28; and Bouwman 2009 *SA Merc LJ* 525.

56 Arsht 1979 *Hofstra LR* 112.

57 Bouwman 2009 *SA Merc LJ* 525.

58 Arsht 1979 *Hofstra LR* 120.

59 Section 76 of the South African Companies Act 71 of 2008; s 180(2) of the Australian Corporations Act 2001; *Brehm v Eisner* 746 A 2d 244 2000 Del fn 100; Bainbridge 2004 *Vanderbilt LR* 101; Branson 2002 *Val U LR* 644; Davies *et al Companies in South Africa* (2013) 124; Mongalo *Corporate Law and Corporate Governance: A Global Picture of Business Undertakings in South Africa* (2003) 159; Mongalo *et al Forms of Business Enterprise: Theory, Structure and Operation* (2004) 217; Havenga 2000 *SA Merc LJ* 28; and Bouwman 2009 *SA Merc LJ* 524.

60 *Brehm v Eisner* 746 A 2d 244 2000 Del fn 100; Bainbridge 2004 *Vanderbilt LR* 101; Branson 2002 *Val U LR* 641; Davies *et al Companies in South Africa* (2013) 124; Cassim *et al Contemporary Company Law* (2012) 564; Havenga 2000 *SA Merc LJ* 28; and Bouwman 2009 *SA Merc LJ* 525.

rational.[61]

On the flip side of the coin, the presence of certain factors precludes the utilisation of the business judgment rule in general and as a doctrine of abstention in particular. Proof of fraud, illegality of the decision made and conflict of interest on the part of the decision-maker displaces the doctrine of abstention.[62] Arsht adds bad faith, gross abuse of discretion, self-dealing and negligence to this list.[63]

The abstention doctrine precludes courts from deciding whether directors violated the duty of care or not.[64] This doctrine has its own merits and demerits. Some of the benefits of the abstention doctrine include the conservation of judicial resources[65] by not wasting time and money on issues that the courts will eventually refer back to the board of directors because the former does not have enough information and experience thereon. The doctrine also helps maintain the board of directors' internal group dynamics.[66] Bouwman adds that market mechanisms favour the abstention doctrine in the sense that "for directors to remain in the market and to continue to be sought after to take office as director, they will have to make sure that they manage the company successfully and abide by the rules."[67] The shareholder profit-maximisation principle has influenced the application of the rule to the extent that directors' decisions will only be protected if they benefited shareholders.[68] However, it is conceded that there are some instances where the rule has been applied even when the directors prioritised other stakeholders' interests over those of shareholders.[69] On the criticisms that have been levelled against the abstention doctrine, Schoeman wonders at how the court determines the reasonableness of a decision without examining the decision itself.[70] Furthermore, there is a risk that if the abstention doctrine is followed, the business judgment rule may end up being a mere determinant of which party bears the burden of proof.[71] This is nothing more than a repetition of the general rule that when the plaintiff fails to prove a *prima facie* case the defendant will be entitled to summary judgment.[72]

3 2 The Business Judgment Rule as an Immunity Doctrine

The business judgment rule has also been couched as an immunity doctrine. Literally, the word "immunity" refers to "special privilege or exemption from any obligation, duty or penalty."[73] The effect of an immunity is to protect the beneficiary from liability for conduct undertaken by persons acting in certain capacities.[74] In this context, the immunity will apply to directors as long as they are acting in their capacity as directors. However, regardless of whether an immunity is public or private, the policy underpinnings are the same.[75] The effect of the business judgment rule is "to insulate directors from liability for their business-related decisions."[76] McMillan concluded one of his published writings on the rule by saying:

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61 Section 76 of the South African Companies Act 71 of 2008; s 180(2) of the Australian Companies Act 2001; *Brehm v Eisner* 746 A 2d 244 2000 Del fn 100; Bainbridge 2004 *Vanderbilt LR* 101; Branson 2002 *Val U LR* 643; and Cassim *et al Contemporary Company Law* (2012) 564.

62 Bainbridge 2004 *Vanderbilt LR* 98 and Arsht 1979 *Hofstra LR* 127.

63 Arsht 1979 *Hofstra R* 108–109. For some of the factors that are considered when proving bad faith see the same article at 127 and; Furlow 2009 *Utah LR* 1088.

64 Bainbridge "The Business Judgment Rule as Abstention Doctrine" 2004 *Vanderbilt LR* 102.

65 Branson 2002 *Val U LR* 637.

66 Bainbridge 2004 *Vanderbilt LR* 127.

67 Bouwman 2009 *SA Merc LJ* 524.

68 Bainbridge "In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green" 1993 *Wash & Lee LR* 1441; Bainbridge 2002 *Stanford LR* 805. See Bainbridge "Much Ado about Little — Directors' Fiduciary Duties in the Vicinity of Insolvency" 2007 *J Bus & Tech L* 341 Bainbridge 2002 *Villanova JL & Investment Management* 19, where the same scholar argues that the rule grants the management discretion to make some trade-offs between shareholder and non-shareholder interests.

69 Bainbridge 2002 *Villanova J L & Investment Management* 19.

70 Schoeman 2013 *Without Prejudice* 12.

71 Bainbridge 2004 *Vanderbilt LR* 101.

72 See *Cede & Co v Technicolor Inc* 634 A 2d 345 (1993); and Bainbridge 2004 *Vanderbilt LR* 103.

73 Black *Black's Law Dictionary* (1979) 676.

74 McMillan 2012 *William & Mary Business LR* 542.

75 *Ibid* 564–565; expressing the opinion that the policy underpinnings of the immunity doctrine are to increase efficiency by encouraging the beneficiary's independent judgment on risky matters, to allow the recipient of the immunity room to make some mistakes and at the same time protect them from those who allege that their decisions were wrong in hindsight and finally to avail remedies to the beneficiaries of such immunities.

76 McMillan 2012 *William & Mary Business LR* 569.

> when I see a bird that walks like a duck and swims like a duck and quacks like a duck, I call that bird a duck. The business judgment rule 'walks' like an immunity, 'swims' like an immunity and 'quacks' like an immunity. It has the same policy underpinnings as an immunity, the same procedure as an immunity and has the same effect as an immunity.[77]

With respect to the immunity doctrine, the defendant bears the onus of proof[78] in that s/he must prove that s/he qualifies for the immunity. Cassim *et al* hold that by operating as an immunity doctrine, the business judgment rule becomes a "safe harbour" from liability for directors.[79] It should be noted however that what the directors are entitled to is qualified immunity and not absolute immunity.[80]

3 3 The Business Judgment Rule as a Standard of Liability

The business judgment rule has also been applied by the courts and described by corporate law scholars as a standard of liability.[81] Such a standard of liability dictates how one should conduct oneself or how one is expected to play an assigned role.[82] In other words, there is a certain degree of freedom or scope for making mistakes that role players are allowed in different settings and capacities which when exceeded would result in liability being imputed onto the offender. In this context, the role players are company directors. Viewed this way, the business judgment rule is a test applied by the courts to determine whether a director's conduct gives rise to personal liability.[83]

There is considerable degree of overlap between the ways in which the rule has been applied. The standard of liability test, like the abstention doctrine, posits that the plaintiff has the burden of proof to establish the existence of factors such as fraud, self-dealing and illegality among others.[84] If the plaintiff fails to meet the appropriate burden of proof, the court will apply the business judgment rule to protect the director(s).[85] However, it has to be noted that grossly negligent decisions fall outside the "grace" of the business judgment rule.[86] However, the challenge will be in defining what gross negligence is and how it differs from mere negligence. Is it defined by the amount of harm suffered by the company, or is it about the unreasonableness of the decision? Branson contends that the degree of care required is *due care* not *some care* or *slight care* or *gross negligence*.[87] In *Cede & Co v Technicolor Inc*[88] the argument concerning the business judgment rule was that: "as a rule of evidence, it creates a presumption that in making a business decision, the directors of a corporation acted on an informed basis, [that is] with due care, in good faith and the honest belief that the action taken was in the best interest of the company."[89]

The standard of liability as a theoretical basis of the business judgment rule is not without its critics. Bainbridge claims that the standard of liability approach is tantamount to putting the cart before the horse in the sense that the courts first seek evidence of misconduct and if they fail to find such they then proceed to adopt the "hands off policy."[90] This approach would result in the courts becoming more and more involved in reviewing directors' decisions. However, judicial review of directors' decisions should be the exception rather than being the norm.[91] Such practice might result in a situation whereby the courts usurp the authority of directors. The fundamentally important question that emerges would be: who is the final decision-maker in the company. The board of directors or the court?

77 *Ibid* 574.
78 *Ibid* 569; and Giraldo 2006 *Vicepresidencia Juridica* 130.
79 Cassim *et al Contemporary Company Law* (2012) 563.
80 Leach *The Correct Understanding of the Business Judgment Rule in Section 76(4) of the Companies Act 71 of 2008: Avoiding the American Mistakes* (LLM thesis, University of Cape Town, 2014) 47.
81 McMillan 2012 *William & Mary Business LR* 529 and; Furlow 2009 *Utah LR* 1083.
82 McMillan 2012 *William & Mary Business LR* 529.
83 *Ibid.*
84 *Ibid.*
85 McMillan 2012 *William & Mary Business LR* 529–530 and; Furlow 2009 *Utah LR* 1083.
86 McMillan 2012 *William & Mary Business LR* 530.
87 Branson 2002 *Val U LR* 638.
88 634 A 2d 345 (1993).
89 *Cede & Co v Technicolor Inc* 634 A 2d 345 (1993).
90 Bainbridge 2004 *Vanderbilt LR* 94; and McMillan 2012 *William & Mary Business LR* 534.
91 *Ibid.*

4 COMPARATIVE ANALYSIS

4 1 The Business Judgment Rule in the United States of America

Scholars[92] agree that the earliest business-judgment-rule case to come before the courts of law was *Percy v Millaudon*.[93] In that case, the shareholders of a bank sued its directors. They alleged that the bank's directors were liable for the losses suffered by the company as a result of misappropriation of funds by the bank's president and cashier. The Louisiana Supreme Court held that:

> when the person who was appointed attorney-in-fact, has the qualifications necessary for the discharge of the ordinary duties of the trust imposed, we are of the opinion that on the occurrence of difficulties, in the exercise of it, which offer only a choice of measures, the adoption of a course from which loss ensues cannot make the agent responsible, if the error was one into which a prudent man might have fallen. The test of responsibility 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.[94]

It is this formulation that later came to be known as the business judgment rule.[95] From the court's *ratio decidendi*, the fallibility of man and the need to encourage able persons to take up the office of director by allowing them reasonable room for error are at the core of the business judgment rule. It can be argued that by using the phrase "test of responsibility", and other similar words and expressions, the court's judgment favoured the standard of liability doctrine. Although the court indirectly presumed the defendant directors not to be liable for the losses suffered by the company, the main focus was not on rebutting some presumptions as favoured by the abstention doctrine.

The American courts were not consistent in their interpretation of the business judgment rule. In the case of *Shlensky v Wrigley,*[96] the plaintiff shareholder brought a derivative action against the board of directors of Chicago Cubs. The Chicago Cubs was a baseball team that used Wrigley Field as its home ground. The team's President, Mr. Wrigley, refused to install lights at the field for night games citing that baseball was a daytime game and that "it would greatly deteriorate the neighbourhood if stadium lights were installed."[97] It is noteworthy that at that time the Chicago Cubs was the only major league team without lights on its field. The plaintiff alleged that other teams, for example, the Chicago White Sox earned significant revenues from night games. Consequently, so claimed the plaintiff, the refusal to install the lights resulted in lower profits for the shareholders.

The main issue was whether the board of directors should install lights on Wrigley Field and pay damages to Shlensky.[98] It was held that the club president was not liable for failing to maximise the team's profits. The court was "not satisfied that the motives [of the directors were] contrary to the best interests of the corporation and the stockholders … [because they] showed no fraud, illegality or conflict of interest in making that decision."[99] It was further highlighted that there was not enough evidence to prove that there was a direct link between the financial position of other clubs and attendance of night games. Furthermore, it was stressed that

> the decision makers are professionals at what they do and most judges would not have the proper knowledge to decide if it was right or not, and the fact that the issue would be looked at after a bad decision made it easier to pick apart. The courts [are] involved when a crime or fraud has been committed by a fiduciary.[100]

From this statement, it can be deduced that the American courts will not interfere with the decision of a director or board of directors unless the latter's decision was influenced by fraud,

92 See Arsht 1979 *Hofstra LR* 93; Bouwman 2009 *SA Merc LJ* 523; and Giraldo 2006 *Vicepresidencia Juridica* 120.
93 8 Mart (ns) 68 (La 1829).
94 *Percy v Millaudon* 8 Mart (ns) 68 (La 1829).
95 Arsht 1979 *Hofstra LR* 97.
96 95 Ill App 2d 173 237 (1968).
97 *Shlensky v Wrigley* 95 Ill App 2d 173 237 (1968).
98 *Ibid.*
99 *Ibid.*
100 *Ibid.*

illegality and personal interest. Undoubtedly, this was the abstention doctrine in action.

In *Gimbel v The Signal Companies Inc*[101] the plaintiff was a shareholder of the respondent company. He brought an action before the Delaware Chancery Court seeking injunctive relief to prevent the consummation of the pending sale by the respondent of all of the outstanding shares of Signal Oil and Gas Company to Burmah Oil Incorporated. Signal Oil and Gas Company was a wholly owned subsidiary of the respondent. The effective sale price, which exceeded 480 million dollars, was approved at a special meeting of the respondent's board of directors towards the end of 1973. The plaintiff alleged that the special meeting was not properly convened and that the proposed sale required authorisation by the majority of the outstanding shares of the respondent.[102] The plaintiff further alleged that the 480 million dollars sale price was insufficient and that certain directors had personal interests in the business decision.[103]

In evaluating the merits of the allegation that the proposed sale price was inadequate, the court noted that directors are presumed to have acted in good faith in the best interests of the company.[104] It held that this presumption is known as the business judgment rule according to which the court cannot "substitute its uninformed opinion for that of experienced board members."[105] Bainbridge and Griffith explain that the presumption effectively shields directors from personal liability.[106] However, application of the rule depends on proof that informed directors actually made a business judgment.[107] The court conceded that utilisation of the rule has been broadened with special mention of cases involving the sale of corporate assets.[108] However, the presumption does not constitute an absolute protection of directors' conduct. In Branson's words, "the business judgment rule does not protect complete absences of care, abdications and the like."[109] The courts will scrutinise the merits of a decision of directors if the plaintiff can prove that the directors acted fraudulently or that the sale price was clearly inadequate.[110] In that case, the court was at it again when it used vague terms such as "constructive fraud", "badge of fraud", "intentional fraud", "inferred fraud" and "actual fraud."[111]

In *Smith v Van Gorkom,*[112] popularly known as "The Trans Union Case", a company by the name Marmon attempted a leveraged buy-out[113] of Trans Union. Trans Union's CEO, Van Gorkom proposed a price of $55 a share. He and his CFO did not conduct any research about the company's actual worth nor was the company's legal department informed about the transaction. Moreover, it turned out that the $55 a share represented only about sixty per cent of what the company was later appraised at. A derivative action against Trans Union's directors was commenced. The trial court found in favour of Van Gorkom stating that the latter's actions "fell within the business judgment rule [according to which] the courts should not second-guess business decisions made by directors."[114] On appeal, the decision of the *court a quo* was reversed. The Appellate Court concluded that

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101 316 A 2d 599 (1974).
102 *Gimbel v The Signal Companies Inc* 316 A 2d 599 (1974).
103 Paragraph 89.
104 Paragraphs 65 to 68.
105 Paragraph 69.
106 Bainbridge 1990 *Minn LR* 264; Griffith "The Omnipresent Specter of Omnicare" 2013 *J Corp L* 788.
107 *Gimbel v The Signal Companies Inc* 316 A 2d 599 (1974); Davies *et al Companies in South Africa* (2013) 124; Cassim *et al Contemporary Company Law* (2012) 564; Havenga 2000 *SA Merc LJ* 28; and Bouwman 2009 *SA Merc LJ* 525.
108 *Gimbel v The Signal Companies Inc* 316 A 2d 599 (1974).
109 Branson "A Business Judgment Rule for Incorporating Jurisdictions in Asia" 2011 *Singapore Academy of LJ* 693.
110 *Ibid.*
111 Paragraph 77.
112 488 A 2d 858 (Del 1985).
113 According to Investopedia http://www.investopedia.com/terms/l/leveragedbuyout.asp#ixzz4FszhJIIe (accessed 30-07-2016): "a leveraged buyout (LBO) is the acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. Often, the assets of the company being acquired are used as collateral for the loans in addition to the assets of the acquiring company. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital."
114 488 A 2d 858 Del (1985).

> the business judgment rule was not a [valid] defense because the directors and Van Gorkom did not use any 'business judgment' when they came to their decision. There is no protection for directors who have made an unintelligent or unadvised judgment. Thus, the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one.[115]

There is some confusion as to whether the rule only applies to the procedural aspects of the decision or whether it extends to substantive issues as well. For example, in the cases of *McMullin v Beran*[116] and *Cede v Technicolor*[117] it was held that "the business judgment rule operates as both a procedural guide for litigants and a substantive rule of law."[118] On the other hand, there is overwhelming authority to support the view that the business judgment rule only applies to the procedural aspects of a decision.[119]

4 2 The Business Judgment Rule in Canada

In Canada, the business judgment rule is encapsulated in case law. In *Maple Leaf Foods Inc v Schneider Corporation*,[120] the appellant, with the support of two small shareholders of the respondent company, was a bidder for Schneider's shares. The appellant had declared its intention to make an unsolicited take-over bid for Schneider at $19 a share. After the establishment of a special committee by the respondent and some consultations between the former and the latter's board of directors, Schneider ended up accepting Smithfield Foods' offer of $25 a share. The appellants alleged that the agreement between the Schneider family and Smithfield Foods unfairly disregarded the interests of non-family shareholders and prejudiced them. It was held that

> the court looks to see that the directors made a reasonable decision not a perfect decision. Provided the decision taken is within a range of reasonableness, the court ought not to substitute its opinion for that of the board even though subsequent events may have cast doubt on the wisdom of the board's determination. As long as the directors have selected one of the several reasonable alternatives, deference is, and should be, accorded to the board's decision. This formulation of deference to the decision of the board is known as the 'business judgment rule'.[121]

The court introduced the requirement of reasonableness, a concept that is not so clear especially when applied to the business judgment rule.[122] The concept of the reasonableness of directors' decisions was repeated in another Canadian case of *Peoples Department Stores Inc v Wise*[123] where the court noted the evolution of the law relating to the business judgment rule, both in Delaware and Ontario.[124] However, Branson argues that reasonableness is not required.[125] As will be seen later, the numerous references to the test for reasonableness in Canadian law, point to the business judgment rule manifesting as an immunity doctrine.

In another Canadian case of *BCE Inc v 1976 Debenture Holders*,[126] a group of debenture holders opposed the approval of a plan of arrangement arguing that "the short-term trading value of the debentures would decline by an average of 20 percent and could lose investment-grade status."[127] It was held that

> the fact that the shareholders stood to benefit from the transaction and that the debenture holders were prejudiced did not in itself give rise to a conclusion that the directors had

115 *Ibid.*
116 765 A 2d 910 Del (2000) 916–917.
117 634 A 2d 345 (1993).
118 *McMullin v Beran* 765 A 2d 910 Del (2000) 916-917 and *Cede & Co v Technicolor Inc* 634 A 2d 345 (1993).
119 *Smith v Van Gorkom* (The Trans Union Case) 488 A 2d 858 Del (1985); Leach *The Correct Understanding of the Business Judgment* (LLM thesis, University of Cape Town, 2014) 29; Bainbridge 2004 *Vanderbilt LR* 101; and Schoeman 2013 *Without Prejudice* 12.
120 42 OR (3d) 177 [1998] OJ No 4142. Schneider Corporation was controlled by members of the Schneider family through a holding company. The issued share capital of Schneider consisted of common voting shares and Class A non-voting shares. Although the family only owned seventeen per cent of the non-voting shares, it controlled the company because it owned approximately seventy five per cent of the common voting shares.
121 *Maple Leaf Foods Inc v Schneider Corporation* 42 OR (3d) 177 (1998) OJ No 4142.
122 *Peoples Department Stores Inc v Wise* 2004 68 (SCC).
123 *Ibid.*
124 2004 68 (SCC).
125 Branson 2002 *Val U LR* 635.
126 2008 69 (SCC).
127 *BCE Inc v 1976 Debenture holders* 2008 69 (SCC).

breached their fiduciary duty to the corporation. Through the business judgment rule, deference should be accorded to business decisions of directors taken in good faith and in the performance of the functions they were elected to perform by the shareholders.[128]

5 THE SCOPE AND EFFECT OF THE BUSINESS JUDGMENT RULE IN SOUTH AFRICA

In South Africa, the way and manner in which company directors should conduct themselves in order for their decisions to be covered by the protective shield of the business judgment rule is provided for in section 76(4) of the Companies Act.[129] Consisting of two paragraphs, the first part of section 76(4) spells out the three requirements that a director must satisfy in order to be found to have acted in the best interests of the company and with the requisite degree of care, skill and diligence,[130] namely making an informed decision, absence of material personal-financial interest and belief that the decision was in the best interests of the company. The second paragraph of section 76(4) outlines the two categories of credible information sources that a director faced with allegations of wrongdoing can rely upon.[131]

Currently, there has been no reported case on the business judgment rule in South Africa. The question is how will the courts apply and interpret this rule in South Africa, taking into consideration the vast changes that have taken place around the globe especially the UK company law reforms.[132] It is commonplace that the UK is the foundation of most if not all of the company law of common-law jurisdictions. However, as highlighted above, the business judgment rule originates from the USA. There is a lot of case law to glean especially from the Chancery Court of Delaware in order to provide guidance on the scope and effect of codification of the rule in South Africa.[133]

Furthermore, it has to be determined which one of the three manifestations of the business judgment rule suits the socio-economic and political terrain of post-apartheid South Africa and complies with the Bill of Rights[134] as provided for in the Constitution.[135] The Companies Act[136] seeks to promote the development of the South African economy by encouraging entrepreneurship and enterprise efficiency,[137] promote innovation and investment in the South African markets,[138] reaffirm the concept of the company as a means of achieving economic and social benefits[139] and balance the rights and obligations of shareholders and directors within companies.[140]

Against this background, it is submitted that the abstention doctrine, which Cassim *et al* refer to as a rule of restraint,[141] is unhealthy and inappropriate for the South African economy. The doctrine requires the plaintiff, who in most cases will be minority shareholders to rebut the presumption that the directors acted in good faith in the best interests of the company. It is unfortunate that there has been no direct judicial pronouncement yet on the codified

128 *Ibid*.
129 71 of 2008.
130 See also s 76(3)(b) and (c).
131 This includes relying on the performance of or any information, opinions, recommendations, reports or statements, including financial statements and other financial data, prepared or presented by the employees, legal counsel, accountants and board members.
132 The House of Commons Trade and Industry Committee noted that a series of reviews were undertaken in response to financial scandals in the late 1980s and early 1990s. The reviews started with the *Cadbury Report* in 1992, followed by the *Rutteman Report* of 1994, the *Greenbury Report* of 1995, the *Hampel Report* of 1998 and the *Turnbull Report* of 1999. These reviews encouraged reforms in the law relating to *inter alia* directors' duties, environmental and social reporting, enhancing shareholder engagement and ensuring better regulation. These reforms were then proposed in the UK's *White Paper on Modernising Company Law Sixth Report of Session* 2002–03 and the Secretary of State for Trade and Industry's Company Law Reform Presentation to Parliament in 2005 and were finally incorporated in the current UK Companies Act, 2006.
133 Section 5(2) of the Companies Act 71 of 2008 states that "to the extent appropriate, a court interpreting or applying this Act may consider foreign company law."
134 See s 7(a) of the Companies Act 71 of 2008. Section 2 of the Constitution of the Republic of South Africa states that it "is the supreme law of the Republic; law or conduct inconsistent with it is invalid, and the obligations imposed by it must be fulfilled".
135 Constitution of the Republic of South Africa, 1996.
136 71 of 2008.
137 Section 7(b)(i) of the Companies Act 71 of 2008.
138 Section 7(c) of the Companies Act 71 of 2008.
139 Section 7(d) of the Companies Act 71 of 2008.
140 Section 7(i) of the Companies Act 71 of 2008.
141 Cassim *et al Contemporary Company Law* (2012) 563.

business judgment rule. However, the recent case of *In re The Walt Disney Company Derivative Litigation*[142] from the Supreme Court of the US State of Delaware is a good illustration of how the business judgment rule can, when it manifests as an abstention doctrine, grossly undermine stakeholders' interests. In that case, Mr. Michael Ovitz ("Ovitz") and The Walt Disney Company ("Disney") entered into an employment agreement according to which Ovitz would serve as President of Disney for five years. However, just fourteen months after commencing employment, Ovitz's contract was terminated for no apparent cause. This resulted in a severance pay-out to him valued at approximately $130 million.[143]

Several Disney shareholders instituted derivative actions in the Delaware Court of Chancery, on behalf of Disney against Ovitz and the directors of Disney.[144] The plaintiffs claimed that "the $130 million severance pay-out was, [*inter alia*], breach of fiduciary duty by the Disney defendants, and a waste of assets."[145] The plaintiffs further contended that such breach of fiduciary duty deprived the Disney defendants of the protection of the business judgment rule.[146] In the alternative, the plaintiffs argued that even if the business judgment rule were to apply, the Disney defendants were still liable because the payout constituted corporate waste and the Court of Chancery erred in concluding otherwise.[147] It was reiterated that in making decisions, directors are rebuttably presumed to have acted on an informed basis, in good faith and in the best interests of the company.[148] Several prominent South African scholars have also echoed similar sentiments.[149] In the case at issue, the only way to rebut the business judgment rule's presumptions was to show that the Disney defendants had either breached their duty of care or had not acted in good faith. To establish a breach of the duty of care, the plaintiffs were supposed to prove that the board acted with gross negligence in which case the burden would shift to the directors to show that the employment contract and related severance pay-out agreement were entirely fair.

The Supreme Court of Delaware held that the plaintiffs (appellants) failed to prove that the Disney directors breached their duty of care or that they acted in bad faith. It further held that "even if the trial court's analytical approach were improper, the appellants have failed to demonstrate any prejudice. Nowhere have the appellants shown that the result would have been any different had the Chancellor proceeded in the manner that they advocate[d]."[150] The presumption is not easy to rebut due to numerous factors, which include information asymmetry. As highlighted above, although a plaintiff can make a special application to access necessary information, this process can take long and might be financially constraining. In South Africa, taking into consideration that most of the stakeholders who might require such information are financially disadvantaged, the abstention doctrine is most likely to discourage transparency and high standards of corporate governance.[151]

For stakeholders, the most agonising fact about the abstention doctrine is that even if the applicants are successful in rebutting the presumption, the courts will only review the procedural aspects of the decision.[152] Accordingly, reasoning along the same lines as Havenga,[153] if the impugned decision was arrived at through the right procedure, the courts will not interfere with it. Therefore, even if the plaintiffs in the Disney case, after all their struggle, were successful in their rebuttal, the Delaware Supreme Court was only going to focus on the manner in which the directors arrived at their decision to make such an outlandish payout to Ovitz. The plaintiffs, however, were not complaining about the way in which the decision was made. Their complaint was about the substantive fairness of the decision itself. It is therefore submitted that, by ignoring the real concerns of the plaintiffs, the abstention doctrine does

142 906 A 2d 27 Del (2006).
143 *In re The Walt Disney Company Derivative Litigation* 906 A 2d 27 Del (2006).
144 *Ibid*.
145 *Ibid*.
146 *In re The Walt Disney Company Derivative Litigation* 906 A 2d 27 Del (2006) 26.
147 *Ibid* 26–27.
148 *In re The Walt Disney Company Derivative Litigation* 906 A 2d 27 Del (2006) 39.
149 Cassim *et al Contemporary Company Law* (2012) 564. See also Du Plessis "Revisiting the Judge-Made Rule of Non-Interference in Internal Company Matters" *SALJ* 318; Coetzee and Kennedy-Good "The Business Judgment Rule" *Obiter* 277; Davies *et al Companies in South Africa* (2013) 117.
150 *In re The Walt Disney Company Derivative Litigation* 906 A 2d 27 Del (2006) 40–41.
151 Section 7(b)(iii) of the Companies Act 71 of 2008.
152 *In re The Walt Disney Company Derivative Litigation* 906 A 2d 27 Del (2006) 48.
153 Havenga 2000 *SA Merc LJ* 35 suggested that directors should not be liable for a breach of the duty of care and skill if they have made a rational and informed decision, in good faith and in the absence of self-interest.

not encourage enterprise efficiency.[154] Furthermore, if shareholders themselves struggle to rebut the presumption, how much more difficult and strenuous will it be for non-shareholder stakeholders to protect their interests?

It was explained above that the business judgment rule also manifests as a standard of liability. The Delaware Supreme Court case of *Cede v Technicolor*[155] was an appeal from the Delaware Chancery Court, which encompassed a number of consolidated suits.[156] The plaintiffs were Cinerama Inc. which was a New York Corporation and Cede & Co.[157] The actions arose from a cash-out merger in which Technicolor Inc. was acquired by MacAndrews & Forbes Group, Incorporated ("MAF"), through a merger with Macanfor Corporation ("Macanfor"), a wholly-owned subsidiary of MAF. According to the terms of the tender offer and later cash-out merger, each shareholder of Technicolor (excluding MAF and its subsidiaries) was offered $23 cash per share.

The question before the Delaware Supreme Court was "whether the Technicolor board's decision to approve the planned merger with MAF was protected by the business judgment rule or should be subject to judicial review for its entire fairness."[158] The standard of liability and abstention doctrines are similar in the fact that they both require the plaintiff to rebut the presumption that the defendant directors acted on an informed basis, in good faith and in the best interests of the company. Therefore, it was the plaintiff's burden "to establish that any director's self-interest was individually, or collectively, so 'material' as to persuade a trier of fact that the independence of the board 'as a whole' had been compromised."[159] The Chancellor in the *court a quo* found that Cinerama failed to rebut the business judgment rule's presumption of director independence.[160]

Before the Supreme Court, the appellants contended that the trial court had committed fundamental errors of law in its formulation and application of the business judgment rule's requirements of director duty of loyalty and duty of care by placing upon a shareholder plaintiff burdens of proof for breach of duty of loyalty and duty of care that are foreign to equity and to Delaware law.[161] It was further argued that, even under the court's articulation of the duty of loyalty element of the rule, the court had clearly erred in finding that there was insufficient evidence to prove that a majority of the directors had breached their duty of loyalty for the purpose of rebuttal of the business judgment rule.[162] On the other hand, the defendants, while agreeing with the Chancellor, asserted that "the trial court's reformulation of the duty of loyalty element of the rule to require a director's interest to be 'material' to be disabling is not new law, but simply different terminology."[163]

The Supreme Court of Delaware held that the business judgment rule operates both as a procedural guide for litigants and as a substantive rule of law.[164] Although, the rule posits a powerful presumption in favour of directors' conduct,[165] the major difference between the abstention and standard of liability doctrines is that, with respect to the latter, if the plaintiff is successful in rebutting the presumption, "the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the 'entire fairness' of the transaction to the shareholder plaintiff."[166] In other words, a successful rebuttal will lead to the court looking into the substantive aspects or the merits of the directors' decision. With respect to the entire fairness standard of judicial review, the defendant directors must establish to the court's satisfaction that the transaction was the product of both fair dealing and fair price.[167] It

154 Section 7(b)(i) of the Companies Act 71 of 2008.
155 634 A 2d 345 (1993).
156 *Cede v Technicolor* 634 A 2d 345 (1993) para 1.
157 *Ibid.*
158 *Cede v Technicolor* 634 A 2d 345 (1993) para 23.
159 *Cede v Technicolor* 634 A 2d 345 (1993) para 25.
160 *Ibid.*
161 *Ibid* 26–27.
162 *Cede v Technicolor* 634 A 2d 345 (1993) para 28.
163 *Ibid.*
164 *Aronson v Lewis Del Supr* 473 A 2d 805 812 (1984).
165 *Cede & Co v Technicolor Inc* 634 A 2d 345 (1993).
166 *Cede & Co v Technicolor Inc* 634 A 2d 345 (1993) 17. See also *In re Merge Healthcare Inc Stockholders Litigation* Consolidated WL 395981 Del (Ch) 20, where it was held that "if a majority of the company's disinterested [shareholders] approves the transaction with a fully informed, uncoerced vote, then the business judgment rule applies 'even if the transaction might otherwise have been subject to the entire fairness standard due to conflicts faced by individual directors'."
167 *Cede & Co v Technicolor Inc* 634 A 2d 345 (1993) 17; *Nixon v Blackwell* 626 A 2d 1376; *Mills Acquisition Co v*

was therefore ordered that the merger plan be scrutinised for its entire fairness.[168] However, some scholars like Prickett and Brown are adamant that the Supreme Court did not authorise a review of the directors' decision.[169] In that case, the key question would be how was the trial court going to decide on the fairness of the decision without looking into the merits thereof. Furthermore, the Supreme Court had hinted that, when couched as a standard of liability, the rule applies both procedurally and substantively.[170]

Along the way, the Supreme Court rejected the plaintiffs' contention that "'any' director self-interest, standing alone and without evidence of disloyalty, is sufficient to rebut the presumption of loyalty of our business judgment rule."[171] Furthermore, in an effort to rebut the presumption, the plaintiffs' use of the reasonable-person standard for determining the materiality of a given director's self-interest in a challenged corporate transaction was also rejected.[172] It is thus evident that even though the standard of liability doctrine offers some space for the courts to scrutinise the substantive aspects of a decision, rebutting the presumption remains a major challenge. Stakeholders will still need to go through the furnace of rebutting the presumption.[173] But, unlike the abstention doctrine, since there is an "outside" chance of a review of the merits of the directors' decisions, the risk can be worth taking. McMillan also states that the standard of liability doctrine moves the liability bar from mere negligence to gross negligence or recklessness.[174] In this scholar's view, gross negligence is a lower standard than mere negligence, but it seems the opposite is true.[175]

Lastly, the business judgment rule also manifests as an immunity doctrine. It seems the immunity version of the rule offers a myriad of incentives to stakeholders. To begin with, availability of the immunity is decided through a motion to dismiss, at an early stage of the litigation process.[176] This saves a significant amount of time and money, making it efficient. In this respect, it should be noted that encouraging enterprise efficiency and entrepreneurship is one of the objectives of the Companies Act.[177] Unlike the other manifestations of the business judgment rule, if a director claims immunity, s/he bears the burden of proving that s/he is entitled to such immunity.[178] It is submitted that the immunity doctrine is less onerous and thereby promotes risk-taking and innovation[179] as company directors may not be excessively cautious for fear of being held accountable for any loss or damage to the company. Furthermore, there is no complete presumption in the sense that no one is entitled to automatic absolute immunity.[180] Instead, as argued by McMillan, "an evaluation of the role the defendant [director] was acting in at the time of the injury must be done to establish absolute immunity, or a good faith or reasonableness evaluation must be done to establish the application of the qualified immunity."[181] Such flexibility is one of the key elements that the new Companies Act[182] seeks to promote.[183]

Accordingly, of the three manifestations of the business judgment rule discussed above, it is argued that the immunity doctrine is the version of the rule that is likely to have the greatest

MacMillan Inc 559 A 2d 1279; and *Weinberger v UOP Inc* 457 A 2d 710.

168 *Cede & Co v Technicolor Inc* 634 A 2d 345 (1993) 25.

169 Prickett and Brown "Cede v Technicolor: The Supreme Court Re-illuminates Existing Lines of Delaware's Level Playing Field" 1994 *Delaware J of Corporate L* 599–600.

170 See *Aronson v Lewis Del Supr* 473 A 2d 805 812 (1984).

171 *Cede & Co v Technicolor Inc* 634 A 2d 345 (1993) 21.

172 *Ibid.*

173 Richards "Cede & Co v Technicolor Inc. A Whole New Ball Game for Dissenting Shareholders" 1989 *Delaware J of Corporate L* 1007, arguing that the presumption is difficult to rebut and the burden often proves insurmountable for the plaintiff shareholder. The scholar cites an example of trying to rebut the presumption by proving fraud in the context of a merger transaction and concludes that "fraud is difficult to prove since mere inadequacy of price will not reveal fraud." "The inadequacy must be so gross as to lead the court to conclude that it was due not to an honest error of judgment but rather to bad faith, or to a reckless indifference to the rights of others interested."

174 McMillan 2013 *William & Mary Business LR* 534.

175 *Ibid.*

176 *Ibid* 567.

177 71 of 2008. See s 7(b)(i).

178 McMillan 2013 *William & Mary Business LR* 568.

179 According to s 7(c) of the Companies Act 71 of 2008, promotion of innovation and investments in South African markets is one of the objectives of the new Act.

180 McMillan 2013 *William & Mary Business LR* 567.

181 *Ibid.*

182 71 of 2008.

183 See s 7(b)(ii) of the Companies Act 71 of 2008.

impact on raising standards of corporate governance in South Africa, as per the objectives of the new Companies Act.[184] Furthermore, considering the South African business environment in which workers' rights are especially vulnerable to abuse, as in the Marikana incident,[185] the version of the business judgment rule, which operates as an immunity doctrine, is more appropriate for this country because of its accommodative stance on balancing the various company stakeholders' rights.[186]

6 CONCLUSION

In light of the above, the business judgment rule continues to evolve. The rule manifests either as an abstention doctrine, standard of liability doctrine or as an immunity doctrine. In the USA, the rule mostly manifests itself as an abstention doctrine, whilst in Canada the courts usually apply the standard of liability version of the rule. The business judgment rule remains uncodified with the exceptions of Australia and South Africa. It was also demonstrated that the abstention doctrine originates from the tension in the USA between the independence of state courts and the exercise of authority by federal courts. The major difference between the abstention and standard of liability doctrines is that, with respect to the latter, if the plaintiff is successful in rebutting the presumption, "the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the 'entire fairness' of the transaction to the shareholder plaintiff."[187] Unlike the other manifestations of the business judgment rule, if a director claims immunity, s/he bears the burden of proving that s/he is entitled to such immunity.[188] It is therefore recommended that South African courts should embrace the immunity version of the business judgment rule, as it is the one most aligned to the purposes of the Companies Act as articulated in sections 5 and 7 thereof.

184 See Muswaka "Thematic Lessons from the Marikana Miners' Strike in South Africa: A Corporate Governance Perspective" 2014 *Mediterranean J of Social Sciences* 64; and Nicolson "South Africa: Two Years after Marikana Massacre, Families Still Wait for Justice" http://www.theguardian.com/world/2014/aug/15/south-africa-two-years-marikana-massacre-justice (accessed 05-06-2015).

185 See Muswaka 2014 *Mediterranean J of Social Sciences* 64; and Nicolson "South Africa: Two Years after Marikana Massacre, Families still wait for Justice" http://www.theguardian.com/world/2014/aug/15/south-africa-two-years-marikana-massacre-justice (accessed 05-06-2015).

186 See s 7(a) and (i) of the Companies Act 71 of 2008 which aims to "promote compliance with the Bill of Rights as provided for in the Constitution, in the application of company law [and] balance the rights and obligations of shareholders and directors within companies."

187 *Cede & Co v Technicolor Inc* 634 A 2d 345 (1993) 17.

188 McMillan 2013 *William & Mary Business LR* 568.