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WHEN YOUR BUSINESS JUDGEMENT IS OFF TRACK

Article by CGF Research and reviewed by Werksmans Attorneys

It is not surprising that many business leaders are becoming a lot more circumspect about their positions -- including their waning risk appetite -- as yet more draconian legislation enters the market in South Africa. Laws such as the Protection of Personal Information Act, the Broad-Based Black Economic Empowerment Act, the Consumer Protection Act -- including a host of labour and environmental Acts -- place significant risks upon businesses and directors, especially when their provisions are not met.

Against this background, considering the increased liabilities attached to directors (and prescribed officers) which is laid out in the Companies Act 2008, failures at corporate and personal levels is set to increase even further if business leaders are not confident in 'calculating' and executing their business risks correctly.

Most business leaders are a rare breed of individuals who thrive on risk-taking for profit; and not being able to execute, arguably, the most basic duty of risk management whilst maintaining profitability is a cause for major concern. Through their entrepreneurial spirit, these are the people who are the main catalyst for job creation and thriving economies. But, as more business leaders are being stifled by a barrage of burdening legislation with even greater possibilities of personal liabilities attached to their daily functions, they will need to weigh the options of more risk-taking and increased personal liabilities against the future profitability, growth and sustainability factors. At the outset, it certainly appears quite unattractive to occupy any senior level leadership position in the South African business landscape, and more so in an ever-increasing litigious environment which is dogged by numerous poor governance practices and cited in the media on almost a daily basis.

Being hard-headed or choosing to remain ignorant of the increasing risks attached to running a business is foolhardy and even the toughest of these die-hards will eventually bow under the pressure. Allied to these burdens is a very sluggish economy which is exacerbated by uninspiring leadership and years of layering, outsourcing and rightsizing which has left many a business and its leadership insecure with growing unemployment and uncertainty weighing heavily upon businesses. It's no wonder that many directors are disillusioned as they try 'rationalise' risk-taking for reward in an environment that appears more hostile for business growth opportunities than ever before.

"A director should be aware of what he or she is being asked to decide and whether he or she is being asked to make a decision on a matter that involves compliance with the law (where a director will not be able to rely on the business judgment rule)."

A director seeking to rely on the business judgment rule will be greatly assisted if he or she is able to demonstrate that each component of the rule has been satisfied."

***Source: Business Judgment Rule - Recent lessons for all Company Directors
June 2011***

As a result of the increased liabilities and often hazardous business terrain, directors may find some relief within the Business Judgement Rule; a common law doctrine which was introduced in the United States of America in the early 1800s and now also found in the South African Companies Act 2008 ('the Act'). In broad terms, the Business Judgement Rule -- also known as the 'indoor management Rule' -- aims to protect a company's leadership from misleading allegations regarding the manner in which they conduct business.



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Found within Section 76(4) of the Act, the Rule aims to protect a director from being held liable for business decisions that were made by directors -- on a reasonably informed basis and where they have no personal financial interest -- that subsequently turned out to be incorrect or unwise and which caused loss or damage to the company and or its shareholders.

The rationale for this Rule, specifically, is to acknowledge that business is innately filled with risk, no matter the nature and or size of the business and its operations. In many cases, decisions taken by the business' leadership may be controversial; but if decisions which are required to be taken are prevented because of the fear of risk-taking and personal prosecution, then frankly speaking there is no business. The Business Judgement Rule further assumes that it is unfair to expect that business leaders will *always* make the 'perfect decision', but underpins its basis that directors will act in the interests of the company. Understandably, with a modern and complex business world as we know it, there are many variables outside our control and which require deep consideration by business leaders. The Rule allows leaders the latitude to be able to take the necessary risks, so long as the courts believe there was rational thinking and actions; even when certain loss or damage was the end result.

Whilst a director's *duty of care* is separate and distinct from the Business Judgement Rule, their duty of care operates in conjunction with the Rule. It is expected that all decisions made by directors are subject to an analysis of whether or not the director has complied with their duty of care owed to the company, as well as whether they -- in making a decision for the company -- applied their mind, used their skills, were at no stage conflicted, and that they were diligent throughout the process.

Interestingly, if a director's decision was not made on an informed basis, or if the director had a material personal financial interest in the decision, the director would then be liable under the duty to act in the best interests of the company with a degree of care, skill and diligence, and the Rule would therefore not be applied. In order to apply the Rule and ensure that it carries the necessary protection for which it was designed, if a plaintiff intends to sue a director for their breach of fiduciary duties, the plaintiff will have to:

1. show that the director was not acting in the best interests of the company; and
2. show that the director failed to exercise their duty with a degree of care, skill and diligence (that may be reasonably expected of another director/person in similar circumstances) by proving that -
 - a. the director's actions were ill-informed (this implies that the director failed to take reasonably diligent steps to become informed about the matter);
 - b. the director had material personal financial interests in the subject matter of the decision and failed to disclose such interest to the other Board members and further did not excuse himself from consideration of the matter; and
 - c. the director made the decision with no rational basis for believing that such decision was in the best interests of the company.

Should it come to light that the director did, in fact, take steps to become reasonably informed, didn't have a financial interest in the matter, and had a rational basis for supporting the decision, the Business Judgement Rule will find application in favour of the director and the plaintiff's case will fail. Hopefully, as South African business leaders pay more attention to the 'safe harbour' defense mechanism found within the Business Judgement Rule, there will be:

1. a healthier understanding and attitude toward risk-taking for profit;
2. more directors will take their place to proactively engage the necessary risk-taking activities that could benefit the company (and ultimately the economy);



3. a greater pool of talented and competent people will emerge and will be encouraged to serve as company directors;
4. less 'post-event' or 'judicial second guessing' will take place by shareholders or judges that argue with hindsight about a director's controversial business decisions, especially after such decisions proved wrong or caused damage;
5. less 'in-house' bickering or legal cases brought about by disgruntled shareholders toward directors with costly legal fees and smear campaigns.

There is no doubt that businesses face many kinds of risks, and the quicker stakeholders realise that there is no way to avoid all the risks that will present themselves, the better. Of course sound business and risk management procedures can minimise many of the losses a business may suffer, but no amount of caution and planning can eliminate risk entirely. That said, risk should not cripple the enthusiasm of leading business, and leaders -- to fulfill their mandate -- must be willing to take calculated risks when they believe there is a strong likelihood that they will succeed.

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Through CGF's strategic partners -- supported by our Corporate Patrons *Rifle-shot Performance Holdings and DQS South Africa* -- our capabilities extend to Board evaluation, GRC management consulting, executive placements, executive mentoring, company secretariat and the facilitation of Corporate Governance and Risk Awareness workshops. To find out more about CGF, our patrons and our associated services, please access www.cgf.co.za, www.corporate-governance.co.za or www.governanceconnect.mobi

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