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## COMPARATIVE CASE LAW ON DIRECTORS' DUTIES

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# Comparative Case Law – Directors' Duties

## OUTLINE

- ▶ General duties in terms of the Companies Bill
- ▶ In re City Equitable Fire Insurance Company Limited
- ▶ In re Walt Disney Co Derivative Litigation
- ▶ Telxon Corporation v Meyerson
- ▶ Smith v Van Gorkom
- ▶ Unocal Corporation v Mesa Petroleum Co

# Comparative Case Law – Directors' Duties

## GENERAL DUTIES IN TERMS OF THE COMPANIES BILL

- ▶ Section 76(3) - when acting in his capacity as a director, a director must exercise his powers and perform his functions
  - (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 those functions and having that director's general knowledge, skill and experience.
  
- ▶ Section 76(4) (the business judgment rule) - a director is protected against allegations of breach of the duties of care and skill and to act in the best interests of the company in relation to a matter where that director has
  - (i) taken reasonably diligent steps to become informed about the matter;
  - (ii) either had no conflict of interest in relation to the matter or complied with the rules on conflicts of interest; and
  - (iii) had a rational basis for believing, and did believe, that his decision was in the best interests of the company.

In addition, a director is specifically entitled by the business judgment rule to rely on the discharge of functions, and information presented by, persons such as employees and advisers who that director reasonably believes to be reliable and competent



# Comparative Case Law – Directors' Duties

## IN RE CITY EQUITABLE FIRE INSURANCE COMPANY LIMITED (1925)

In a case where the liability of directors for negligence was in question, the court found that a director:

- ▶ must act honestly;
- ▶ must exercise such degree of skill and diligence as would amount to the reasonable care which an ordinary man might be expected to take, in the circumstances, on his own behalf;
- ▶ need not exhibit a greater degree of skill than may reasonably be expected from a person of his knowledge and experience - in other words, he is not liable for mere errors of judgment;
- ▶ is not bound to give continuous attention to the affairs of his company – his duties are of an intermittent nature to be performed at periodical meetings, and though not bound to attend all such meetings he should do so when reasonably able to
- ▶ in respect of all duties which may properly be left to some other official, he is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.



# Comparative Case Law – Directors' Duties

## IN RE WALT DISNEY CO DERIVATIVE LITIGATION (2003)

Shareholders of Disney brought a derivative action against the directors of the company for breach of fiduciary duties in circumstances where it was alleged that:

- ▶ the CEO (Eisner) personally hired his friend of 25 years (Ovitz) as President (2<sup>nd</sup> in command)
- ▶ the compensation committee did not consider the details of the employment contract and left the negotiation to Eisner
- ▶ the board did not consider any information about the contract, but appointed Ovitz
- ▶ Ovitz served for just over a year but performed poorly
- ▶ Ovitz then sought to leave, but without forfeiting benefits and without reputational damage
- ▶ Eisner and Ovitz worked together as friends to protect their images
- ▶ without approaching the board, Eisner and one other director agreed to a "no fault" termination involving the payment of approximately US\$39 million plus stock options to Ovitz



# Comparative Case Law – Directors' Duties

## IN RE WALT DISNEY CO DERIVATIVE LITIGATION (2003)

The court refused to dismiss the action against the directors and held that the business judgment rule's presumption in favour of the directors would be rebutted by the facts alleged because the directors:

- ▶ did not review the employment contract which turned out to be very generous
- ▶ did not evaluate the details of his salary or severance arrangements
- ▶ did not take expert advice on the advantages and disadvantages of the employment contract or its conformance with industry norms
- ▶ allowed Eisner to negotiate with his friend
- ▶ knew they were making a material decision without adequate information or deliberation
- ▶ never sought to terminate Ovitz's employment or negotiate with him on the subject
- ▶ on hearing about the termination, did not ask questions or challenge Eisner's action

# Comparative Case Law – Directors' Duties

IN RE WALT DISNEY CO DERIVATIVE LITIGATION (2003)

The court also found that Ovitz could be liable for breach of fiduciary duty in the circumstances because:

- ▶ directoral self-compensation decisions lie outside the business judgment rule's presumptive protection and so are subject to an affirmative showing that the compensation arrangements are fair to the company
- ▶ he did not negotiate the termination with the board in an adversarial and arms-length manner, but instead developed a secret strategy with his close friend



# Comparative Case Law – Directors' Duties

## TELXON CORPORATION V MEYERSON (2002)

A company sued its former directors for breach of fiduciary duties in circumstances where it was alleged that:

- ▶ the chairman sold an asset to the company on unfair terms, even though the board obtained a fairness opinion from an independent financial adviser
- ▶ although the chairman abstained from all discussions of the matter, the board was dominated by the chairman and could therefore not act independently



# Comparative Case Law – Directors' Duties

## TELXON CORPORATION V MEYERSON (2002)

The court found that the directors could not rely on the business judgment rule if they did not act independently:

- ▶ the fact that the other directors were disinterested would not assist them if the interested director controls or dominates the board as a whole
- ▶ the dependence of the other board members on the chairman had to be judged as a matter of fact

# Comparative Case Law – Directors' Duties

## SMITH v VAN GORKOM (1985)

- ▶ Company has tax problems
- ▶ Board considers position and prepares 5 year strategic plan to grow its taxable income by series acquisitions. Emphasis no need to do anything urgently and no reference to sale
- ▶ Senior director acting alone starts considering LBO, determines a price per share (\$55), solicits offer at that price from a friend and has legal agreements prepared
- ▶ Arranges urgent board meeting for Saturday and proposes LBO at \$55. No legal agreements presented and no explanation given for price. Board approves LBO in 2 hour board meeting

# Comparative Case Law – Directors' Duties

## SMITH v VAN GORKOM (1985)

- ▶ Business judgment rule protects board against “unyielding fiduciary duties”
- ▶ Presumption that board acted on informed basis, in good faith and in honest belief that in best interests of company
- ▶ Informed:
  - Must consider all material information reasonably available
  - Must proceed with a critical eye in assessing information present under the circumstances
- ▶ Basis for liability is gross negligence

# Comparative Case Law – Directors' Duties

## SMITH v VAN GORKOM (1985)

### ▶ Findings:

- Board did not adequately inform themselves of terms of LBO
- Board was uninformed about intrinsic value of shares and whether or not \$55 was reasonable value

### ▶ Conclusion: Board was grossly negligent in approving LBO in a 2 hour meeting of which proper notice was not given in circumstances where there was no crisis or emergency



# Comparative Case Law – Directors' Duties

## UNOCAL v MESA (1985)

- ▶ Business judgment rule also applies in hostile take-over situations
- ▶ Board considering hostile take-over bid must:
  - Determine if offer is in best interests of company and all shareholders
  - Take informed decision whether to recommend or take defensive steps
- ▶ May only use corporate funds to take defensive steps if:
  - Acting in good faith and no fraud
  - Reasonable investigation has been made