

PART III

FRAMEWORK FOR A DUTY TO CREDITORS

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CHAPTER 4

JUDICIAL FRAMEWORK

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4.1 INTRODUCTION

The judiciary has taken the lead in advocating directors' responsibility to creditors.³⁶⁶ It is therefore necessary to examine decisions in which statements regarding directors'

³⁶⁶ The legislature seems reluctant to afford any leeway to a duty to creditors. In the New Zealand Law Commission Report No 9 *Company Law Reform and Restatement* (Wellington, 1989) as referred to by Wishart "Models and Theories of Directors' Duties to Creditors" (1991) 14 *New Zealand Universities Law Review* 323 324, it is stated, eg, that the contractual status of creditors should be emphasised and that their only shields should be a duty owed by management to the company to maintain solvency. It is furthermore recommended that directors should owe no duty to creditors, and that the interests of creditors should be subordinated to the best interest of the company and the benefit of the existing shareholders. The English legislature seems equally reluctant to formalise a duty to creditors. The judiciary appears to be more willing to develop directors' duties to allow for the inclusion of creditors' interests. The Australian judiciary seems to be on the forefront of this development with the possibility of directors' duties to creditors being mooted as early as 1976 in the well-known case of *Walker v Wimborne* (1975 – 1976) 137 CLR 1 6 – 7, where the court stated that

it should be emphasised that the directors of a company in discharging their duty to the company must take account of the interests of its shareholders and creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them.

The English judiciary followed suit some years later in *Lonrho Ltd v Shell Petroleum Co Ltd* [1980] 1 WLR 627 634, where Lord Diplock indicated support for a duty to creditors with his statement that the best interests of the company "are not necessarily those of the shareholders but may include those of the creditors".

duties to creditors were made,³⁶⁷ or in which decisions were based on the recognition of directors' duties to creditors,³⁶⁸ in an attempt to form a clearer picture of the framework envisaged by the courts for such a duty.

The first Canadian case dealing with the issue of directors' duties to creditors, namely *Peoples Department Stores Inc (trustee of) v Wise* [1998] QJ No 3571 (QSC (Bankruptcy and Insolvency Division)), was only decided in 1998 – much later than, eg, the first Australian case. It must therefore be accepted that this area of the law is better developed in some jurisdictions than others, a fact that will necessarily be reflected in the comparative analysis of cases below.

The extension of directors' duties to include the interests of creditors received scant attention by the South African judiciary. In some cases the judiciary seems to have left a back door open for the interests of corporate constituents, other than shareholders, to be considered by directors in complying with their duties to the company. See eg *S v Hepker* 1973 1 SA 472 484 (W), where the court stated that

[t]he concept of creditors having recourse only against a company as such, leaving shareholders immune beyond their shareholdings, was a legal invention of surpassing significance for the industrial expansion of the world. But it has placed great responsibility upon directors. Because of its limited liability, directors have a duty to manage the company strictly on a basis of fairness *to all those who deal with it* and who have no means of knowing its internal affairs. The Courts will not be tolerant to deviation from this indispensable commercial guideline;

as well as *Kerbyn 178 (Pty) Ltd v Van den Heever* 2000 4 SA 804 817 (W), where the court, with reference to the applicant's submission that there could be no question of breach of fiduciary duty or fraud because its conduct had taken place with the concurrence of the company, stated that

[t]he question is not whether shareholders might have an action, but whether an action is available to creditors, and hence to the trustee or liquidator acting on their behalf.

Since this case was decided on the basis of the *actio Pauliana* any reference to a breach of fiduciary duties is merely *obiter*, however. The elements of a duty to creditors was thus not properly considered or examined by the courts in any South African case.

³⁶⁷ Many statements, though made *obiter* and therefore not authoritative, are important nonetheless, in that they provide some insights as to how directors' duties to creditors are perceived by the courts. The persuasive powers of these *obiter* statements should also not be underestimated: see eg the New Zealand case of *David Neil and Co Ltd (in rec) v Neil* (1986) 3 NZCLC 99,658 99,672, where the court stated that it is legitimate for it to consider *obiter* principles regarding directors' duties to creditors formulated in another case, *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242, in exercising its discretion.

³⁶⁸ In some cases directors were held liable by the courts by reason of the fact that they prejudiced or failed to consider creditors' interests; see eg *Ring v Sutton* (1980) 5 ACLR 546; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722; *Grove v Flavel* (1986) 43 SASR 410; *Jeffree v National Companies & Securities Commission* (1989) 15 ACLR 217 (hereinafter *Jeffree v NCSC*) in Australia; *In re Day-Nite Carriers Ltd* [1975] 1 NZLR 172; *In re Avon Chambers Ltd* [1978] 2 NZLR 638; *Hilton International Ltd v Hilton* [1989] 1 NZLR 442 in New Zealand; *Liquidator of West Mercia Safetywear Ltd v Dodd* 1988 PCC CA 212 in England; *Peoples Department Stores Inc (trustee of) v Wise* [1998] QJ No 3571 (QSC

An analysis of the cases reveals that the courts, sometimes even in the same jurisdiction, are not unanimous as to whether directors are obliged to consider creditors' interests,³⁶⁹ let alone as to the principles which should form the basis of such a duty. The cases do therefore not provide definite answers as to how the duty, if indeed such a duty exists, should operate in various jurisdictions.

What does emerge from these cases, however, is the fact that the courts, when confronted with the issue of directors' duties to creditors, grapple with similar issues, even in different jurisdictions.

The first issue concerns the content of such duty, specifically whether it is directors' fiduciary duties or duty of care and skill that is extended to creditors.³⁷⁰ The second concerns the issue whether the duty is a continuous one, or whether it arises under particular circumstances related to the financial state of affairs of the company.³⁷¹ A last issue concerns the identity of the beneficiary of the duty. This particular aspect encompasses questions such as the proper party to institute action should directors fail to comply with their duty to creditors; the power of the general meeting to ratify a breach of

(Bankruptcy and Insolvency Division)) in Canada (this decision was, however, overturned by the Quebec Court of Appeal: *Peoples Department Stores Inc (Trustee of) v Wise* (2003) 224 DLR (4th) 509, although Lederman J left the door open for the application of such a duty in other states in *Dylex Ltd (Trustee of) v Anderson* (2003) 63 OR (3rd) 659, 32 BLR (3rd) 295 (Ont SCJ Comm List); and *Geyer v Ingersoll Publications Co* 621 A 2d 784 (Del Ch 1992) in the United States.

³⁶⁹ See eg the opposing English cases of *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* [1983] 2 All ER 563 585, where the court expressly stated that directors owe fiduciary duties to the company, but "not to the creditors, present or future"; and *Liquidator of West Mercia Safetywear Ltd v Dodd supra*, where the court supported the viewpoint that creditors' interests become paramount when the company is insolvent. With reference to the Canadian position, Morgan & Underwood "Directors' Liability to Creditors on a Corporation's Insolvency in Light of the *Dylex* and *Peoples Department Stores* Litigation" (2004) 39 *Canadian Business Law Journal* 336 337 state that "[t]he current jurisprudence demonstrates that the law on this issue in Canada is at a crossroads, and that no clear direction has been chosen to date".

³⁷⁰ See *infra* Ch 5 (Protection Afforded by Fiduciary Duties) and Ch 6 (Protection Afforded by the Duty of Care and Skill) for more detail on the suitability of these duties in offering protection for the interests of corporate creditors.

³⁷¹ See *infra* Ch 7 (Point in Time When the Duty Arises) for more on this point.

directors' duties, where the main aim of these duties is in fact to protect creditors' interests; and the different classes of creditors that may be protected by such duty.³⁷²

In this chapter the introductory discussion of these key issues is followed by an overview of the cases dealing with directors' duties to creditors in various jurisdictions³⁷³ for the purpose of establishing how the courts dealt with key issues regarding directors' duties to creditors. It is also important to compare the totality of the legal principles³⁷⁴ in respect of these jurisdictions to ensure that the basis of comparison is valid.³⁷⁵

In conclusion an overview of the elements of a framework for a duty to creditors as envisaged by the courts is provided.

4.2 TYPE OF DUTY

4.2.1 Introduction

The cases that provided for an obligation on the part of directors to consider or protect the interests of creditors did so through reliance on existing company law principles pertaining to directors' duties. Traditionally two types of duties are imposed on directors of companies, namely fiduciary duties³⁷⁶ and the duty to act with the necessary care.³⁷⁷ It

³⁷² See *infra* Ch 8 (Beneficiary of the Duty) for further discussion in this regard.

³⁷³ The jurisdictions referred to for purposes of a comparative study are Australia, New Zealand, England, Canada and the USA, for the reasons referred to *supra* Ch 1 (Introduction).

³⁷⁴ Specifically those pertaining to insolvency and share capital.

³⁷⁵ In this regard it must be emphasised that the purpose of this chapter is merely to identify and provide a broad overview of the key elements of a duty to creditors for the purpose of facilitating further discussion. The intricacies exposed by the courts' pronouncements and questions raised in respect of these elements are dealt with in more detail below (*infra* Ch 5 – Ch 8).

³⁷⁶ This duty goes by different names in different jurisdictions, eg duty of loyalty, or duty of good faith. For the sake of clarity it is referred to as "fiduciary duty" in this section, with more detailed discussion on its content, specifically those aspects of the duty related to the protection of creditors' interests, below. See *infra* Ch 5 (Protection Afforded by Fiduciary Duties).

³⁷⁷ This duty may be referred to as the duty of care and skill; duty of care, skill and diligence, etc. For the sake of convenience it is referred to as "duty of care" in this section. A more detailed discussion of the various elements of this duty, especially with reference to the protection of the interests of corporate creditors, will follow later. See *infra* Ch 6 (Protection Afforded by the Duty of Care and Skill).

is necessary to determine which one of these categories of duties, if not both, was used by the courts to hold directors liable, or relied upon by complainants in an attempt to hold directors liable for their failure to protect the interests of creditors.

4.2.2 Australia

Australian creditors succeeded with actions against directors in a number of instances, based on the directors' failure to take creditors' interests into consideration. Director conduct that lead to their liability included loans made by the company to the director at interest rates that were so low that it was inferred that the loans were detrimental to the company and solely for the benefit of the director;³⁷⁸ a leasing agreement between the directors and the company at a rent substantially below the real value three months before the company was wound up;³⁷⁹ the movement of funds between companies that were controlled by the same person, before one of the companies was subsequently wound-up, to protect the directors and/or other companies under their control to the detriment of creditors;³⁸⁰ and the transfer of all the assets of one company to another, controlled by the same people, to defeat an anticipated arbitration award.³⁸¹

The above examples all seem to point to directors' traditional fiduciary type duties being extended to provide for the protection of creditors' interests, as the liability of the directors in question was based on the fact that they preferred their own interests to those of the creditors,³⁸² or improperly made use of information acquired by virtue of holding the office of director to gain an advantage for themselves.^{383 384}

³⁷⁸ *Ring v Sutton supra*.

³⁷⁹ *Kinsela v Russell Kinsela Pty Ltd (in liq) supra*.

³⁸⁰ *Walker v Wimborne supra; Grove v Flavel supra*.

³⁸¹ *Jeffree v NCSC supra*.

³⁸² Eg in *Kinsela v Russell Kinsela Pty Ltd (in liq) supra*.

³⁸³ Eg in *Jeffree v NCSC supra*, where the action against the director was based on the improper use of information, as provided for by s 229(4) of the *Companies (WA) Code*.

³⁸⁴ The question that immediately comes to mind in this regard is whether the directors in question may not be held liable in terms of traditional fiduciary duties, since they clearly did not act *bona fide* in the best

4.2.3 New Zealand

The New Zealand cases in which directors were found to be liable on the basis of a breach of their duties to the company in that they failed to consider creditors' interests, seem to rest on a similar extension of fiduciary type duties towards creditors. Conduct that resulted in directors being held liable comprised misappropriation of company funds just before the companies were wound up;³⁸⁵ a sale of company property to a director at a price much lower than the market value;³⁸⁶ and payment of a capital dividend to director shareholders when the company was barely in a position to afford it.³⁸⁷

The majority of cases in New Zealand dealing with directors' duties to creditors were thus instituted on the basis of a breach of fiduciary duties, or, at least, the codified version thereof.³⁸⁸

In *Hilton International Ltd v Hilton*,³⁸⁹ however, directors were held liable for the amount of a capital dividend paid to them as shareholders, because, even though they acted

interest of the company, without having to resort to extending fiduciary duties to encompass creditors' interests. The court faced the problem, however, that the directors were in a position to control the general meeting of shareholders and consequently force a ratification of a breach of their fiduciary duties. In an attempt to prevent an abuse of power in this way, the court proposed that directors are under obligation to creditors in some instances (see discussion *infra* par 4.3, as well as Ch 7 (Point in Time When the Duty Arises) for more detail on the circumstances that may give rise to a duty to creditors) and that *shareholders* are not in a position to ratify a breach of a duty to *creditors* (see *infra* par 4.6 for more detail). The court did not engage in any discussion as to whether these particular wrongs could not be ratifiable on the basis that they may be considered as "unratifiable" wrongs. See *infra* Ch 8 (Beneficiary of the Duty), particularly par 8.2.3. for further discussion regarding this particular aspect.

³⁸⁵ In *In re Day-Nite Carriers Ltd supra*, by way of salaries that were drawn from profits; and in *In re Avon Chambers Ltd supra*, by way of dividend payments to the directors and sole shareholders.

³⁸⁶ *David Neil and Co Ltd (in rec) v Neil supra*.

³⁸⁷ *Hilton International Ltd v Hilton supra*.

³⁸⁸ In *In re Day-Nite Carriers Ltd supra*; *In re Avon Chambers Ltd supra*; and *In re Lake Tekapo Motor Inn Ltd (in liq)* (1987) 3 NZCLC 100, 156, eg, action was instituted against the respective directors under s 321 of the Companies Act 1955, dealing with misfeasance or breach of trust on the part of the directors.

³⁸⁹ *Supra*.

honestly, they were found to be *negligent*.³⁹⁰ This seems to indicate that the directors were held liable, not because they breached their fiduciary duties, but rather because they breached their duty of care.³⁹¹

4.2.4 England

The two cases in England that eventually held that directors were liable because they failed to consider the interests of creditors, are very similar to their Australian and New Zealand counterparts – in both instances the directors being the only shareholders, were held liable because they benefited themselves to the prejudice of creditors.³⁹²

In the majority of English cases in which directors were sought to be held liable on the basis that they did not comply with their duty to creditors, the actions were based on misfeasance,³⁹³ indicating an alleged breach of fiduciary duties on the part of the directors.³⁹⁴

In *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd*,³⁹⁵ on the other hand, the action against the directors was founded on tort

³⁹⁰ Their negligence was inferred from their failure to appreciate the consequences of payment of such a dividend, namely that it would jeopardise the solvency of the company, resulting from the fact that they did not have accounts prepared before paying the dividend.

³⁹¹ This conclusion is supported by Tipping J's express statement that: "Whereas it has not been shown that the directors acted dishonestly I am quite satisfied that they did not act with *reasonable care* in all the circumstances" (*id* 476; own emphasis).

³⁹² In *Winkworth v Edward Baron Development Co Ltd* [1987] 1 All ER 114 118 it was found that the directors breached their duty because the company's property was "dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors"; and in *Liquidator of West Mercia Safetywear Ltd v Dodd supra* 216 the director was found to be "guilty of breach of duty when, for his own purposes, he caused the £4,000 to be transferred in disregard of the interests of the general creditors of this insolvent company".

³⁹³ See eg *In re Horsley & Weight Ltd* [1982] 3 All ER 1045; *Brady v Brady* [1988] 2 All ER 617; and *Liquidator of West Mercia Safetywear Ltd v Dodd supra*.

³⁹⁴ In *In re B Johnson & Co (Builders) Ltd* [1955] 2 All ER 775 it was held that misfeasance proceedings will not lie against a director or other officer of a company to recover compensation for breach of a duty owed to the company, unless the duty was fiduciary in nature. Misfeasance proceedings could thus not be used to recover damages from a director for mere negligence.

³⁹⁵ *Supra*.

based on negligent decisions made by the plaintiff company's directors. The action was thus clearly based on a breach of the duty of care. The court was very explicit, however, in denying the existence of a duty of care to creditors of the company and the action consequently failed.³⁹⁶

An extension of a duty similar to fiduciary duties thus seems to be supported in England, rather than a duty of care.

4.2.5 Canada

The action against the directors in *Peoples Department Stores Inc v Wise*³⁹⁷ was based on section 122 of the Canadian Business Corporations Act.³⁹⁸ This provision places a duty on directors to “act honestly and in good faith with a view to the best interests of the corporation”³⁹⁹ and to “exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances”.⁴⁰⁰ Even though this statutory provision encompasses both the duty of care and fiduciary duties, the court found the directors liable in the end because “they failed to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances”,⁴⁰¹ or, in other words, because they did not comply with their duty of care.

³⁹⁶ Even though this particular action was based on an alleged breach of duty of care, Dillon LJ continued to state that directors owe neither a duty of care, nor fiduciary duties to creditors of a company (*id* 585). This decision was distinguished from a later decision by the same judge in which he acknowledged a duty to creditors, namely *Liquidator of West Mercia Safetywear Ltd v Dodd*, *supra*, on the basis that the company in *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* was solvent at the time and the parties were acting in good faith – these being the reasons why it was held that directors were not under any obligation to creditors.

³⁹⁷ *Supra*.

³⁹⁸ *Canadian Business Corporations Act*, RSC 1985, c C-44 (hereinafter *CBCA*).

³⁹⁹ *Id* s 122(1)(a).

⁴⁰⁰ *Id* s 122(1)(b).

⁴⁰¹ *Peoples Department Stores Inc (trustee of) v Wise supra* par 80.

In both *Canbook Distribution Corporation v Borins*⁴⁰² and *Lakehead Newsprint (1990) Ltd v 893499 Ontario Ltd*⁴⁰³ actions against directors were based on breach of fiduciary duties for failing to consider creditors' interests. While the action in *Lakehead Newsprint (1990) Ltd v 893499 Ontario Ltd* failed on the facts,⁴⁰⁴ the court in *Canbook Distribution Corporation v Borins* acknowledged that "Canadian law appears to be moving in the direction of recognizing such fiduciary duty".⁴⁰⁵

This development now seems to have been halted by the decision of the Canadian supreme court in *Peoples Department Stores Inc v Wise*,⁴⁰⁶ where the supreme court made it clear that directors' fiduciary duties are owed to the *corporation* and that the interests of the corporation should not be confused with those of its creditors.⁴⁰⁷ The court did allow, however, that directors' duty of care is owed to creditors in addition to shareholders.⁴⁰⁸

4.2.6 United States of America

Directors' conduct that resulted in their liability for breaching their fiduciary duties in that they did not protect creditors' interests, consisted of diverting corporate assets for their own benefit, or for the benefit of preferred creditors. In *Geyer v Ingersoll Publications Co*,⁴⁰⁹ for example, the plaintiff-creditor complained that the director caused the company to surrender its major assets to third parties in return for his personal

⁴⁰² (1999) 45 OR (3d) 565 (Ont SCJ).

⁴⁰³ [2001] OJ No 1 (Ont SCJ).

⁴⁰⁴ There was no pleading that the company was insolvent at the time of the impugned transaction, or that the impugned transaction rendered the company insolvent.

⁴⁰⁵ *Supra* par 16.

⁴⁰⁶ 2004 SCC 68.

⁴⁰⁷ *Id* par 43. The existence of an alternative remedy, namely the oppression remedy afforded by s 241 of the *CBCA*, formed a key part of the court's decision as to why fiduciary duties should not be extended to creditors. This remedy is not without problems of its own, however, as was indicated *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.2.2.4.

⁴⁰⁸ *Id* par 57.

⁴⁰⁹ *Supra*.

benefit, at the expense of the company who remained indebted to him. In all the cases discussed in this section, actions against directors were based on breach of typical fiduciary duties.⁴¹⁰

The extension of a fiduciary type of duty therefore seems to be supported in the United States of America as well.⁴¹¹

4.3 POINT IN TIME WHEN THE DUTY ARISES

4.3.1 Introduction

An issue faced by the courts when dealing with directors' duties to creditors is determining the point in time when this duty arises. There are a number of possible answers to this question and once again the courts are not unanimous. In some instances courts limited directors' duties to consider the interests of creditors to insolvent companies, or at least companies experiencing financial difficulties. In other cases, however, the courts were willing to recognise such a duty despite the fact that the companies were solvent at the time of the impugned transaction.

4.3.2 Australia

Australian decisions have a lack of unanimity on the point as to *when* directors are under obligation to consider the interests of creditors in discharging their duties to the company and various viewpoints are advanced.

In terms of one viewpoint "the directors' duty to a company as a whole extends *in an insolvency context* to not prejudicing the interests of creditors".⁴¹²

⁴¹⁰ Eg *Bovay v HM Bylesby & Co* 38 A 2d 808 (Del 1944); *Simons v Cogan* 549 A 2d 300 (Del 1988); *Geyer v Ingersoll Publications Co supra*; *Credit Lyonnais Bank Netherland, NV v Pathe Communications Corp* No 12150, 1991 WL 277613 (Del Ch Dec 30, 1991), reprinted in (1992) 17 *Delaware Journal of Corporate Law* 1099.

⁴¹¹ See authority cited by Lin "Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors" (1993) 46 *Vanderbilt Law Review* 1485 1513 n 92 – 98, for decisions in other states indicating support for this construction of the duty.

⁴¹² As formulated by Street CJ in *Kinsela v Russell Kinsela Pty Ltd (in liq) supra* 732 – 733 (own emphasis).

In other decisions, however, impugned transactions were performed while the companies were still solvent.⁴¹³ A second viewpoint thus seems to be that directors may incur liability for entering into transactions that are detrimental to creditors' interests, even though the company was not actually insolvent at the time when these transactions were concluded.

In *Grove v Flavel*⁴¹⁴ it was stressed, however, that a proposition that directors can be held liable for not considering creditors' interests independently from insolvency or financial difficulties, would be difficult to support,⁴¹⁵ leading one to conclude that some degree of financial instability, if not actual insolvency, is at least required before directors are in some way obliged to consider creditors' interests. Later cases in which the precarious financial situation of the companies in question were emphasised as an indicator that directors are under obligation to consider creditors' interests seem to support this inference.⁴¹⁶

⁴¹³ See eg *Wright v Frisina* (1983) 7 ACLR 532; *Ring v Sutton supra*; and *Grove v Flavel supra*. In all cases action was successfully instituted against the directors, even though the companies were not insolvent when the transactions were concluded. In fact, in *Grove v Flavel supra* 417 the court specifically stated, with reference to the decision in *Walker v Wimborne supra*, that "there is nothing in the statement of Mason J to suggest that it is insolvency that gives rise to the duty to take account (*sic*) of the interests of creditors. Indeed, he speaks of prejudice in futuro, 'in the event that the company becomes insolvent'."

⁴¹⁴ *Supra*.

⁴¹⁵ *Id* 420. The court stated that the widely criticised decision in *Ring v Sutton supra* (see eg Butcher *Directors' Duties: A New Millennium, A New Approach* (2000) 176; Sealy "Directors' 'Wider' Responsibilities – Problems Conceptual, Practical and Procedural" (1987) 13 *Monash University Law Review* 164 (hereinafter *Directors' "Wider" Responsibilities*) 172, 175 and 180; and Sealy "Directors' Duties – An Unnecessary Gloss" (1988) 47 *Cambridge Law Journal* 175 (hereinafter *Directors' Duties*) 176 for criticism against the decision) does not support the proposition that a duty is owed to creditors independently of insolvency or financial instability, as judgment in that case could have been based on the fact that the director was in breach of his duty to act in the interests of the company, "rather than in a specific breach of duty to the creditors".

⁴¹⁶ See eg *Lyford v CTH Bank supra* 283, where the court stated that directors' duties extend to not prejudicing the interests of creditors in cases where the company is "insolvent, nearly insolvent or of doubtful solvency". In *Pascoe Ltd (in liq) v Lucas* (1998) SASC 6660, the court's refusal to address the question of creditors' interests, based on the fact that the company was solvent at all relevant times, clearly dispels any notion that directors are under obligation to consider the interests of creditors of solvent companies. In *In re New World Alliance Pty Ltd (rec and mgr apptd); Sycotex Pty Ltd v Baseler supra* 550, the court stated that where a company is "insolvent or nearing insolvency, the creditors are to be seen as having a direct interest in the company and that interests cannot be overridden by the shareholders" (own

4.3.3 New Zealand

According to Cooke J in *Nicholson v Permakraft (NZ) Ltd*⁴¹⁷ directors are under an obligation to consider the interests of creditors, if the company is “insolvent, or near-insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency”.⁴¹⁸ In an attempt at explaining the meaning of these terms, it was further emphasised that the only concern is not whether the company is able to maintain balance sheet solvency, or to keep subscribed capital intact, but also the fact that directors should ensure their company’s practical ability to discharge its debts promptly.⁴¹⁹ A similar sentiment was expressed in *Equitycorp Industries Group Ltd v Attorney-General*,⁴²⁰ namely that the obligation to creditors is “especially important when the company is facing financial difficulty”.⁴²¹

Based on the above, the principle once again seems to be that only directors of those companies that are not able to maintain both factual and commercial solvency, or companies in financial difficulty may incur liability for failing to take creditors’ interests into consideration.

It is important, however, to take note of the warning issued by the court in *In re Lake Tekapo Motor Inn Ltd (in liq)*,⁴²² namely that the mere fact that a company is insolvent when a particular transaction is entered into, does not automatically lead to liability on

emphasis). Also see *Australian Growth Resources Corporation Pty Ltd v Van Reesema* (1988) 13 ACLR 261 268 – 271; *Chew v The Queen* (1991) 4 WAR 395 450; and *Linton v Telnet Pty Ltd* (1999) 17 ACLC 619 628; 631.

⁴¹⁷ *Supra*.

⁴¹⁸ *Id* 249.

⁴¹⁹ *Ibid*. The *obiter* statements in this case were referred to with approval in *David Neil and Co Ltd (in rec) v Neil supra*.

⁴²⁰ [1998] 2 NZLR 481.

⁴²¹ *Id* 549.

⁴²² *Supra*.

the part of directors. Complaints by creditors in this regard will have to be supported by the facts and creditors will have to be able to show an intent to defraud, or reckless disregard of their position, before they will succeed with claims against directors.⁴²³

4.3.4 England

The courts in England seem to agree that a company must be experiencing some form of financial difficulty before a duty to creditors will be recognised. In *In re Horsley & Weight Ltd*⁴²⁴ the court expressly stated that, had the company been “doubtfully solvent” at the time of the grant complained of, the grant made by the directors would have been considered as “fraud on the creditors”.⁴²⁵ A similar viewpoint is reiterated in *Winkworth v Edward Baron Development Co*,⁴²⁶ where it was expressly stated that the breaches of duty would not have mattered, had the directors been able to maintain the solvency of the company. In *Liquidator of West Mercia Safetywear v Dodd*⁴²⁷ Dillon LJ, who expressed the view in *Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd*⁴²⁸ that directors do not owe duties to creditors, found that directors are in breach of their duties because they failed to consider the interests of the creditors. This distinction is made on the basis that the company in *Liquidator of West Mercia Safetywear v Dodd*⁴²⁹ was insolvent at the time directors performed the act complained of.

⁴²³ In this case the action against the directors was based solely on statutory liability for reckless and fraudulent trading, however, and it should therefore be distinguished from cases like *Re Day-Nite Carriers supra*; *Re Avon Chambers Ltd supra*; and *Hilton International Ltd v Hilton supra*, which were based on breach of trust or misfeasance. In *Re Lake Tekapo Motor Inn Ltd (in liq) supra*, the court found that the statement of claim did not in any way refer to breach of trust or negligence, precluding the plaintiffs from going beyond the allegations of reckless and fraudulent trading in an attempt to hold the directors liable based on breach of trust or negligence.

⁴²⁴ *Supra*.

⁴²⁵ *Id* 1056.

⁴²⁶ *Supra* 118.

⁴²⁷ *Supra*.

⁴²⁸ *Supra*.

⁴²⁹ *Supra*.

The importance of the financial state of affairs of a company in determining whether creditors are protected by directors' duties to them was also clearly enunciated in *Brady v Brady*.⁴³⁰ The House of Lords, in commenting on the Court of Appeal's decision that financial assistance was not in the interest of the company because there was no evidence that the interest of the company's creditors had been considered, was very clear on the point that the proposal should not fail on that ground, as the companies were clearly solvent at the relevant time.

In two more recent cases, *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd*⁴³¹ and *Miller v Bain*,⁴³² the court also linked the fact that directors have to consider the interests of creditors in discharging their duties to the company to the possibility of imminent insolvency, or insolvency.

4.3.5 Canada

The Canadian courts are unanimous that directors' duties to creditors only exist in circumstances where the company was insolvent when it entered into the challenged transaction, or where the challenged transaction rendered it insolvent.⁴³³ This inference is clearly supported by the fact that the court refused to allow a claim by creditors for breach of fiduciary duties by directors where it was not submitted by the plaintiffs that the company was insolvent at the time of the impugned transaction, or that the transaction rendered it insolvent.⁴³⁴

⁴³⁰ *Supra* 632.

⁴³¹ 2002 WL 31676321 (internet source – no page numbers available).

⁴³² 2001 WL 1743253 (internet source – no page numbers available).

⁴³³ *Peoples Department Stores (trustee of) Inc v Wise supra* par 202; *Canbook Distribution Corporation v Borins supra* par 16.

⁴³⁴ *Lakehead Newsprint (1990) Ltd v 893499 Ontario Ltd supra* par 33 – 34.

4.3.6 United States of America

The Delaware courts are very clear on the point that directors of solvent corporations owe their common law fiduciary duties to the corporation and its shareholders.⁴³⁵ Creditors of solvent corporations have to rely on contractual duties owed to them for protection of their interests,⁴³⁶ but may hold directors accountable on a non-contractual basis under special circumstances, for example fraud or insolvency.⁴³⁷

Should these special circumstances be present, the corporation's assets are regarded as a "trust fund"⁴³⁸ for creditors. Directors are regarded as the "trustees"⁴³⁹ of that trust fund, implicating that they owe creditors fiduciary duties in that capacity.

Despite opinions by commentators that the trust fund doctrine does not enjoy the full support of the Delaware courts,⁴⁴⁰ the view that directors of insolvent corporations owe fiduciary duties to creditors was finally and unequivocally recognised in *Geyer v*

⁴³⁵ In *Smith v Van Gorkom* 488 A 2d 858 (Del 1985) 872 the Supreme Court of Delaware expressly stated: "In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders." Directors of solvent corporations are furthermore only permitted to consider the interests of other corporate constituents in, for example, a takeover situation, if stockholders also benefit from a particular course of action that will benefit the other corporate constituents. See *Revlon Inc v MacAndrews & Forbes Holdings Inc* 506 A 2d 173 (Del 1986) 176; *Mills Acquisition Co v MacMillan Inc* 559 A 2d 1261 (Del 1989) 1282.

⁴³⁶ This viewpoint is defined in a number of Delaware cases. See eg *Harff v Kerkorian* 324 A 2d 215 (Del Ch 1974) 222; *Katz v Oak Industries Inc* 508 A 2d 873 (Del Ch 1986) 879; *Revlon Inc v MacAndrews & Forbes Holdings Inc supra* 182; and *Simons v Cogan supra* 302.

⁴³⁷ *Harff v Kerkorian supra* 222.

⁴³⁸ The trust fund doctrine was first mooted in the federal case of *Wood v Drummer* 30 F Cas 435 (CCD Me 1824) (No 17 944).

⁴³⁹ In *Bovay v HM Byllesby & Co supra* 813 the court stated that directors should not be literally regarded as trustees, but that they would be subject to the same high standards as trustees when they "have unlawfully profited through breach of duty".

⁴⁴⁰ See eg Cohen "Directors' Negligence Liability to Creditors: A Comparative and Critical View" (2001) 26 *The Journal of Corporation Law* 351 380 note 211; Nicholson "Recent Delaware Case Law Regarding Director's Duties to Bondholders" (1994) 19 *Delaware Journal of Corporate Law* 573 580 *et seq*; and Varallo & Finkelstein "Fiduciary Obligations of Directors of the Financially Troubled Company" (1992) 48 *The Business Lawyer* 239 248 *et seq*.

*Ingersoll Publications Co.*⁴⁴¹ In this case the court made provision for directors' duties to creditors in circumstances where the company is "insolvent in fact".⁴⁴² Insolvency "in fact" is defined by the court as the entity being "unable to pay its debts as they fall due to the usual course of business...That is, an entity is insolvent when it has liabilities in excess of a reasonable market value of assets held".⁴⁴³ It is clear therefore that the court did not require formal statutory proceedings to have been instituted in order for a duty to creditors to be recognised,⁴⁴⁴ as was alleged by the defendant in the case.⁴⁴⁵

In light of the cases discussed above, it seems that there can be no doubt as to the fact that only directors of corporations that are in financial difficulty are under obligation to consider the interests of creditors. This obligation is furthermore not dependent on statutory proceedings having been instituted.

Uncertainty is created, however, by the court's ambiguous statement in the unreported decision of *Credit Lyonnais Bank Netherland, NV v Pathe Communications Corporation*,⁴⁴⁶ namely that

[a]t least where a corporation is operating in the *vicinity of insolvency*, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to *the corporate enterprise*.⁴⁴⁷

⁴⁴¹ *Supra* 784.

⁴⁴² *Id* 787.

⁴⁴³ *Id* 789.

⁴⁴⁴ *Id* 787.

⁴⁴⁵ The court in *Geyer v Ingersol supra* departed from the earlier viewpoint held in cases like *Mackenzie Oil Co v Omar Oil & Gas Co* 120 A 852 (Del Ch 1923) 857 and *Asmussen v Quaker City Co* 156 A 180 (Del Ch 1931) 183, that the trust fund doctrine will only be applied once statutory proceedings have been instituted and proceeded with the same willingness, as in *Bovay v HM Byllesby & Co supra* 809, to look past the formalities of statutory proceedings and recognising a managerial duty to creditors upon "insolvency in fact".

⁴⁴⁶ *Supra*.

⁴⁴⁷ *Id* 1155 (own emphasis).

At first glance it is clear that the above statement contains two noteworthy phrases. In the first place, even though commentators discuss this case with reference to directors' duties to creditors,⁴⁴⁸ no mention is in fact made of creditors' interests in the body of the text.⁴⁴⁹ The focus is rather on the interests of the corporation itself, with the court placing directors under an obligation "to consider the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity".⁴⁵⁰

Secondly, directors are put under the above-mentioned obligation when the corporation is operating in the "vicinity of insolvency".⁴⁵¹ Unfortunately no explanation is given of what is meant by the phrase "vicinity of insolvency".⁴⁵²

A strict interpretation of *Credit Lyonnais Bank Netherland, NV v Pathe Communications Corporation*⁴⁵³ leads one to conclude that it does not impact on directors' direct duties to creditors, which still only become operative when the corporation is insolvent. Directors of corporations that are in the "vicinity of insolvency" are not required to protect

⁴⁴⁸ McDonnell "Geyer v Ingersoll Publications Co: Insolvency Shifts Directors' Burden from Shareholders to Creditors" (1994) 19 *Delaware Journal of Corporate Law* 177 178 made the express statement that: "In *Credit Lyonnaise (sic)*, the court of chancery implied that a director of a corporation which was in the 'vicinity of insolvency' may owe a duty to the corporation's creditors". See also Jelisavcic "A Safe Harbor Proposal to Define the Limits of Directors' Fiduciary Duty to Creditors in the 'Vicinity of Insolvency': *Credit Lyonnais v Pathe*" (1992) 18 *The Journal of Corporation Law* 145 152.

⁴⁴⁹ The tension that may exist between shareholders' and creditors' interests, especially under circumstances where the corporation is insolvent, or in the "vicinity of insolvency", is highlighted in a footnote to the decision (n 55). Nowhere is it expressly stated, however, that the court expects directors to safeguard the interests of one group over those of another.

⁴⁵⁰ *Supra* 1155. The phrase "community of interests" was used by the judiciary as early as 1939 in *Pepper v Litton* 308 US 295 (1939) 307, where Douglas J expressed the view that the fiduciary duties of directors of corporations in financial distress, are "designed for the protection of the entire *community of interests in the corporation* – creditors as well as stockholders" (own emphasis).

⁴⁵¹ *Ibid.*

⁴⁵² Nicholson *supra* 575 bemoans the use of this phrase as "regrettably ambiguous in its timing and scope, unrealistic in its expectations, and lacking in a procedural enforcement mechanism".

⁴⁵³ *Supra.*

creditors' interests, but have somebody or something else's interests to consider, namely the corporation's community of interests.⁴⁵⁴

*Credit Lyonnais Bank Netherland, NV v Pathe Communications Corporation*⁴⁵⁵ thus seems to offer support for the indirect duty model in respect of corporations that are in the "vicinity of insolvency". Creditors stand to profit indirectly from this in that directors are now required to consider non-shareholder constituents even before the company is insolvent.⁴⁵⁶ The corporation being in the "vicinity of insolvency" does not, however, give rise to a direct duty to creditors.

4.4 BENEFICIARY OF THE DUTY

4.4.1 Introduction

An analysis of the cases in which the issue of directors' duties to creditors was mooted, indicates that two methods are used to effect this type of creditor protection.

The first method clings to the traditional viewpoint, namely that directors owe their duties to the company as a whole and that they should act in the best interests of the company.⁴⁵⁷ The way in which the courts managed to extend directors' duties to include creditors, is by redefining the interests of the company. The interests of the company, which are

⁴⁵⁴ This argument seems to be in line with the conclusion of Nicholson *supra* 589, who regards the effect of *Credit Lyonnais Bank Netherland, NV v Pathe Communications Corporation supra* as having created a new duty for directors, whose obligations will shift from obligations to shareholders (when the corporation is solvent), to the community of interests (when the corporation is in the vicinity of insolvency), to creditors (when the corporation is insolvent). Varallo & Finkelstein *supra* 243 regard *Credit Lyonnais Bank Netherland, NV v Pathe Communications Corporation* as a recognition of a shift in directors' duties from stockholders to the corporation, or perhaps a supervening duty to the corporation, boiling down to the fact that "the board of a nearly insolvent firm must pay special attention to the long term interests of the corporation, even if in so doing it pursues a course contrary to the wishes of its shareholders".

⁴⁵⁵ *Supra*.

⁴⁵⁶ Nicholson *supra* 592.

⁴⁵⁷ *Percival v Wright* [1902] 2 Ch 421 424 – 425; *In re Smith & Fawcett Ltd* [1942] Ch 304 306.

usually equated with the interests of the shareholders,⁴⁵⁸ are extended to creditors as one of the constituencies in the company. In terms of this method, the company thus remains the beneficiary of directors' duties. The "interest" of the company is redefined, however, with reference to the interest of its creditors, rather than those of its members.⁴⁵⁹ Directors can therefore incur liability based on the fact they did not act *bona fide* in the best interests of a company, because they neglected to consider or protect creditors' interests.⁴⁶⁰

Another way in which the courts made provision for creditor protection through directors' duties is by recognising an independent duty *owed* by the directors directly to the creditors. In terms of this method it would not be sufficient if directors only *considered* the interests of the creditors in discharging their duties to the company, as was required in the application of the first method. The creditors are therefore seen to be the direct recipients of the duty if the second method is applied.⁴⁶¹

The choice of a method may have far-reaching consequences. First, it may play a role in determining who would have *locus standi* to institute an action against directors for failing to comply with their duties to creditors. Second, it may help to provide guidelines with regard to the question of ratification of a breach of directors' duties to creditors. The

⁴⁵⁸ *Parke v The Daily News Ltd* [1962] Ch 927 943; *Greenhalgh v Arderne Cinemas Ltd* [1951] 1 Ch 286 290.

⁴⁵⁹ Hereinafter "indirect duty model".

⁴⁶⁰ Strictly speaking one should not use the phrase "directors' duties to creditors" in the context of the indirect duty model, as this method does not provide for a direct duty to creditors. It is, however, a "generally accepted shorthand way of referring to the duty", as is noted by Keay "The Director's Duty to Take Into Account the Interests of Company Creditors: When is it Triggered?" (2001) 25 *Melbourne University Law Review* 315 317, and will be used subject to the same proviso mentioned by Keay 317, namely that "the necessary caveats are mentioned".

⁴⁶¹ Hereinafter "direct duty method".

choice of a method may finally play an important role in providing guidelines as to the classes of creditors who should enjoy the protection flowing from of such duty.⁴⁶²

4.4.2 Australia

The method that seems to be favoured in Australia is the first method, or indirect duty model. In the first cases on directors' duties to creditors, the court emphasised that the directors of a company, in discharging their duty to *the company*, must consider the interest of its creditors.⁴⁶³ This impression is reinforced by the support expressed for the indirect duty model in later decisions in which the question of directors' duties to creditors was referred to,⁴⁶⁴ and by the express rejection of the second method, or direct duty method, in others.⁴⁶⁵

4.4.3 New Zealand

⁴⁶² See *infra* Ch 8 (Beneficiary of the Duty) for more detail on the implications of each method in respect of matters such as *locus standi*; the ratification of a breach of the duty; and the classes of creditors protected in terms of the duty.

⁴⁶³ See *Walker v Wimborne supra* 449; *Ring v Sutton supra* 550; *Kinsela v Russell Kinsela Pty Ltd (in liq) supra* 733; *Grove v Flavel supra* 417; *Jeffrey v NCSC supra* 228.

⁴⁶⁴ In *Lyford v CTH Bank supra* 283 the court once again stated that “directors owe a fiduciary obligation to the company” and that this duty “extends to not prejudicing the interests of creditors”, a viewpoint repeated in the latest in the line of cases in which directors' duties to creditors are mentioned, namely *Sheahan v Verco* (2001) 79 SASR 109 132 with the court stating that “the duty of a director to the company...to act in the interests of the company...requires consideration of the interests of creditors”.

⁴⁶⁵ In *Re New World Alliance Pty Ltd (rec and mgr apptd)*; *Sycotex Pty Ltd v Baseler supra* 550 the court rejected the concept of creditors being direct beneficiaries of directors' duties and limited the application of such a duty to a mere restriction on the right of shareholders to ratify breaches of the duty owed to the company. See also *Spies v The Queen* (2000) 173 ALR 529 555, where the court was very clear on the point that remarks suggesting that “directors owe an independent duty to, and enforceable by, the creditors by reason of their position as directors...are contrary to principle...and do not correctly state the law.” Some commentators, eg McConvill “Directors' Duties to Creditors in Australia after *Spies v The Queen*” (2002) 20 *Company & Securities Law Journal* 4 5 – 6 are of the opinion, however, that the huge amount of interest created by this statement is misplaced, as it was only made *obiter* and was actually an attack of the majority of the court on the prosecution's clear misuse of a criminal statutory provision. Cf Hargovan “Directors' Duties in Australia after *Spies v The Queen* – Is the Development of an Independent Fiduciary Duty Dead or Alive?” (2003) 21 *Company & Securities Law Journal* 390 for a detailed analysis of the importance of this decision, namely that it provides a clear answer that “directors' fiduciary duties are not owed directly to, and enforceable by, creditors at common law” (*id* 409), as well as the commentary thereon by various authors.

In *Nicholson v Permakraft (NZ) Ltd*,⁴⁶⁶ one of the leading cases in New Zealand dealing with directors' duties to creditors, Cooke J was clear on the point that "the duties of directors are owed to *the company*" and that "this may require the directors to consider inter alia the interests of creditors".⁴⁶⁷ He added, however, that under certain circumstances creditors may have an independent right of action against directors for "breach of a particular duty of care arising on ordinary negligence principles".⁴⁶⁸

One of the most recent cases dealing with directors' duties to creditors in New Zealand, *Hilton International Ltd v Hilton*,⁴⁶⁹ may create the impression that a back door was left open for the application of the direct duty method. This case dealt with the payment of capital dividends by directors to themselves in their capacity as shareholders, while the company was barely in a position to afford such payment. Tipping J formulated a number of principles pertaining to the legal responsibility of directors with regard to the declaration of dividends, mainly regarding the fact that a company has to maintain balance sheet and trading solvency and that payment of dividends should not jeopardise this. In terms of the eighth principle, directors, when declaring a dividend, owe a duty "not only to the company but *also to its creditors...to act in accordance with the foregoing principles*".⁴⁷⁰ This statement may at first glance be interpreted as support for the direct duty method. It should be noted, however, that this duty is not imposed in general terms, but limited to the context of a declaration of dividends, which therefore largely restricts its application.

⁴⁶⁶ *Supra*.

⁴⁶⁷ *Id* 249 (own emphasis).

⁴⁶⁸ *Id* 250. The example given of such circumstances is directors obtaining credit for the company when they ought to know that the creditor incorrectly understood a valuable asset to belong to the company.

⁴⁶⁹ *Supra*.

⁴⁷⁰ *Id* 475 (own emphasis).

The fact that all the New Zealand cases discussed in this section were instituted by the liquidator on behalf of the company, along with the fact that there is no authoritative support for the general application of the direct duty method, justifies the conclusion that the indirect duty model is favoured in New Zealand.

4.4.4 England

The majority of English cases seem to offer support for the indirect duty model.⁴⁷¹ Comments made by Lord Templeman in *Winkworth v Edward Baron Development Co Ltd*⁴⁷² provide a clear indication that the courts are not unanimous in their support for the indirect duty model. Lord Templeman made the well-known remark that

a company owes a duty to its creditors, present and future...The conscience of the company, as well as its management, is confided to its directors. A duty is owed by the directors to the company *and to the creditors of the company* to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors.⁴⁷³

The above statement seems to indicate some support for the direct duty method. In light of criticism levelled against this statement⁴⁷⁴ and the fact that it is contrary to all other cases in England on the same point, one feels compelled to agree with Farrar that these

⁴⁷¹ In one of the first cases in England in which a duty to creditors was mooted, namely *Lonrho Ltd v Shell Petroleum Co Ltd supra* 634 Lord Diplock, referring to the interests of the company, stated that the best interests of the company “are not necessarily those of the shareholders but may include those of the creditors”. This viewpoint was endorsed by an *obiter* remark by Buckley LJ, delivering the primary judgment in *Re Horsley & Weight Ltd supra* 1055, namely that it may be “somewhat loosely said that the directors owe an indirect duty to the creditors...but I would regard it as more accurate to say that the directors owe a duty *to the company*” (own emphasis). In *Yukong Line Ltd v Rendsburg Investments* [1988] 2 BCLC 485 503 Toulson J is also clear on the point that a director “does not owe a direct fiduciary duty towards an individual creditor, nor is an individual creditor entitled to sue for breach of the fiduciary duty owed by the director to the company”. Also see *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd supra*, where the court stated that directors must act in the best interests of the company, which includes considering the interests of the company’s creditors, should there be a possibility of imminent insolvency.

⁴⁷² *Supra*.

⁴⁷³ *Id* 118 (own emphasis).

⁴⁷⁴ See eg Sealy *Directors’ Duties* 176 who is of the opinion that “if sentiments like this had prevailed over the past century and a half, the limited liability company would never have got off the ground”; and Farrar “The Responsibility of Directors and Shareholders for a Company’s Debts” (1989) 4 *Canterbury Law Review* 12 14, who submitted that these remarks are “too widely stated”.

obiter remarks should not be regarded as anything else, but a somewhat warbled version of the capital maintenance principles formulated in *Flitcroft's Case*.⁴⁷⁵

4.4.5 Canada

The Canadian courts have recognised that directors' are under an obligation to consider creditors' interests under particular circumstances.⁴⁷⁶ It is not clear from decisions on this point, however, whether the Canadian courts envisage directors' duties as owed to the company with creditors as stakeholders, or whether they are willing to recognise an independent duty owed directly to creditors.

In *Peoples Department Stores Inc (trustee of) v Wise*,⁴⁷⁷ the first Canadian judgment in which directors' duties to creditors were considered, the court referred to numerous cases in other jurisdictions in which directors' duties to creditors were discussed,⁴⁷⁸ and then stated that it agreed "with the thrust of those judgments and find that Canadian Corporate Law should evolve in that direction".⁴⁷⁹ In most of the cases referred to by the court, the indirect duty model was followed.⁴⁸⁰

⁴⁷⁵ Farrar *supra* 14. The case referred to is *In re Exchange Banking Co (Flitcroft's Case)* (1882) 21 ChD 519, which serves as authority for the traditional capital maintenance doctrine that it is unlawful to pay dividends out of funds representing share capital.

⁴⁷⁶ See eg *Peoples Department Stores Inc (trustee of) v Wise supra*; *Sidaplex-Plastic Suppliers Inc v Elta Group* (1998) 40 OR (3d) 53 (Ont CA).

⁴⁷⁷ *Supra*.

⁴⁷⁸ Decisions referred to include *Nicholson v Permakraft (NZ) Ltd supra* (New Zealand); *Kinsela v Russell Kinsela Pty Ltd (in liq) supra* (Australia); *Walker v Wimborne supra* (Australia); *Winkworth v Edward Baron Development Co Ltd supra* (England); *Liquidator of West Mercia Safetywear Ltd v Dodd supra* (England).

⁴⁷⁹ *Supra* par 200.

⁴⁸⁰ Apart from an *obiter* statement in *Winkworth v Edward Baron Development Co Ltd supra* that seems to leave room for the application of the direct duty method, all the cases referred to by the court are in support of the indirect duty model.

Two subsequent decisions, *Canbook Distribution Corporation v Borins*⁴⁸¹ and *Lakehead Newsprint (1990) Ltd v 893499 Ontario Ltd*,⁴⁸² seem to indicate, however, that the courts favour the direct duty method. In *Canbook Distribution Corporation v Borins*⁴⁸³ reference was made to the fact that a party may institute action against directors, “as a creditor...to whom the directors...owed a fiduciary duty”⁴⁸⁴ and in *Lakehead Newsprint (1990) Ltd v 893499 Ontario Ltd*⁴⁸⁵ it was stated that the central theme in the cases on directors’ duties to creditors is that “directors may owe fiduciary duties to creditors”.⁴⁸⁶

These statements, along with the fact that it was the creditors themselves instituting action based on the breach of fiduciary duties against directors in both instances, may create the impression that the Canadian courts favour the direct duty method. Both cases refer to and rely on *Peoples Department Stores Inc v Wise*,⁴⁸⁷ however, from which the opposite viewpoint was inferred.

The only explanation for the apparent contradiction between *Canbook Distribution Corporation v Borins*⁴⁸⁸ and *Lakehead Newsprint (1990) Ltd v 893499 Ontario Ltd*⁴⁸⁹ on the one hand, and *Peoples Department Stores Inc (trustee of) v Wise*⁴⁹⁰ on the other, is that the courts are in favour of extending directors’ duties to creditors, but have not yet properly considered the basis on which this should be done.

⁴⁸¹ *Supra.*

⁴⁸² *Supra.*

⁴⁸³ *Supra.*

⁴⁸⁴ *Id* par 18.

⁴⁸⁵ *Supra.*

⁴⁸⁶ *Id* par 33.

⁴⁸⁷ *Supra.*

⁴⁸⁸ *Supra.*

⁴⁸⁹ *Supra.*

⁴⁹⁰ *Supra.*

4.4.6 United States of America

In the United States of America, case law seem to indicate that the direct duty method is supported in respect of insolvent corporations. This is illustrated by the fact that creditors are allowed to institute action against a director for non-compliance with duties on their own behalf.⁴⁹¹ A creditor is therefore not forced to wait for the bankruptcy trustee,⁴⁹² who is acting on behalf of the “corporation”, or company, to institute action against directors who acted in breach of their duties.

The right of a creditor to institute action against a director for non-compliance with his duties to creditors is, however, dependent on the financial situation of the corporation and there seems to be a definite link between the method that is followed when providing for directors’ duties to creditors and the solvency of the particular corporation. In respect of corporations that operate in the vicinity of insolvency, for example, the courts seem to favour the indirect duty model.

4.5 PROTECTED CREDITORS

4.5.1 Introduction

A further question that the courts grapple with when dealing with directors’ duties to creditors, is which creditors enjoy the protection afforded by such a duty. The courts identified two possibilities. The first is that the duty only extends to existing creditors, in other words creditors who had fixed claims against the company when the directors performed the particular act complained of. In other instances, however, the courts went so far as to recognise a duty to future creditors, in other words creditors who did not have fixed claims against the company when directors performed the act in question, but whose claims only became certain at a later stage.⁴⁹³

⁴⁹¹ See eg *Geyer v Ingersoll Publications Co supra*.

⁴⁹² Known to us as the liquidator of the company being wound up.

⁴⁹³ The issue as to which creditors should be protected was only referred to by the courts in the context of present and future creditors of the company and are therefore only dealt with in that context in this specific chapter. Problems regarding a possible conflict of interests between different classes of creditors when discussing directors’ duties to creditors, eg secured and unsecured creditors, or the different rights of

The question as to which creditors are protected by directors' duties isn't only important in determining whether directors acted in breach of their duties, but also with regard to the solvency of the company. Taking into consideration possible claims by future creditors, or disregarding such claims, will play a very important role in determining the financial status of a company.

4.5.2 Australia

The question as to whether directors' duties to the company include an obligation to consider the interests of future creditors featured prominently in *Jeffree v NCSC*.⁴⁹⁴ In this case all the existing trade and other creditors were paid in full when the assets of Wanup Pty Ltd were transferred to another company in an attempt to defeat an anticipated arbitration award.

The only person affected detrimentally by the particular conduct of the director, namely the successful party to the arbitration suit, was not even a creditor at the stage when the transaction was concluded. The court still found the director guilty of an offence, as he breached his duty to the company and its creditors, which include the contingent creditor.⁴⁹⁵

The *obiter* remark by Mullighan J in *Sheahan v Verco*⁴⁹⁶ that directors are required to consider the interests of creditors, including future creditors,⁴⁹⁷ seems to offer further support for the viewpoint offered by *Jeffree v NCSC*.⁴⁹⁸

voluntary creditors like bondholders, trade creditors, etc and involuntary creditors, eg delictual creditors, were not addressed by the courts. These questions are addressed in a subsequent chapter. See *infra* Ch 8 (Beneficiary of the Duty).

⁴⁹⁴ *Supra*.

⁴⁹⁵ *Id* 228.

⁴⁹⁶ *Supra*.

⁴⁹⁷ *Id* 132.

⁴⁹⁸ *Supra*.

4.5.3 New Zealand

In *In re Avon Chambers Ltd*⁴⁹⁹ the court was confronted with a scenario very similar to the one in *Jeffree v NCSC*.⁵⁰⁰ Here a company was once again being stripped of its assets, this time through the declaration and payment of a dividend to its principal shareholder and director, in order to defeat an anticipated arbitration award. The liquidator sought to recover the amount of the dividend from the director by means of an action based on misfeasance or breach of trust, as no provision was made for payment of the anticipated rental claim.

In its judgment in favour of the liquidator, the court defended its reliance on *In re Day-Nite Carriers*,⁵⁰¹ a case dealing with the interests of existing creditors, by stating that it does not make any difference whether or not there is an existing debt. The test applied is whether “[t]he contingency...amounted to a commercial certainty that the company would soon have to pay a large sum in arrears”.⁵⁰²

The court thus seems willing to go so far as to require directors to consider the interests of future creditors of the company, under circumstances where payment of such debts can be regarded as a commercial certainty.

In *Nicholson v Permakraft (NZ) Ltd*⁵⁰³ the court seemed willing once more to extend directors’ duties to future creditors, this time distinguishing between “future *new* creditors” and future creditors who already have an “established trade relationship” with

⁴⁹⁹ *Supra*.

⁵⁰⁰ *Supra*.

⁵⁰¹ *Supra*.

⁵⁰² *In re Avon Chambers supra* 640.

⁵⁰³ *Supra*.

a company – the former not to be regarded as beneficiaries of a managerial duty, while the latter should be entitled to have their interests protected by directors.⁵⁰⁴

4.5.4 England

An *obiter* remark in *Winkworth v Edward Baron Development Co Ltd*,⁵⁰⁵ namely that “a company owes a duty to its creditors, *present and future*”⁵⁰⁶ provides the only indication that English courts are willing to extend directors’ duties to consider creditors’ interests to future creditors as well. Whether this statement will carry much weight in providing authority for the viewpoint that directors’ duties to consider the interests of creditors include future creditors, is doubtful, because it was made *obiter*.

In *Brady v Brady*⁵⁰⁷ the judiciary furthermore seems to limit the duty of directors specifically to existing creditors, casting even more doubt on the probability of directors’ duties being extended to future creditors.⁵⁰⁸

⁵⁰⁴ *Id* 250. Cooke J summarised the position of future creditors as follows:

[T]o make out a duty to future *new* creditors would be much more difficult. Those minded to commence trading with and give credit to a limited liability company do so on the footing that its subscribed capital has not been returned to the shareholders, but otherwise they must normally take the company as it is when they elect to do business with it. In the case of a supplier who already has an established trade relationship with a company, there is of course a distinction between current and future debts. It seems to me neither necessary nor desirable, however, to use that distinction so as to limit the duties of the directors of the debtor company to considering whether debts already incurred can be paid. If the company’s financial position is precarious the fortunes of such suppliers may be so linked with those of the company so as to bring them within the reasonable scope of the directors’ duties. They may continue to give credit in ignorance of a change damaging to their prospects of payment.

⁵⁰⁵ *Supra*.

⁵⁰⁶ *Id* 118 (own emphasis).

⁵⁰⁷ *Supra*.

⁵⁰⁸ *Id* 632. The court noted that “it cannot therefore be necessarily fatal to the agreement that the individual parties to it may not...have had in mind specifically the interests of *future creditors*” and “there was no reason to suppose that the position of *any present creditor* was in the least affected” (own emphasis).

4.5.5 Canada

In all the Canadian cases discussed in this section, the court only had to deal with prejudice suffered by the existing creditors of the company. The Canadian courts therefore did not address the question as to whether directors' duties to consider the interests of creditors extend to future creditors of the company.

4.5.6 United States of America

In all the Delaware cases discussed in this section, the courts had to deal with claims against directors because they failed to consider the interests of existing creditors. The courts therefore did not have to address the question as to whether directors' common law duties to creditors extend to future creditors of the corporation and remained silent on the topic.⁵⁰⁹

4.6 POWER OF THE GENERAL MEETING TO RATIFY A BREACH OF THE DUTY

4.6.1 Introduction

It is trite law that the company in general meeting may ratify a breach of directors' duties to the company.⁵¹⁰ The question that needs to be answered is whether *shareholders* are able to ratify a breach of directors' duties, where it is alleged that directors acted in breach of their duties to the company because they failed to consider the interests of

⁵⁰⁹ Statutory provision is made for the interests of future creditors, however, through the so-called "dissolution statutes". See eg *Delaware General Corporation Law* Del Code Ann tit 8 (1991) ss 280 – 282. These statutes provide that upon the dissolution of a corporation sufficient security for all future unknown claims and/or claimants are required; as well as temporal parity among contingent and unknown claimants; and *pro rata* payments for claims of equal priority to the extent the corporation had insufficient funds to pay all claims and obligations in full. For the way in which the courts approach the application of these provisions, see *In re RegO Co* 623 A 2d 92 (Del Ch 1992) as well as the discussion by Stilson "Re-examining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors" (1995) 20 *Delaware Journal of Corporate Law* 1. The focus of this study is on directors' duties and the protection that could be afforded to creditors' interests in terms thereof. Statutory provisions aimed at creditor protection, like the ones referred to, therefore fall outside the scope of this study and are not addressed in any further detail.

⁵¹⁰ *Bamford v Bamford* [1970] Ch 212. See *infra* Ch 8 (Beneficiary of the Duty) par 8.2.3 for more detail.

creditors. This question appears especially vexing when following the indirect duty model in extending directors' duties to creditors.⁵¹¹

4.6.2 Australia

In Australia this issue was touched upon in a number of cases, in all of which the court was very clear on the point that a breach of directors' duties to consider the interests of creditors cannot be ratified by the shareholders.⁵¹²

This departure from the generally accepted principle, namely that shareholders have the authority to ratify a breach of directors' duties, is explained by the fact that, once the company experiences "financial difficulties",⁵¹³ it is "the creditors' money which is at risk, in contrast to the shareholders' proprietary interests".⁵¹⁴

4.6.3 New Zealand

From the *obiter* statement by Cooke J in *Nicholson v Permakraft (NZ) Ltd*⁵¹⁵ that the "unanimous assent of shareholders is not enough to justify the breach of duty to the creditors",⁵¹⁶ it can be deduced that New Zealand courts will also be reluctant to allow shareholders to condone breaches of directors' duties to creditors. According to Cooke J the ratification by shareholders of a duty owed to creditors will only prevent any complaint by the shareholders themselves.⁵¹⁷

⁵¹¹ Should the second method be followed, namely that directors owe an independent duty to creditors, this particular issue does not present serious difficulties, as shareholders are clearly not in a position to ratify a breach of duties that are specifically owed to creditors.

⁵¹² *Ring v Sutton supra* 547; *Kinsela v Russell Kinsela Pty Ltd (in liq) supra* 732; *Re New World Alliance Pty Ltd (rec and mgr apptd); Sycotex Pty Ltd v Baseler supra* 550.

⁵¹³ The negation of the generally accepted principle that shareholders may condone breaches of directors' duties is therefore once again clearly linked to the fact that the company in question must be experiencing some form of "financial difficulties". See *supra* par 4.3 for the various ways in which the court phrased this requirement, as well as the discussion *infra* Ch 7 (Point in Time When the Duty Arises) for detail on various circumstances related to the financial state of affairs in the company that may be considered as a "trigger" for the duty to creditors.

⁵¹⁴ *Kinsela v Russell Kinsela Pty Ltd (in liq) supra* 732 – 733.

⁵¹⁵ *Supra*.

⁵¹⁶ *Id* 20.

⁵¹⁷ *Ibid*.

This conclusion is supported by remarks in *Hilton International Ltd v Hilton*.⁵¹⁸ The court, in formulating a number of principles regarding the legal responsibility of directors with regard to the declaration of dividends, stated that directors of a company owe a duty to the company and its creditors to abide by these principles and that they are not protected from liability for breach of such a duty by ratification of their actions by shareholders.⁵¹⁹

Even though the statements referred to above were either made *obiter* or limited to very specific circumstances, it cannot detract from the fact that the general view of the court seems to be that shareholders are not in a position to absolve directors from a breach of their duty to creditors.

4.6.4 England

The only indication of the English courts' view on ratification by shareholders of a breach of a duty to creditors, is an *obiter* remark by Cumming-Bruce LJ and Templeman LJ in *Re Horsley & Weight Ltd*.⁵²⁰ Both felt that, even though it was unnecessary to decide the question as to whether directors, as controlling shareholders, may ratify a breach of their duties, it would be a “surprise...to find that the law is to be so understood” and that one cannot be satisfied that “directors convicted of such misfeasance...could excuse themselves because two of them held all the issued shares in the company”.⁵²¹

The importance of these remarks is limited by the fact that they were made *obiter* and were furthermore limited to the specific facts of the case that concerned a closely controlled company, in other words a company where the directors were also the only shareholders.

⁵¹⁸ *Supra*.

⁵¹⁹ *Id* 475.

⁵²⁰ *Supra*.

⁵²¹ *Id* 1055 – 1056.

4.6.5 Canada

The Canadian courts did not formulate any general principles regarding the power of the general meeting to ratify breaches of directors' duties to consider the interests of creditors.

4.6.6 United States of America

The question as to whether shareholders are in a position to ratify a breach of directors' duties to creditors is not specifically addressed in the cases discussed in this section. The reason for this can be found in the application of the direct duty method, which clearly obviates the necessity of addressing this issue in any detail. A "shift" from shareholders to creditors as the beneficiaries of directors' duties upon insolvency, would entail that shareholders are not able to ratify breaches of directors' duties, as they are no longer the recipients of these duties.

This issue becomes more problematic, however, where a corporation is not insolvent but only operating in the vicinity of insolvency. Under circumstances like these the courts did not provide for a direct duty to creditors, but seemed inclined to support the indirect duty model, with creditors merely being one of the corporate constituents whose interests should be considered, creating much more potential for conflict between the interests of the various stakeholders.

4.7 CONCLUSION

On the basis of common elements regarding directors' duties to creditors, as gleaned from the majority of cases discussed above, it is possible to draft the following judicial framework for such a duty:

Actions against directors for failing to consider creditors' interests are most often based on breach of fiduciary type duties, rather than breach of the duty of care, although the latter was used in some instances.

Directors are placed under an obligation to consider the interests of creditors upon insolvency, or when the company is in the vicinity of insolvency. A duty to creditors is thus clearly linked to the financial situation of the company.

The way in which creditors are to enforce a duty owed to them depends largely on the model that is followed for such a duty. Application of the indirect duty model seems to indicate that the accepted principle that directors owe their duties to the company is adhered to. These duties are consequently to be enforced by the company. Upon the company in question experiencing financial difficulties creditors will, however, step into the shoes of the shareholders as the parties who are indirectly protected by directors' duties. A breach of directors' duties to consider creditors' interests will have to be enforced on behalf of the creditors by the liquidator.

However, if the direct duty method is applied, creditors become the direct beneficiaries of these duties once the duties to creditors are "triggered", entitling them to institute action on their own behalf.

It furthermore seems to be generally accepted by the judiciary in all jurisdictions that shareholders are not in a position to ratify a breach of directors' duties to the company, where the breach involves failure to consider the interests of creditors. This is the case irrespective of whether it is the direct duty model or indirect duty model that is applied.

The position of future creditors varies from jurisdiction to jurisdiction. The perception seems to be that the courts in Australia and New Zealand are not unwilling to extend this duty to future creditors of a company. The English judiciary does not seem to be so liberal, however, while the courts in Canada and Delaware did not address this issue in any detail.

The above framework may seem deceptively simple. A closer look will reveal a number of problems inherent to the framework, however, and it leaves numerous practical questions unanswered.

It may be asked, for example, whether the conduct of directors in many of the cases mentioned in this section did not give rise to liability based on ordinary principles of fiduciary duties. The necessity of invoking creditors' interests as a basis for inferring director liability is thus open to attack. An explanation for the courts opting for this route seems to be the fact that the shareholders ratified the alleged breaches of directors' duties in many instances, in an attempt to prevent any action being taken against the directors. Rephrasing directors' duties as being owed to creditors rather than shareholders, whether it be directly or indirectly, successfully deprives shareholders of the right to ratify these breaches of directors' duties and thus opens the door for action being taken against the directors.

This approach raises another issue, however, namely whether the same result may not be achieved through the mere categorisation of the wrongs that took place as "unratifiable", as this will also remove the power of shareholders to effectively ratify these wrongs.

Other practical concerns relate to the content of the duty owed to creditors and the way in which creditors should enforce such a duty. It is one thing to categorise the duty as a fiduciary type duty, or a duty of care. This does not answer the question, however, as to what is expected from directors in terms of a duty to creditors.

The circumstances that may give rise to a duty to creditors are also shrouded in uncertainty. It seems to be generally accepted that a duty to creditors is dependent on the company in question being in some form of financial difficulty. However, the court phrased this requirement in a number of ways. Directors may also be left in the unenviable position of having owed a duty to consider the interests of creditors at a particular point in time, without them having been aware of this at that particular moment. It is clearly unacceptable to burden directors with a duty that they only become aware of after the fact.

Enforceability of a duty to creditors is another critical issue. Drawing a distinction between a direct duty model and an indirect duty model offers superficial guidance only regarding the way in which a duty is to be enforced.

These issues are addressed in more detail below⁵²² in an attempt to provide a practical framework within which directors' duties to creditors may function.

⁵²² Ch 5 – Ch 9.

CHAPTER 5

PROTECTION AFFORDED BY FIDUCIARY DUTIES

SUMMARY

- 5.1 INTRODUCTION
 - 5.2 SOURCES AND FORMULATION
 - 5.3 RELEVANT ELEMENTS
 - 5.4 CONSEQUENCES OF BREACH OF DUTY
 - 5.5 APPLICATION TO A DUTY TO CREDITORS
 - 5.6 CONCLUSION
-

5.1 INTRODUCTION

Directors have practically unlimited powers to manage the affairs of the company and devices for controlling directors in the exercise of these powers are clearly necessary.⁵²³ One such device is the strict fiduciary principles that directors should adhere to in fulfilling their directorial functions.⁵²⁴

Mechanisms such as these, which are designed to serve as a check on directors' powers, may be seen as the means by which the law fills in the otherwise standard contract commonly adopted between directors and shareholders.⁵²⁵ However, not only shareholders are protected against a directorial abuse of powers in terms of principles of fiduciary duties – both the judiciary and commentators recognise that creditors also

⁵²³ Farrar & Hannigan *Farrar's Company Law* (1998) (hereinafter Farrar) 377.

⁵²⁴ Brown "Speaking with Complete Candor: Shareholder Ratification and the Elimination of the Duty of Loyalty" (2003) 54 *Hastings Law Journal* 641 644 describes fiduciary obligations as having a "talismanic quality" and representing "the only significant limitation on board action". Also see Du Plessis "Direkteure se Vertrouenspligte en die Grondslag van Aanspreeklikheid vir die Verbreking Daarvan" 1993 *THRHR* 11 (hereinafter Du Plessis *Aanspreeklikheidsgrondslag*); Farrar *supra* 377; Fourie "Vertrouenspligte en Intrakorporatiewe Verhoudings" 1985 *TRW* 119 126 (hereinafter Fourie *Vertrouenspligte*); and Fourie "Die *Sui Generis* Aksie teen Direkteure Weens Verbreking van Vertrouenspligte" 1995 *Stell LR* 408.

⁵²⁵ Farrar *supra* 377.

stand to lose much if directors breach their fiduciary duties.⁵²⁶ This viewpoint seems to be underlined by the fact that the majority of cases dealing with directors' duties to creditors were concerned with directors who acted in breach of their fiduciary duties.⁵²⁷

Unfortunately legal principles with regard to the way in which directors should exercise their powers are considered as one of the most complex areas of company law.⁵²⁸ Despite the growth in the trust and confidence type fiduciary relationship⁵²⁹ and it having become a “standard wrong in commercial dealings”,⁵³⁰ it remains difficult to define the exact parameters of a fiduciary relationship with certainty.⁵³¹

⁵²⁶ *Cooper v Luxor (Eastbourne) Ltd* [1939] 4 All ER 411 (CA) 418 – 419. Larkin “The Fiduciary Duties of the Company Director (I)” 1979 *SA Company LJ* E-1 agrees that the function of the fiduciary relationship is also to “safeguard [the company’s] creditors in view of the principle of limited liability”.

⁵²⁷ See discussion *supra* Ch 4 (Judicial Framework) par 4.2.

⁵²⁸ Fourie *Vertrouenspligte* 124. He also provides a list of factors that may have contributed towards the complexity of the law in this area (*id* 119 – 120). Havenga “Directors’ Fiduciary Duties under Our Future Company Law Regime” (1997) *SA Merc LJ* 310 311 regards a company directorship as “one of the most complex fiduciary offices”.

⁵²⁹ Glover *Commercial Equity: Fiduciary Relationships* (1995) 8 distinguishes between three categories of fiduciary relationships, namely fiduciary relationships of trust and confidence; fiduciary relationships of influence; and fiduciary relationships of confidential information. The principle of trust as basis of directors’ fiduciary duties seems to be confirmed by the judiciary in *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168 179, where it is stated that liability for a breach of fiduciary duties rests “upon the broad doctrine that a man, *who stands in a position of trust* towards another, cannot in matters affected by that position, advance his own interests...at that other’s expense” (own emphasis). Naude *Die Regsposisie van die Maatskappydirekteur met Besondere Verwysing na die Interne Maatskappyverband* (1970) (hereinafter *Naude Regsposisie van die Maatskappydirekteur*) 108 – 109 also indicates that the figure of the company director was brought under the broad concept of *trust* (“vertroue”). He warns, however, that the fiduciary relationship that a director has with the company of which he is a director is simply one of the categories of the broad *genus* of relationships of trust and that it would be wrong to deduce that the position of the company director should be equated with that of a trustee on the basis that he holds a position of trust. The relationship of trust is furthermore based on the holding of the office of director and is not dependent on the director assuming certain responsibilities that are normally associated with a relationship of trust, eg when acting as representative of the company.

⁵³⁰ Glover *supra* 17.

⁵³¹ Glover *supra* 17. Fourie *Vertrouenspligte* 122 refers to the following statement by Shepherd in the preface to *Law of Fiduciaries* (1981) in this regard:

The law of fiduciaries is the legal system’s attempt to recognize the more blatant abuses of the trust we place in each other. It is undoubtedly the most human area of the legal system, and as such the most undefinable.

Some form of theoretical structure for this relationship is, however, imperative to ensure that a fiduciary obligation is more than “merely descriptive” and is “sufficiently analytic” to permit the predictable application thereof to a variety of circumstances.⁵³²

The need for some clarity with regard to the theoretical structure of directors’ fiduciary duties becomes even more pronounced when an attempt is made at extending these duties to include creditors’ interests. It is rightly noted:

To understand how creditors came to be owed fiduciary duties in certain circumstances, *it is first necessary to understand the traditional fiduciary duties owed by directors* to their corporation and its shareholders.⁵³³

It is therefore firstly necessary to provide some general background on directors’ common law fiduciary duties. Aspects referred to in this regard are the sources and formulation of directors’ fiduciary duties;⁵³⁴ specific elements of fiduciary duties that are relevant for the purposes of this study;⁵³⁵ and the consequences of a breach of fiduciary duties.⁵³⁶

The general discussion is followed by an evaluation of legal principles pertaining to fiduciary duties, specifically with regard to the application thereof to a duty to creditors.⁵³⁷

⁵³² De Mott “Beyond Metaphor: An Analysis of Fiduciary Obligation” 1988 *Duke Law Journal* 879 909.

⁵³³ Barnett “*Healthco* and the ‘Insolvency Exception’: An Unnecessary Expansion of the Doctrine?” (2000) 16 *Bankruptcy Developments Journal* 441 442 (own emphasis).

⁵³⁴ *Infra* par 5.2.

⁵³⁵ *Infra* par 5.3. An analysis of case law on directors’ duties to creditors indicates that creditors are particularly vulnerable to breaches of particular fiduciary duties and it is only these aspects of fiduciary duties that are discussed in any detail in this section. The first element of fiduciary duties that is relevant for the purposes of this study is that directors are required to act *bona fide* in the best interests of the company in terms of their fiduciary duties; the second that directors must maintain an unfettered discretion; and the last that directors must avoid a conflict of interest.

⁵³⁶ *Infra* par 5.4.

⁵³⁷ *Infra* par 5.5.

5.2 SOURCES AND FORMULATION

5.2.1 South Africa

In South Africa directors' fiduciary duties form part of their common law duties.⁵³⁸ The general content of fiduciary duties is expressed in a number of ways by various authors. According to Cilliers and Benade, fiduciary duties entail that directors should act in good faith; exercise their powers for the benefit of the company; and that they should avoid a conflict of interests.⁵³⁹ Hahlo regards it as a "paramount duty of directors...to exercise their powers bona fide in the best interests of the company",⁵⁴⁰ while Naude is of the opinion that directors have to exercise their powers in good faith and avoid a conflict of interests.⁵⁴¹ On this broad basis, a number of typical fiduciary duties have been identified.

The fiduciary duties of members of a close corporation are formulated in terms of statute,⁵⁴² as are the fiduciary duties of directors of banks.⁵⁴³ Although not specifically applicable to the fiduciary duties of company directors, it may provide an indication of how the legislature views the framework within which fiduciary duties function.⁵⁴⁴ The relevant provision in the *Close Corporations Act* seem to provide for two main types of fiduciary duties, namely the duty to act honestly and in good faith,⁵⁴⁵ and the

⁵³⁸ Cilliers & Benade *Corporate Law* (2000) par 10.08 – par 10.09.

⁵³⁹ *Id* par 10.10.

⁵⁴⁰ Pretorius; Delpont; Havenga & Vermaas *Hahlo's South African Company Law through the Cases* (1999) 279.

⁵⁴¹ Naude *Regsposisie van die Maatskappydirekteur* 111.

⁵⁴² In terms of s 42 of the *Close Corporations Act* 69 of 1984 (hereinafter *Close Corporations Act*).

⁵⁴³ In terms of s 60 of the *Banks Act* 94 of 1990 (hereinafter *Banks Act*). This fiduciary duty is applicable not only to directors, but also to chief executive officers and executive officers of banks.

⁵⁴⁴ It must be noted, however, that the formulation in terms of s 42 of the *Close Corporations Act* is not conclusive, as s 42(2) expressly provides that any statutory expression of the content of the "fiduciary relationship" between members and the close corporation, is "[w]ithout prejudice to the generality of the expression 'fiduciary relationship'". In this regard the reason for referring to this particular statutory statement of fiduciary duties, namely only to serve as an indication of how the legislature views fiduciary duties, must be emphasised.

⁵⁴⁵ In terms of s 42(2)(a).

duty to avoid a conflict of interests.⁵⁴⁶ The duty to act in good faith is described as a duty to exercise powers in the interest and for the benefit of the close corporation;⁵⁴⁷ and the duty not to exceed those powers.⁵⁴⁸ The duty to avoid a conflict of interest entails, in particular, the duty not to derive any unwarranted personal benefit;⁵⁴⁹ the duty to notify other members of any interest in any contract of the close corporation;⁵⁵⁰ and the duty not to compete with the close corporation in its business activities.⁵⁵¹

In terms of the *Banks Act* the fiduciary duty that a director owes to the bank comprises a duty to act *bona fide* for the benefit of the bank;⁵⁵² and a duty to avoid a conflict between the bank's interests and his own interests.⁵⁵³

5.2.2 Australia

The fiduciary duties of Australian directors are codified in terms of a number of provisions of the Australian *Corporations Act*.⁵⁵⁴ The first of these, section 181(1), stipulates:

A director or other officer of a corporation must exercise their powers and discharge their duties:

- (a) in good faith in the best interests of the corporation; and
- (b) for a proper purpose.

Section 182(1) furthermore provides:

⁵⁴⁶ In terms of s 42(2)(b).

⁵⁴⁷ S 42(2)(a)(i).

⁵⁴⁸ S 42(2)(a)(ii).

⁵⁴⁹ S 42(2)(b)(i).

⁵⁵⁰ S 42(2)(b)(ii).

⁵⁵¹ S 42(2)(b)(iii). This particular framework for the various elements of fiduciary obligations, to a large extent, seems to correspond with the view of Naude *Regsposisie van die Maatskappydirekteur* on how the fiduciary duties of company directors should be viewed.

⁵⁵² In terms of s 60(1A)(a).

⁵⁵³ In terms of s 60(1A)(b).

⁵⁵⁴ *Corporations Act* 2001 (hereinafter *Australian Corporations Act*).

A director, secretary, other officer or employee of a corporation must not improperly use their position to:

- (a) gain an advantage for themselves or someone else; or
- (b) cause detriment to the corporation.

According to the last of these provisions, section 183(1):

A person who obtains information because they are, or have been a director or other officer or employee of a corporation must not improperly use the information to:

- (a) gain an advantage for themselves or someone else; or
- (b) cause detriment to the corporation.

5.2.3 New Zealand

Section 131 of the New Zealand *Companies Act*⁵⁵⁵ also contains a statutory expression of directors' fiduciary duties. In terms of this provision:

- (1) [A] director of a company, when exercising powers or performing duties, must act in good faith and in what the director believes to be the best interests of the company.
- (2) A director of a company, that is a wholly-owned subsidiary may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of that company's holding company even though it may not be in the best interests of the company.
- (3) A director of a company that is a subsidiary (but not a wholly-owned subsidiary) may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company and with the prior agreement of the shareholders (other than its holding company), act in a manner which he or she believes is in the best interests of that company's holding company even though it may not be in the best interests of the company.
- (4) A director of a company that is carrying out a joint venture between the shareholders may, when exercising powers or performing duties as a director in connection with the carrying out of the joint venture, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the

⁵⁵⁵ *Companies Act* 1993 (hereinafter *New Zealand Companies Act*).

best interests of a shareholder or shareholders, even though it may not be in the best interests of the company.

5.2.4 England

The content of directors' fiduciary duties in England is to be found in common law principles. These duties are formulated in a number of ways by different authors and closely resemble the obligations that South African directors have in terms of their common law fiduciary duties.⁵⁵⁶

Section B10 of the *Company Law Reform Bill*⁵⁵⁷ provides an indication, however, that a statutory formulation of directors' duties is going to replace the existing common law principles.⁵⁵⁸ The general principles applicable to directors are set out in various provisions.

Section B2 reads as follows:

⁵⁵⁶ See eg Farrar *supra* 378 according to whom directors' fiduciary duties require them to act *bona fide* in the interests of the company and not to exercise their powers for any collateral purpose. They are also liable to account to the company for any profit made by use of their positions. Should a director furthermore conclude a contract with the company and find himself in a position where his duty to the company and his personal interests are in conflict, the contract is voidable at the instance of the company. Davies *Gower's Principles of Modern Company Law* (1997) 601 distinguishes four rules that comprise directors' fiduciary duties. These rules are that directors must act in good faith in what they believe to be the best interests of the company; they must exercise their powers for the purpose for which they were conferred; they must not fetter their discretion; and they must not, without the informed consent of the company, place themselves in a position where their personal interests conflict with those of the company. In the next edition of this book the main elements of fiduciary duties have been extended to six, in order to follow the scheme of the proposed statutory statement (see Davies *Gower and Davies' Principles of Modern Company Law* (2001) (hereinafter Gower) 381). Pennington *Pennington's Company Law* (2001) 709 – 725 lists directors' fiduciary duties as the duty not to exceed their powers; the duty to act primarily in the interests of the shareholders of the company as a whole in exercising their powers; the duty to account to the company for any profit made without the company's consent by virtue of them holding the office of director in the company; and the duty not to misuse their powers but exercise it for the benefit of the company and for a proper purpose.

⁵⁵⁷ Proposals by the Company Law Review resulted in a White Paper published by the English government in March 2005. This *Company Law Reform Bill* is available at www.dti.gov.uk/cld.review.htm. The section specifically dealing with directors' duties is available at www.dti.gov.uk/cld/chapter7.pdf. This document is hereinafter referred to as the English *Company Law Reform Bill*.

⁵⁵⁸ S B10(1) provides:

The general duties are based on certain common law rules and equitable principles as they apply in relation to directors and *have effect in place of those rules and principles* as regards the duties owed to a company by a director (own emphasis).

As a director of a company you must–

- (a) act in accordance with the company’s constitution, and
- (b) only exercise powers for the purposes for which they are conferred.⁵⁵⁹

Section B3 reads as follows:

- (1) As a director of a company you must act in the way you consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.
- (2) Where or to the extent that the company is established for purposes other than the benefit of its members, your duty is to act in the way you consider, in good faith, would be most likely to achieve those purposes.
- (3) In fulfilling the duty imposed by this section you must take account (where relevant and so far as reasonably practicable) of –
 - (a) the likely consequences of any decision in both the long and the short term,
 - (b) any need of the company –
 - (i) to have regard to the interests of its employees,
 - (ii) to foster its business relationships with suppliers, customers and others,
 - (iii) to consider the impact of its operations on the community and the environment, and
 - (iv) to maintain a reputation for high standards of business conduct, and
 - (c) the need to act fairly as between members of the company who have different interests.
- (4) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

Section B4 provides:

⁵⁵⁹ This provision can be equated with directors’ duty not to exceed their powers and to exercise powers for a proper purpose.

- (1) As a director of a company you must exercise independent judgment.
- (2) This duty is not infringed by your acting –
 - (a) in accordance with an agreement duly entered into by the company that restricts the future exercise of discretion by its directors, or
 - (b) in a way authorised by the company's constitution.

Section B6 stipulates:

- (1) As a director of a company you must avoid a situation in which you have, or can have, a direct or indirect interest that conflicts, or possibly may conflict with the interests in the company.
- (2) This applies in particular to the exploitation of any property, information or opportunity (and it is immaterial whether the company could take advantage of the property, information or opportunity).
- (3) This duty is not infringed –
 - (a) if there is no real possibility of a conflict of interest;
 - (b) if the conflict of interest arises in relation to a proposed transaction or arrangement with the company (but see section B8 (duty to declare interest in proposed transaction with company));
 - (c) if the conflict of interest arises in relation to a transaction or arrangement duly entered into by the company;
 - (d) if authorisation has been given by the company in accordance with subsection (4).
- (4) Authorisation by the company may be given –
 - (a) by the matter being proposed to the members of the company and authorised by them; or
 - (b) where the company is a private company and nothing in the company's constitution invalidates such authorisation, by the matter being proposed to and authorised by the directors; or
 - (c) where the company is a public company and its constitution includes provision enabling the directors to authorise the matter, by the matter being proposed to and authorised by them in accordance with the constitution.

Section B7 reads as follows:

- (1) As a director of a company you must not accept a benefit from a third party conferred by reason of –
 - (a) your being a director, or
 - (b) your doing (or not doing) anything as director.
- (2) A “third party” means a person other than the company, an associated company or a person acting on behalf of the company or an associated company.
- (3) Benefits received by you from a person by whom your services (as a director or otherwise) are provided to the company are not regarded as conferred by a third party.
- (4) This duty is not infringed –
 - (a) if there is no real possibility of a conflict of interest;
 - (b) if the matter has been proposed to the members of the company and authorised by them.
- (5) Any reference in this section to a conflict of interest includes a conflict of interest and duty and a conflict of duties.

Section B8, the last provision dealing with general duties, provides:

- (1) As a director of a company you must declare the nature and extent of any interest, direct or indirect, you have in a proposed transaction or arrangement with the company.
- (2) If an earlier declaration of interest proves to be, or becomes, inaccurate or incomplete (for instance, because of subsequent changes in the matters to which it relates) you must make a further declaration.
- (3) Any declaration required by this section –
 - (a) may be made to the other directors or to the members of the company, and
 - (b) must be made before the company enters into the transaction or arrangement.
- (4) You will be regarded as failing to comply with the duty imposed by this section if you fail to make a declaration, or fail to declare fully the nature and extent of your interest, because you are unaware of matters of which you ought reasonably to be aware.
- (5) ...

5.2.5 Canada

Directors in Canada are subject to statutory fiduciary duties in terms of section 122(1)(a) of the *Canada Business Corporations Act*,⁵⁶⁰ which provides as follows:

Every director and officer of a corporation in exercising their powers and discharging their duties shall act honestly and in good faith with a view to the best interests of the corporation.

5.2.6 United States of America

Directors' duties are partially codified in a large number of states in terms of provisions along the lines of section 8.30(a) of the 1984 *Model Business Corporations Act*.⁵⁶¹ In terms of this provision:

A director shall discharge his duties as a director...

- (1) in good faith;
- (2) with the care an ordinary person in a like position would exercise under similar circumstances;
- (3) in a manner he reasonably believes to be in the best interests of the corporation.

Commentators seem to agree that directors are deemed to owe fiduciary duties, which are divided into a duty of loyalty and a duty of care.⁵⁶² The duty of loyalty, in terms of which directors must act in good faith and in a manner they reasonably believe to be in the best interests of the corporation, is clearly the equivalent of what we know as fiduciary duties.

In terms of their duty of loyalty, directors are expected to act with “undivided loyalty to their corporations, and they may not so use corporate assets, or deal with the corporation, as to benefit themselves at the expense of the corporation”.⁵⁶³ This duty

⁵⁶⁰ RSC 1985, c C-44 (hereinafter *CBCA*).

⁵⁶¹ Hereinafter 1984 *MBCA*.

⁵⁶² Miller “Corporate Governance in Chapter 11: The Fiduciary Relationship between Directors and Stockholders of Solvent and Insolvent Corporations” (1993) 23 *Seton Hall Law Review* 1467; Millner “What Does it Mean for Directors of Financially Troubled Companies to Have Fiduciary Duties to Creditors?” (2000) 9 *Journal of Bankruptcy Law and Practice* 201.

⁵⁶³ Clark *Corporate Law* (1986) 34.

prohibits self-dealing-type conduct, for example misappropriation of corporate opportunities and using corporate assets or information for personal gain.⁵⁶⁴

5.3 RELEVANT ELEMENTS

5.3.1 Acting in Good Faith in the Best Interests of the Company

5.3.1.1 General

Directors are required to act in good faith in the best interests of the company when exercising their management powers. In all the jurisdictions referred to above it is regarded as an integral part or even the broad basis of directors' fiduciary duties. It is uncertain, however, whether the requirement to act in good faith and for the benefit of the company is regarded as a single concept or as two concepts.

In *Greenhalgh v Arderne Cinemas Ltd*⁵⁶⁵ the court expressed the opinion that the phrase “‘*bona fide* for the benefit of the company as a whole’ means not two things but one thing”.⁵⁶⁶

Section 60(1A)(a) of the *Banks Act* provides that directors owe a duty to the bank to “act *bona fide* for the benefit of the bank”, which could be regarded as an indication that the South African legislature views this as a single concept. The statutory formulation of the fiduciary duties of members of a close corporation may, on the other hand, indicate that the obligation to act in good faith in the best interests of the company should not necessarily be regarded as a single concept.⁵⁶⁷

For the purposes of this discussion the approach adopted in the majority of jurisdictions referred to in this study, namely that the phrase refers to one concept, is

⁵⁶⁴ Miller *supra* 1476; Millner *supra* 204.

⁵⁶⁵ [1951] 1 Ch 286.

⁵⁶⁶ *Id* 291.

⁵⁶⁷ S 42(2)(a) of the *Close Corporations Act* provides that members are required to act honestly in good faith. In a further subsection this duty is described to entail, amongst other things, a duty to exercise their powers in the interest and for the benefit of the close corporation (s 42(2)(a)(i)).

accepted.⁵⁶⁸ The two aspects will be discussed separately, however, to distinguish clearly between the problems of interpretation that exist in respect of each of them.

5.3.1.2 Requirement of Good Faith

It seems to be generally accepted that directors, as part of their fiduciary duties, should act in good faith when exercising their management powers. It is not clear what is to be understood by the requirement of good faith, however.

One possibility is that it merely places directors under an obligation to act honestly, indicating clearly that this particular arm of fiduciary duties is a very subjective one.⁵⁶⁹ This entails that a court is expected to pronounce upon directors' intentions in performing a particular act, in order to establish whether they were indeed acting honestly, or in good faith.

Another possibility points towards a more objective standard, with "good faith" referring to a concept similar to "genuine".⁵⁷⁰ This approach seems to be preferable on the face of it, as it disposes of the burden on the judiciary to question directors' intentions and apparently places directors under a more stringent obligation.

The Australian judiciary have adopted a "hybrid objective-subjective approach" when interpreting the phrase.⁵⁷¹ In terms of the first stage of the test the honesty of the exercise of powers by the directors is evaluated. This is in line with the traditional subjective approach to the good faith requirement. The second stage of the test,

⁵⁶⁸ This is also the approach followed by the legislature in the majority of jurisdictions referred to in this study. See eg s 181(1)(a) of the Australian *Corporations Act*; s 131(1) of the New Zealand *Companies Act*; s B3(1) of the English *Company Law Reform Bill*; and s 122(1)(a) of the *CBCA*. The 1984 *MBCA* provides for these concepts in separate subsections, however, namely s 8.30(a)(1) and s 8.30(a)(3).

⁵⁶⁹ Naude *Regsposisie van die Maatskappydirekteur* 111 holds this viewpoint.

⁵⁷⁰ Sealy "‘Bona fides’ and ‘Proper Purposes’ in Corporate Decisions" (1989) 15 *Monash University Law Review* 265 269.

⁵⁷¹ Heath "Directors' Duties and Corporate Governance" (2000) 18 *Company & Securities Law Journal* 377 379, with reference to *Teck Corporation Ltd v Millar* (1973) 33 DLR (3rd) 288 315.

however, measures subjective honesty against an objective threshold,⁵⁷² for example whether the decision is one that a reasonable director or board could have reached, or whether the director acted like an honest person of ordinary prudence.⁵⁷³

5.3.1.3 Defining the Interests of the Company

It seems that all the jurisdictions discussed above recognise that directors' fiduciary duties entail that they should act in the best interests of the company, or should exercise their powers for the benefit of the company.⁵⁷⁴ A vexing issue in this regard is how the best interests of the company are to be defined.⁵⁷⁵

According to one view the fact that directors' duties are formulated as being "owed" to the company, or that they should act in the "best interests of the company", simply relates to a question of enforceability.⁵⁷⁶ Should directors fail to comply with their duties to the company, the company, as a general rule, is the only proper party to bring action against the directors.

The fact that directors have to act in the best interests of the company does not, however, mean that they have to promote the welfare of the artificial entity, as it would be impossible to give a definite content of a duty framed in terms of benefiting the entity itself.⁵⁷⁷ Such a formulation will furthermore be unhelpful as it fails to identify the relevant constituencies and does not give any indication of the priority enjoined by them *inter se*.⁵⁷⁸

⁵⁷² Sealy "Directors' Duties Revisited" (2001) 22 *The Company Lawyer* 79 82 (hereinafter Sealy *Directors' Duties*) identifies an increasingly objective approach to various questions, with a consequent raising of standards, as one of the modern trends in the development of company law.

⁵⁷³ Heath *supra* 379.

⁵⁷⁴ *Supra* par 5.2.

⁵⁷⁵ Heath *supra* 379 rightly notes that "this formula has been interpreted in a somewhat elusive ad hoc manner".

⁵⁷⁶ Parkinson *Corporate Power and Responsibility: Issues in the Theory of Company Law* (1993) 76.

⁵⁷⁷ Parkinson *supra* 76 states that "a requirement to benefit an artificial entity, *as an end in itself*, would be irrational and futile, since a non-real entity is incapable of experiencing well-being". Gower *supra* 371 also recognises the problem of treating a metaphysical entity as the beneficiary of directors' duties. This point is discussed in more detail below (see *infra* Ch 8 (Beneficiary of the Duty)).

⁵⁷⁸ Parkinson *supra* 79.

It is suggested that a duty formulated for the benefit of *the enterprise* only becomes possible if the purpose of the enterprise is taken into consideration. This purpose can only be properly understood with reference to the enterprise serving human interests or objectives.⁵⁷⁹ Parkinson concludes that the “correct position is thus that the corporate entity is a vehicle for benefiting the interests of a specified group or groups”.⁵⁸⁰

This conclusion still begs the question, however, of the identity of the specified group or groups who should benefit from the duty. In this regard the traditional viewpoint seems to be that it is the shareholders or members of the company whose interests should enjoy prime if not sole consideration.⁵⁸¹

The traditional equation of the company’s interests exclusively with those of its shareholders does not, however, seem to provide a complete solution.⁵⁸² Although the

⁵⁷⁹ *Id* 77.

⁵⁸⁰ *Ibid*.

⁵⁸¹ This viewpoint came across very clearly in *Greenhalgh v Arderne Cinemas Ltd supra* 291, where the court stated that

“the company as a whole”, does not...mean the company as a commercial entity, distinct from the incorporators. It means *the incorporators as a general body* (own emphasis);

as well as *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* [1983] 2 All ER 563 585, where a similar statement was qualified with reference to the company’s financial position. The court expressed the view that

so long as the company is solvent *the shareholders are in substance the company* (own emphasis).

⁵⁸² The question is asked whether “members” refer to present members only, or whether the long-term interests of future members should also be considered. Commentators hold different viewpoints in this regard. Some, eg Farrar *supra* 381, are of the opinion that the short-term interests of present members should be balanced against the long-term interests of future members, unless it is only the interests of the current shareholders that are relevant. Others, eg Parkinson *supra* 80, regard it as “difficult...to see why the directors should have to take account of the interests of the as yet unidentifiable persons who might acquire shares in the company at some future date”.

legislature in some jurisdictions seems inclined to stick to the traditional approach,⁵⁸³ this approach appears to be under attack by the judiciary⁵⁸⁴ and is also questioned by commentators.⁵⁸⁵

A second problem relating to directors' duty to act in the best interests of the company is whether compliance with this duty should be assessed in a subjective or an objective way. An objective approach regarding this duty suggests that directors must act in a way that they *reasonably* believe to be in the best interests of the company.⁵⁸⁶

⁵⁸³ See eg s B3(1) of the English *Company Law Reform Bill*, which harks back to the traditional equation of the interests of the company with those of its members, as indicated by the phrase that a director is required to "promote the success of the company *for the benefit of its members as a whole*" (own emphasis).

⁵⁸⁴ See eg *Fulham Football Club Ltd v Cabra Estates* [1992] BCC 863 876, where the court provides a clear indication of a general departure from the orthodox viewpoint through its statement that, even if the directors had acted improperly by fettering their discretion, it would have made no difference that the agreement into which the company had entered enjoyed the unanimous assent of the shareholders. The court based this argument on its view that

the company is more than just the sum total of its members. Creditors, both present and potential, are interested, while section 309 of the Companies Act 1985 imposes a specific duty on directors to have regard to the company's employees in general.

Also see *supra* Ch 4 (Judicial Framework) for various cases in which the judiciary recognised that directors, in complying with their duties to the company, should consider the interests of corporate creditors. Examples are *Walker v Wimborne* (1975 – 1976) 137 CLR 1 6 – 7; *Kinsela v Russell Kinsela (Pty) Ltd (in liq)* (1986) 4 NSWLR 722 730; 732; *Yukong Line Ltd v Rendsburg Investments* [1998] 2 BCLC 485 503; *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd* 2002 WL 31676321 (internet source – no page no), etc.

⁵⁸⁵ See eg *Gower supra* 372 who states that

even in these terms it might be thought to follow that, as the company nears insolvency, the interests of the members should be replaced by the interests of the creditors.

⁵⁸⁶ This is the viewpoint held by *Farrar supra* 382 who states:

The proper approach is to consider whether an intelligent and honest man in the position of the director of the company concerned could, in the whole of the existing circumstances, have *reasonably* believed that the transaction was for the benefit of the company (own emphasis).

A subjective approach, on the other hand, merely requires directors to act in a way that *they* believe to be in the best interests of the company.⁵⁸⁷

In light of the court's pronouncement in *Re Smith & Fawcett Ltd*,⁵⁸⁸ namely that directors must act "bona fide in what *they* consider – not what a court may consider – is in the interests of the company",⁵⁸⁹ one may conclude that the court favours a subjective approach. The court's preference for a subjective approach is understandable in light of the fact that "judges are not obviously well qualified to make substantive evaluations of business policy".⁵⁹⁰

However, the problem inherent to an approach where the duty is formulated with reference to subjective intentions is that determining the true objectives of directors would in practice often be beyond the court's capabilities.⁵⁹¹ Directors may, for example, contest that the consideration of employees' interests was done with a long-term view of shareholders' interests.

A more preferable approach is that adopted in *Lyford v Commonwealth Bank of Australia*,⁵⁹² a case specifically dealing with the extension of directors' duties to include creditors' interests. The court summarised its approach as follows:

The question whether the directors did act in the interests of the company...requires consideration to be given to the state of mind of those who acted, and the motive on which they acted and what their intention was, collecting from the surrounding circumstances all the materials which genuinely throw light upon the question of the

⁵⁸⁷ Gower *supra* 388 – 389 emphasises the subjectivity of this part of fiduciary duties which leads to the courts largely being excluded from second-guessing the decisions of directors as to where the best interests of the company lie. He states that it may be regarded as appropriate on the grounds that courts have little expertise in these matters, but notes on the downside that such a subjective approach would lead to this duty offering little protection for the interests that it is supposed to protect.

⁵⁸⁸ *Supra*.

⁵⁸⁹ *Id* 306 (own emphasis).

⁵⁹⁰ Parkinson *supra* 94.

⁵⁹¹ *Ibid*.

⁵⁹² (1995) 130 ALR 267.

state of mind of the directors so as to show whether they were honestly acting in discharge of their powers in the interests of the company.⁵⁹³

The court thus seems to recognise the subjective approach through its reference to the state of mind of the directors and their motives and intentions. This must, however, be objectively determined in light of “all the materials that genuinely throw light upon the question of the state of mind of the directors”.⁵⁹⁴ The mere fact that directors subjectively believed something to be in the best interests of the company does not automatically infer compliance with their fiduciary duties – surrounding circumstances must have warranted this subjective belief.⁵⁹⁵ In this case the court thus seems to favour a hybrid subjective-objective approach.

A decision by directors may therefore be open to attack if no reasonable man will regard it to be *bona fide* in the best interests of the company.⁵⁹⁶ It must be conceded, however, that the courts rarely interfere⁵⁹⁷ and one is inclined to agree that the “overall emphasis on a subjective test can be criticised as entrenching management to an unacceptable degree”.⁵⁹⁸

The legislatures in the jurisdictions referred to adopted various approaches. In New Zealand, for example, the legislature expressly provided that a director is required to act in good faith “and in *what the director believes* to be the best interests of the

⁵⁹³ *Id* 284.

⁵⁹⁴ *Ibid*.

⁵⁹⁵ The suggestion of Parkinson *supra* 96 that an aid to discovering intention, namely that “what no reasonable board could have believed to be beneficial to the company, the actual board could not have believed either”, or put differently, that “where the means adopted could not on any reasonable view lead to the end of benefiting the company, the directors could not have been motivated by a desire to achieve that end”, is in line with the approach followed by the court.

⁵⁹⁶ Farrar *supra* 381, with reference to *In re Smith & Fawcett Ltd* [1942] Ch 304; and *Heron International Ltd v Lord Grade* [1983] BCLC 244.

⁵⁹⁷ Worthington “Directors’ Duties, Creditors’ Rights and Shareholder Intervention” (1991) 18 *Melbourne University Law Review* 121 132 suggests that the duty to act in good faith in the best interests of the company still only requires loyalty from directors and does not impose an objective standard of behaviour.

⁵⁹⁸ Farrar *supra* 381.

company”,⁵⁹⁹ indicating a clear preference for a subjective yardstick. Section B3(1) of the English *Company Law Reform Bill* also appears to entrench the subjective test, in that it states that as a director you are required to “act in the way *you* consider, in good faith, would be most likely to promote the success of the company”.⁶⁰⁰

⁵⁹⁹ S 131(1) of the New Zealand *Companies Act*.

⁶⁰⁰ Own emphasis.

5.3.2 Maintaining an Unfettered Discretion

5.3.2.1 General

Directors should at all times be free to exercise their powers in good faith for the benefit of the company. As a result of this directors should be allowed to, or are required to, maintain an unfettered discretion. Directors are in danger of breaching this duty in various circumstances, for example when concluding contracts to vote in a particular way, especially in a take-over situation;⁶⁰¹ or when holding the position of “nominee director”⁶⁰² in a company.

The first-mentioned application of this duty seems to be aimed mainly at protecting the interests of shareholders in a potential take-over situation and is not discussed in any more detail, as it has little bearing on the interests of corporate creditors. A breach of this duty by nominee directors, especially in the context of company groups, may, however, have a detrimental impact on the position of creditors and it is discussed in more detail.

5.3.2.2 Nominee Directors

A nominee director is defined in *S v Shaban*⁶⁰³ as “a lawfully elected director, put on the board by a shareholder who controls sufficient voting power for the purpose”.⁶⁰⁴

⁶⁰¹ See eg *Dawson International plc* [1990] BCLC 560; and *John Crowther Group plc v Carpets International plc* [1990] BCLC 460. Both cases were concerned with an undertaking by the boards of target companies to recommend bids by specific bidder companies.

⁶⁰² This is also the term used in Australia, New Zealand and the England. In the USA these directors are referred to as “designated” directors.

⁶⁰³ 1965 4 SA 651 (W).

⁶⁰⁴ *Id* 651. Even though this decision refers expressly to the possibility that a shareholder could appoint nominees, Redmond “Problems for Insiders” in Gillooly (ed) *The Law Relating to Corporate Groups* (1993) 209 213 indicates that it is equally possible for creditors, debenture holders, a participant in a corporate joint venture, or even a group of employees, to contractually obtain the right to appoint a representative to the board of directors. According to Redmond *supra* 214 directors appointed to the boards of subsidiary companies could, however, be regarded as the principal class of nominee director. Also see Boros “The Duties of Nominee and Multiple Directors (I)” (1989) 10 *The Company Lawyer* 211 for a discussion of the difference between nominees other than those of controlling shareholders (*id* 216) and nominees of controlling shareholders (*id* 217); as well as Du Plessis “Nominee Directors Versus Puppet, Dummy and Stooze Directors: Reflections on these Directors and Their Nominators or Appointors” 1995 *TSAR* 310 316 (hereinafter Du Plessis *Nominee Directors*).

These shareholders will clearly expect the director so appointed to serve as their spokesman on the board and to protect their interests in the company.⁶⁰⁵

This would, however, be contrary to the traditional principle in terms of which a director is required to act exclusively in the best interests of the company on whose board he is serving.⁶⁰⁶ One is therefore inclined to agree that the following synopsis given by Margo J in *Fisheries Development Corporation of SA Ltd v Jorgensen*⁶⁰⁷ should rather be taken to present the correct legal principle:⁶⁰⁸

A director is in that capacity not the servant or agent of the shareholder who votes for or otherwise procures his appointment to the board...The director's duty is to observe the utmost good faith *towards the company*, and in discharging that duty he is required to exercise an independent judgment and to take decisions according to the *best interest of the company* as his principal. He may in fact be representing the interests of the person who nominated him, and he may even be the servant or agent of that person, but, in carrying out his duties and functions as a director, *he is in law obliged to serve the interests of the company to the exclusion of the interests of any nominator, employer or principal.*⁶⁰⁹

⁶⁰⁵ Larkin "The Fiduciary Duties of the Company Director (II)" 1979 *SA Company LJ* E-11 E-17, with reference to Naude *Regsposisie van die Maatskappydirekteur*. This "expectation" even seems to be accepted by the judiciary in some instances. See eg *S v Shaban* 1965 (4) SA 646 (W) 651, where Hiemstra J seems comfortable with the idea that a nominee director "goes to a meeting and *acts in the way his principal wants him to*" (own emphasis).

⁶⁰⁶ The traditional principle is based on the concept of the company as a separate entity, in terms of which a company is viewed as a juristic person with its own rights and duties, separate from its members, as was illustrated in *Salomon v Salomon & Co Ltd* [1897] AC 22 (HL). This principle was followed in subsequent cases in which directors' duties to creditors came to the fore, eg *Walker v Wimborne supra* 6 – 7. In this case Mason J made it clear that

the fundamental principle is that each [company within a group is] a separate and independent legal entity, and that it was the duty of the directors of [each company] to consult its interests alone in deciding whether payments should be made to other companies.

⁶⁰⁷ 1980 4 SA 156 (W).

⁶⁰⁸ As is suggested by Du Plessis *Nominee Directors* 312.

⁶⁰⁹ *Fisheries Development Corporation of SA Ltd v Jorgensen supra* 163 (own emphasis).

The traditional approach to the duty, in terms of which a director is under an obligation to act in the best interests of the subsidiary exclusively when exercising his management powers in that company, seems to be followed in South Africa,⁶¹⁰ England,⁶¹¹ Canada⁶¹² and the United States of America.⁶¹³

⁶¹⁰ As indicated by the above statement quoted from *Fisheries Development Corporation of SA Ltd v Jorgensen supra*.

⁶¹¹ The English judiciary made it clear that directors appointed to the boards of companies as nominees are required to ignore the interests of the nominator and serve only those of the company, should their interests conflict. In this regard see *Boulting v ACTT* [1963] 2 QB 606 626, where the following was said with regard to the appointment of a nominee director by a large shareholder:

There is nothing wrong in it. It is done every day. Nothing wrong, that is, *so long as the director is left free to exercise his best judgment in the interests of the company that he serves*. But if he is put upon terms that he is bound to act in the affairs of the company in accordance with the directions of his patron, it is beyond doubt unlawful (own emphasis).

Also see *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1990] 3 All ER 404. A strict application of this rule is seemingly tempered by the decision in *Charterbridge Corporation Ltd v Lloyd's Bank Ltd* [1970] Ch 62, where the court made the *obiter* remark that a director was not automatically in breach of his fiduciary duties to the subsidiary on whose board he serves if the exercised his powers for the benefit of the group as a whole, without having given separate consideration to the interests of the subsidiary. The preceding statement contains an affirmation of the traditional rule in no uncertain terms, however, with Pennycuik J making it clear that each company in a group is still to be considered “a separate legal entity and that the directors of a particular company are not entitled to sacrifice the interests of that company” (*id* 74). This case should therefore not be regarded to embody a drastic departure from accepted dogma. The traditional approach may in future be relaxed in terms of statute. In terms of s B4(1) of the English *Company Law Reform Bill* a director is required to exercise independent judgment. S B4(2)(b) provides, however, that this duty is not infringed if the director acts in a way authorised by the company’s constitution. This provision thus creates room for a director to consider other factors in exercising his managing powers in the subsidiary company, for example the interests of the holding company or the group as a whole, provided that it is authorised in terms of the subsidiary company’s constitution.

⁶¹² Hansel & Gillies “Nearing the Brink of Financial Crisis and Issues for the Unrelated Director” in Queen’s Annual Business Law Symposium 1995 *Corporate Restructurings and Insolvencies: Issues and Perspectives* (1996) 159 164 indicate that there is relatively little jurisprudence on the subject of nominee directors in Canada until 1993, when the case of *PWA Corporation v Gemini Group Automated Distribution Systems Inc* (1993) 8 BLR (2d) 221 (Ont Gen Div (Comm List)) was decided. In this case the court, while acknowledging that directors might find it difficult to view the interests of the company as divorced from the interests of the shareholder who appointed them, left no room for doubt that directors must act in the best interests of the company and that they are required to separate potentially conflicting allegiances.

⁶¹³ Enriquez “Honor Thy Shareholder at All Costs? Towards a Better Understanding of the Fiduciary Duties of Directors of Wholly-owned Subsidiaries” (2003) 32 *Southwestern University Law Review* 97 98 refers to *First American Corporation v Al-Nahyan* 17 F Supp 2d 10 (DDC 1998) to indicate that subsidiary companies in the USA are generally regarded as entities that are separate from their holding companies. In this case directors of a wholly-owned subsidiary concluded a transaction that was to the detriment of the subsidiary, but favourable to the holding company. They were accused of having breached their fiduciary duties. In their defence they raised the argument that the only fiduciary duty

This particular issue received considerable attention from numerous commentators⁶¹⁴ and the question is often asked whether this principle is as easy to apply in practice as it is to formulate in theory,⁶¹⁵ as it represents a “stark divergence between regulatory philosophy and commercial reality”.⁶¹⁶

The Australian and New Zealand legislatures took some steps in an attempt to bring the theoretical principles in line with the practical reality of the situation faced by nominee directors. This was done in terms of specific statutory provisions in terms of which directors are permitted to further the interests of the holding company without having to fear personal liability for having breached their duties to the subsidiary.

they owed was to the ultimate holding company. The court rejected this argument in no uncertain terms, making it clear that “[d]irectors owe fiduciary duties to the corporation and to the shareholders, taken as a whole” (*id* 25) and that “directors of a wholly-owned subsidiary owe the corporation fiduciary duties, just as they would any other corporation” (*id* 26).

⁶¹⁴ See eg Baxt “Duties to a Corporate Group – One Step Forward or Two Steps Backwards?” (1994) 22 *Australian Business Law Review* 138; Crutchfield “Nominee Directors: The Law and Commercial Reality” (1992) 20 *Australian Business Law Review* 109; Enriquez *supra* 97; Finn *Fiduciary Obligations* (1977) 54; Pizer “Holding an Appointor Vicariously Liable for its Nominee Director’s Wrongdoing – An Australian Roadmap” (1997) 15 *Company & Securities Law Journal* 81; Ramsay “Allocating Liability in Corporate Groups: An Australian Perspective” (1999) 13 *Connecticut Journal of International Law* 329; and others referred to in this section.

⁶¹⁵ In this regard Du Plessis *Nominee Directors* 319 rightly notes that “company law has not yet succeeded in bringing the theoretical doctrine of a director’s undivided responsibility towards the company into harmony with commercial reality of nominee directors”; while Parsons “The Director’s Duty of Good Faith” (1967) 5 *Monash University Law Review* 395 418 describes the unenviable position in which such directors find themselves well:

The director who is a nominee of a substantial shareholder is between the devil and the deep blue sea. Happily perhaps for his peace of mind he is most often unaware of the company law principles. No doubt he will only remain a director while he furthers the wishes of the shareholder by whom he was appointed.

Also see Gouvin “Resolving the Subsidiary Director’s Dilemma” (1996) 47 *Hastings Law Journal* 287 302; 304; and Hadden “The Regulation of Corporate Groups in Australia” (1992) 15 *University of New South Wales Law Journal* 61 77 for similar viewpoints. Havenga “The Company, the Constitution, and the Stakeholders” 1997 *Juta’s Business Law* 134 139 suggests that nominee directors should be permitted to pay attention to the interests of the person who appointed them, as long as the interests of the company are not sacrificed in the process.

⁶¹⁶ Lee “Serving Two Masters – The Dual Loyalties of the Nominee Director in Corporate Groups” 2003 *Journal of Business Law* 449.

This opportunity is granted subject to certain conditions, however. In Australia a director of a wholly-owned subsidiary who acted in the best interests of the holding company, would be deemed to have acted in the best interests of the subsidiary,⁶¹⁷ subject to the conditions that the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company;⁶¹⁸ that the director acts in good faith in the best interests of the holding company;⁶¹⁹ and that the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director's act.⁶²⁰

The New Zealand legislature provided for a relaxation of the traditional duty, but has taken this relaxation one step further than its Australian counterpart in that not only directors of wholly-owned subsidiaries, but also directors of subsidiaries which are not wholly-owned subsidiaries, may act in the best interests of the holding company when exercising their management powers. This is permissible even where such act might not be in the best interests of the subsidiary.⁶²¹

Once again the exercise of such powers is subject to certain conditions. The first is that the director must expressly be permitted to do so by the constitution of the company.⁶²² In respect of a subsidiary which is not a wholly-owned subsidiary, a second condition is added, namely that the director acted in the best interests of the holding company with the prior agreement of the shareholders.⁶²³

⁶¹⁷ S 187 of the Australian *Corporations Act*.

⁶¹⁸ S 187(a).

⁶¹⁹ S 187(b).

⁶²⁰ S 187(c).

⁶²¹ Ss 131(2) and (3) of the New Zealand *Companies Act*.

⁶²² S 131(2).

⁶²³ S 131(3).

5.3.3 Avoiding a Conflict of Interests

5.3.3.1 General

The duty of directors to avoid a conflict of interests entails that directors should not exploit assets or opportunities⁶²⁴ of the company for their own benefit.⁶²⁵ This principle has a twofold practical effect. The first is that directors are in general not entitled to any benefit deriving from them holding the office of director in a company, beyond what the company is willing to pay them.⁶²⁶ The second is that they cannot, in general, conclude valid contracts with the company.⁶²⁷

Case law on directors' duties to creditors indicate that creditors are particularly vulnerable to a breach of this particular arm of directors' fiduciary duties.⁶²⁸

⁶²⁴ This particular element of the duty to avoid a conflict of interests seems to be evolving into a separate doctrine, namely the corporate opportunities doctrine. See Lowry & Edmunds "The No Conflict-No Profit Rules and the Corporate Fiduciary: Challenging the Orthodoxy of Absolutism" 2000 *Journal of Business Law* 122 134 – 139 in this regard. Also see the following sources for more detail on this doctrine: Bean "Corporate Governance and Corporate Opportunities" (1994) 15 *The Company Lawyer* 266; Davis "Fiduciary Duties of Non-executive Directors" 1984 *SALJ* 567; Havenga "Company Directors – Fiduciary Duties, Corporate Opportunities and Confidential Information" 1989 *SA Merc LJ* 122; Havenga *Fiduciary Duties of Company Directors with Specific Regard to Corporate Opportunities* LLD UNISA (1995) (hereinafter *Havenga Fiduciary Duties*); Havenga "Corporate Opportunities: A South African Update (Part I)" 1996 *SA Merc LJ* 40; Havenga "Corporate Opportunities: A South African Update (Part II)" 1996 *SA Merc LJ* 233. This doctrine was also expounded upon by the judiciary in *Movie Camera Company (Pty) Ltd v Van Wyk* [2003] 2 All SA 291 (C).

⁶²⁵ Gower *supra* 391 *et seq.* This principle was clearly enunciated as part of South African law in *Robinson v Randfontein Estates Gold Mining Co Ltd* *supra* 177 by Innes J who stated:

Where one man stands to another in a position of confidence involving a duty to protect the interests of that other, he is not allowed to make a secret profit at the other's expense or place himself in a position where his interests conflict with his duty.

And later on

For it rests upon the broad doctrine that a man, who stands in a position of trust towards another, cannot, in matters affected by that position, advance his own interests (eg, by making a profit) at that other's expense (*id* 179).

⁶²⁶ See discussion *infra* par 5.3.3.2 for further detail.

⁶²⁷ See discussion *infra* par 5.3.3.3 for further detail.

⁶²⁸ See eg *David Neil and Co Ltd v Neil* (1986) 3 NZCLC 99 658 where the sole director of the company sold property of the company in financial difficulty to himself at an undervalue; *Grove v Flavel* (1986) 43 SASR 410 where the director used knowledge of the company's precarious financial

5.3.3.2 Unwarranted Personal Benefit

A director is precluded from making a profit from any opportunities resulting from his holding the office of director in a company.⁶²⁹ Case law illustrates that this principle applies even where directors act in good faith.⁶³⁰ It is not possible for a director to circumvent this duty by taking up an opportunity deriving from him holding the office of director, after having resigned from the board of directors.⁶³¹

5.3.3.3 Contracts with the Company

As a general rule a contract between a director and his company is voidable.⁶³² This injunction does not only apply to transactions directly with the director, but also to those in which they have an interest, directly or indirectly.⁶³³

The application of this rule may, however, be avoided in terms of the company's constitution.⁶³⁴ A provision in the articles of association permitting contracts between

position to gain a *de facto* preference for internal or group creditors and himself; *Ring v Sutton* (1980) 5 ACLR 546 where the director used his office to have the company lend him money through a number of loan transactions at interest rates which were so low that one could infer that he preferred his own interests to those of the company; and *Liquidator of West Mercia Safetywear Ltd v Dodd* 1988 PCC CA 212 where a director serving on the board of both the holding and subsidiary company transferred money from the holding company, at a time that he knew it to be insolvent, to the subsidiary in order that the subsidiary could meet its obligations in terms of a loan that the director guaranteed in his personal capacity.

⁶²⁹ *Robinson v Randfontein Gold Mining Co Ltd supra* 177; *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd* 1981 2 SA 173 (T); *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC* 1988 2 SA 54 T 67; *Cyberscene Ltd v i-Kiosk Internet and Information (Pty) Ltd* 2000 3 SA 806 (C) 820; and *Movie Camera Company (Pty) Ltd v Van Wyk supra* 307. Commentators agree that the principle as stated correctly represents the law. See eg Cilliers & Benade *supra* 10.14 *et seq*; Farrar *supra* 415 *et seq*; Gower *supra* 416 *et seq*; Naude *Regsposisie van die Maatskappydirekteur* 116; Pennington *supra* 712 *et seq*.

⁶³⁰ See eg *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378. Such profits may be retained by directors, however, in the event of their actions being ratified by the company in general meeting.

⁶³¹ As illustrated in *Industrial Development Consultants Ltd v Cooley* [1972] 2 All ER 162; *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC supra* 68; and *Cyberscene Ltd v i-Kiosk Internet and Information (Pty) Ltd supra* 820. The Australian *Corporations Act* ensures that directors do not escape the consequences of a breach of the duty to use corporate information for their own benefit in terms of s 183(1), which provides that “[a] person who obtains information because they are, or have been, a director...must not improperly use the information...(own emphasis).

⁶³² *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461.

⁶³³ *Transvaal Lands Co v New Belgium (Transvaal) Land and Development Co* [1914] 2 Ch 488 CA; *Movitex Ltd v Bulfield* [1988] BCLC 104.

the director and the company will therefore cause these contracts to be valid. On the same basis an *ex post facto* approval of such a contract by a fully informed general meeting will ensure that a contract between the director and the company is valid.⁶³⁵

5.4 CONSEQUENCES OF BREACH OF DUTY

5.4.1 General

Traditionally the company has three remedies in respect of a breach or impending breach of fiduciary duties, namely setting aside of the particular act;⁶³⁶ recourse against the particular director;⁶³⁷ and obtaining an interdict to prevent a threatening breach of fiduciary duties.⁶³⁸ In some jurisdictions, for example Australia, provision is furthermore made for pecuniary penalties.⁶³⁹

5.4.2 Setting Aside of Transaction

The nature of the breach committed by the delinquent director determines the type of remedy available to the company. The proper remedy in case of a breach of the duty to exercise directorial powers for a proper purpose is setting aside of the transaction,⁶⁴⁰ as a general rule.⁶⁴¹

⁶³⁴ Cilliers & Benade *supra* par 10.47; Farrar *supra* 397; Gower *supra* 393 *et seq*; Naude *Regsposisie van die Maatskappydirekteur* 128; Pennington *supra* 728. This principle was confirmed in *Novic v Comair Holdings Ltd* 1979 2 SA 116 (W) 137.

⁶³⁵ Cilliers & Benade *supra* par 10.47; Farrar *supra* 397; Gower *supra* 395; Naude *Regsposisie van die Maatskappydirekteur* 128; Pennington *supra* 729. Also see Marsh “Are Directors Trustees? Conflict of Interest and Corporate Morality” (1966) 22 *The Business Lawyer* 35 for more detail on company contracts to which a director is a party or in which a director has an interest.

⁶³⁶ See *infra* par 5.4.2 for further discussion.

⁶³⁷ See *infra* par 5.4.3 for more detail.

⁶³⁸ Gower *supra* 425. This remedy was applied in *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC supra*. In Australia injunctive relief is provided for in terms of s 1324 of the Australian *Corporations Act*.

⁶³⁹ See *infra* par 5.4.4 for more information.

⁶⁴⁰ *Punt v Symons & Co Ltd* [1903] 2 Ch 506; *Piercy v S Mills & Co* [1920] 1 Ch 77; *Hogg v Cramphorn Ltd* [1966] 3 All ER 420; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1 All ER 1126; *Lee Panavision Ltd v Lee Lighting Ltd* [1992] BCLC 22; *Bishopsgate Investment Management Ltd v Maxwell (No 2)* [1994] 1 All ER 261.

⁶⁴¹ According to Pennington *supra* 724, with reference to *Charterbridge Corporation Ltd v Lloyds Bank Ltd supra*; and *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* [1986] Ch 246, the company will not always be able to set the transaction aside. This will, eg, be the case where the third party gave valuable consideration without being aware that the directors misused their powers.

Some regard these transactions as “void”, but the majority of opinion hold the view that they are in fact “voidable”.⁶⁴²

5.4.3 Civil Personal Liability

5.4.3.1 Extent of Personal Liability

Directors who breached their fiduciary duties and thereby caused a loss to the company may be held personally liable for such loss, without the company having to prove negligence.⁶⁴³ Similarly, directors who made a profit for themselves by not avoiding a conflict between their own personal interests and those of the company are accountable for any such profit to the company,⁶⁴⁴ even though the company suffers no damage as a result of their conduct.

A question asked in this regard is whether the liability of directors who breached their fiduciary duties extends to making good any *damages* that they caused to the company through their conduct, in addition to being liable for the profit that they made as a result. Section 1317H of the Australian *Corporations Act* seems to provide for compensation for damage suffered in case of a breach of fiduciary duties, in addition to the remedy of recovering profits made by the director in breach of his duties.⁶⁴⁵

⁶⁴² See Blackman “Directors’ Duty to Exercise their Powers for an Authorised Business Purpose” 1990 *SA Merc LJ* 1 15 n 79 and n 80 for authority for both viewpoints.

⁶⁴³ *Cullerne v London and Suburban General Permanent Building Society* (1890) 25 QBD 485 490; *In re Sharpe* [1892] 1 Ch 154. According to Havenga *Fiduciary Duties* 77 n 152 compensation for material loss is very similar to the award of common law damages and the amount in each instance will be calculated in the same manner. She continues to state that the court has always had power in equity to award pecuniary compensation for loss caused by a breach of equitable obligations and refers to two cases where such awards have been made, namely *Selangor United Rubber Estates Ltd v Cradock (No 3)* [1968] 2 All ER 1073; and *Belmont Finance Corporation Ltd v Williams Furniture Ltd (No 2)* [1980] 1 All ER 393.

⁶⁴⁴ See eg *Robinson v Randfontein Estates Gold Mining Co Ltd supra* 177 and 179; as well as *Industrial Development Consultants v Cooley supra*, where the director profited from an opportunity that came his way because he held the office of director in the company and because the company itself could not exploit it.

⁶⁴⁵ In terms of s 1317H(2) the profits made by a director as a result of a particular contravention are *included* when determining the damage suffered by a corporation for the purposes of making a compensation order. It is thus clear that damage for the purpose of a compensation order is not necessarily equal to profit and may very well exceed the profit that the director made.

However, many commentators are opposed to directors being subject to liability for damages for a breach of fiduciary duties. The reasons advanced for their opposition is that holding directors liable for an account of profits, as well as compensation for the loss arising out of the same breach of duty, will be an “overkill”,⁶⁴⁶ that it runs the risk of “mismatching” duty and remedy;⁶⁴⁷ and that it carries the danger that the “notion of fiduciary relationship may shrink in order to avoid the imposition of draconian remedies”.⁶⁴⁸

5.4.3.2 Basis of Personal Liability

The basis on which a director may be held liable for a breach of his fiduciary duties depends on whether these duties are provided for in terms of statute. If a statutory statement of fiduciary duties exist⁶⁴⁹ directors will clearly incur statutory liability.

In the absence of statutory fiduciary duties, the basis of liability must be found in common law principles. The South African judiciary indicated that directors’ liability for a breach of fiduciary duties is *sui generis* and based on breach of trust – not breach of contract – and that the claim is not one for damages.⁶⁵⁰ This viewpoint of the court is widely accepted by commentators.⁶⁵¹

⁶⁴⁶ Sealy *Directors’ Duties* 81.

⁶⁴⁷ McCamus “Prometheus Unbound: Fiduciary Obligation in the Supreme Court of Canada” (1997) 28 *Canadian Business Law Journal* 107 135.

⁶⁴⁸ *Ibid.*

⁶⁴⁹ As in Australia, New Zealand and Canada.

⁶⁵⁰ This was made clear in *Robinson v Randfontein Estates Gold Mining Co Ltd supra* 199 by Innes CJ, who expressly stated that the claim is not

one for *damages*. Nor is it an action on either an oral or a written contract. The fiduciary relationship on which it depends may rest upon an implied mandate; but *the suit is not one upon contract*. It asks neither for contractual performance *nor for damages* (own emphasis).

Solomon JA also left no doubt that

the action is not based upon a contract of agency but upon the fiduciary relationship...The action indeed is, as the Judges in the court below held, one *sui generis*...(id 242);

and Jura JA, who agreed that

A contrary opinion is that liability for a breach of fiduciary duties should be *ex lege Aquiliae*.⁶⁵² This suggestion is based on various arguments, for example, that because the *sui generis* basis of liability derived from English principles which developed against a particular legal background,⁶⁵³ they should not be transplanted into South African law without second thought; and that uncertainty exists with regard to the content of fiduciary duties and the remedies that are available in cases of a breach of fiduciary duties.⁶⁵⁴ Application of the principles of the *actio legis Aquiliae* may contribute to resolving some of the uncertainties in this respect and thus contribute to legal certainty.⁶⁵⁵ An added benefit of this approach is that it will eliminate the strict divide between fiduciary duties and the duty of care and skill.⁶⁵⁶

The fact that liability for a breach of fiduciary duties is of a *sui generis* nature was confirmed in a number of cases.⁶⁵⁷ It is therefore submitted that liability for a breach of fiduciary duties remains *sui generis*.

[t]he claim is not one for damages, nor is it an action on a contract. Nor is it a *condictio indebiti* (*id* 262).

⁶⁵¹ See eg Cilliers & Benade *supra* 10.12; Havenga “Breach of Directors’ Fiduciary Duties: Liability on What Basis?” 1996 *SA Merc LJ* 366 (hereinafter Havenga *Breach of Fiduciary Duties: Liability*); Naude *Regsposisie van die Maatskappydirekteur* 142 – 143 etc.

⁶⁵² Du Plessis *Aanspreeklikheidsgrondslag* 31.

⁶⁵³ *Id* 15 –17, with specific reference to the way in which the *courts of equity*, where these principles were developed, functioned and the strong influence of the English trust law principles.

⁶⁵⁴ *Id* 23 – 28.

⁶⁵⁵ *Id* 34 – 36. He also indicates that another alternative for removing uncertainty, namely a codification of fiduciary duties, will not have the desired results (*id* 26 – 27; 37).

⁶⁵⁶ *Id* 37.

⁶⁵⁷ Eg *Cohen v Segal* 1970 3 SA 702 (W) 706; *Du Plessis v Phelps* 1995 4 SA 165 (C) 171, where the court, apart from confirming that liability is *sui generis*, expressly rejected the suggestion of Du Plessis that liability for a breach of fiduciary duties should be based on the principles of the *actio legis Aquiliae*, as this suggestion is “not supported by authority”; and *Cyberscene Ltd v i-Kiosk Internet and Information (Pty) Ltd* *supra* 820. In *McLelland v Hulett* 1992 1 SA 456 (D) an intermingling of negligence principles with directors’ failure to secure property for a company for personal reasons, created the impression that liability for a breach of fiduciary duties may in some instances be delictual. In light of authority confirming *sui generis* liability for a breach of fiduciary duties in later cases, this case is not convincing.

5.4.3.3 Defendant

5.4.3.3.1 Defining “Director”

This study is concerned with the duties that *directors* have towards creditors.⁶⁵⁸ However, there seems to be some uncertainty as to who exactly should be regarded as the directors of the company.⁶⁵⁹ “Director” may have both a statutory meaning and a meaning for the purposes of common law.⁶⁶⁰ The proper definition also seems to depend on whether a director is involved in a criminal or civil suit.⁶⁶¹

In most jurisdictions “director” is defined by statute. The South African *Companies Act* defines “director” as including “any person occupying the position of director or alternate director of a company, by whatever name he may be designated”.⁶⁶²

In Australia a “director” is defined as anybody appointed to the position of director, or the position of an alternate director and who is acting in that capacity, regardless of what they are called. It also includes persons who were not validly appointed, but who act as directors, or whose instructions or wishes are adhered to by the directors.⁶⁶³

⁶⁵⁸ For the sake of completeness it must be noted that case law indicate that other parties in the corporate management environment may also incur liability for a breach of fiduciary duties. See eg *Canadian Aero Service Ltd v O’Malley* (1974) 40 DLR (3d) 371, where the following was said:

I do not think it matters whether O and Z were properly *appointed as directors* of C or *whether they did or did not act as directors*...Theirs was a larger, more exacting duty which...was similar to that owed to a corporate employer by its directors (own emphasis).

Certain provisions of the Australian *Corporations Act*, specifically ss 182 and 183 also indicate that persons other than directors may incur statutory liability for what could typically be considered a breach of fiduciary duties. S 182(1), eg, provides that directors, secretaries, other officers or employees of a company must not improperly use their position to benefit themselves. S 183(1) also covers a contravention by a director, officer or employee of the corporation.

⁶⁵⁹ See Du Plessis “Some Subtle Distinctions in the Term ‘Director’” (hereinafter *Du Plessis Term Director*) 1995 *TSAR* 153 for reasons why this definition is be problematic.

⁶⁶⁰ Du Plessis *Term Director* 153 – 154.

⁶⁶¹ See Du Plessis *Term Director* 156 – 158 and authority there referred to for more detail.

⁶⁶² S 1(1).

⁶⁶³ In terms of s 9 of the Australian *Corporations Act*.

The New Zealand *Companies Act* contains quite an extensive definition of “director”. A director is defined as “any person occupying the position of director of the company by whatever name called”.⁶⁶⁴ Also included in the definition are other persons, for the specific purpose of particular provisions of the New Zealand *Companies Act*. For the particular purpose of the provisions dealing with directors’ duties, these would include a person “in accordance with whose directions or instructions a person referred to in paragraph (a)...may be required or is accustomed to act”;⁶⁶⁵ a person “in accordance with whose directions or instructions the board of the company may be required or is accustomed to act”;⁶⁶⁶ as well as a person “who exercise or who is entitled to exercise or who controls or who is entitled to control the exercise of powers which, apart from the constitution of the company, would fall to be exercised by the board”.⁶⁶⁷ It continues to provide that a director is also a person “to whom a power or duty of the board has been directly delegated by the board with that person’s consent or acquiescence, or who exercises the power or duty with the consent or acquiescence of the board”.⁶⁶⁸

The English *Companies Act*⁶⁶⁹ provides definitions of “director”⁶⁷⁰ as well as “shadow director”.⁶⁷¹ The definition of “director” is very similar to the one in the South African *Companies Act*. A shadow director is defined as “a person in accordance with whose directions or instructions the directors of the company are accustomed to act”,

⁶⁶⁴ S 126(1)(a).

⁶⁶⁵ S 126(1)(b)(i).

⁶⁶⁶ S 126(1)(b)(ii).

⁶⁶⁷ S 126(1)(b)(iii).

⁶⁶⁸ S 126(1)(c).

⁶⁶⁹ *Companies Act* 1985.

⁶⁷⁰ In terms of s 741(1).

⁶⁷¹ In terms of s 741(2).

otherwise than only because “the directors act on advice given by him in a professional capacity”.⁶⁷²

In Canada a director is defined as “any person occupying the position of director by whatever name called”.⁶⁷³

Problems in identifying the directors that may incur liability for a breach of fiduciary duties may occur in respect of *de facto* directors; non-executive directors; so-called “puppet”, “dummy”, or “stooge” directors⁶⁷⁴ and “shadow” directors.

5.4.3.3.2 De Facto Directors

There is some difference of opinion with regard to the definition of a *de facto* director. In terms of one definition a *de facto* director is described as director who is in fact appointed, but in whose appointment some defect exists.⁶⁷⁵ Another definition is a bit wider and includes as *de facto* directors those who act as directors without any form of appointment.⁶⁷⁶

It is submitted that *de facto* directors, for the purpose of identifying the party that may incur liability for a breach of fiduciary duties, should include those directors who acted without any form of appointment at all.

⁶⁷² S 741(2). The Company Law Review Steering Group *Modern Company Law for a Competitive Economy* (Final Report Vol I) par 6.7 proposed that the present definition of a shadow director be retained and that the general duties of directors should be applied to shadow directors.

⁶⁷³ In terms of s 2(1) of the *CBCA*.

⁶⁷⁴ The terms “puppets”, “stooges” and “dummies” were used by Hiemstra J in *S v Shaban supra* 651; 652; and by Holmes JA in *S v De Jager* 1965 2 SA 616 (A) 622, 623 and 628.

⁶⁷⁵ As defined in *R v Mall* 1959 4 SA 607 (N) 624.

⁶⁷⁶ Naude *Regsposisie van die Maatskappydirekteur* 69. Meskin, Kunst, Galgut, Delport & Vorster *Henochsberg on the Companies Act* (1994 –) (hereinafter Henochsberg) 8(1) use the term “pretended directors” in respect of these directors and suggest that they are not to be regarded as directors for purposes of the South African *Companies Act* and that the term *de facto* director should be reserved for directors who have been appointed, but in whose appointment there is some irregularity. The possibility of treating those who act as directors without any form of appointment as *de facto* directors for the purpose of common law principles, specifically directors’ duties, is, however, not expressly excluded.

This submission is in line with the approach adopted by the judiciary, as indicated by the following statement in *Cyberscene Ltd v i-Kiosk Internet and Information (Pty) Ltd*:⁶⁷⁷

[A] director who was not formally appointed, *either because of some defect in his appointment or because there was no formal appointment at all, stands in the fiduciary relationship from the time he commences to act as a director; for the relationship arises, not as legal consequence of his holding the office as if it was an incident of the office itself, but from the nature of his position in relation to the company and the company's position to him.*⁶⁷⁸

A further question is whether *de facto* directors, including those who acted without any form of appointment, owe fiduciary duties to the company and consequently duties to consider the interests of creditors under particular circumstances.

Commentators hold conflicting views on this point.⁶⁷⁹ In this respect one has to agree with the argument that it will be more satisfactory to apply the principle of “no power without responsibility”⁶⁸⁰ and thus hold a person who occupies a position of trust responsible to the duty that inevitably attaches to that trust.⁶⁸¹ A *de facto* director who has placed himself in a fiduciary position should therefore bear the consequences and responsibilities of that position.⁶⁸²

The above statement quoted from *Cyberscene Ltd v i-Kiosk Internet and Information (Pty) Ltd*⁶⁸³ seems to indicate that this is indeed the legal position.

⁶⁷⁷ *Supra*.

⁶⁷⁸ *Id* 814 (own emphasis).

⁶⁷⁹ Naude *Regsposisie van die Maatskappydirekteur* 69 suggests that these persons may incur similar liability on the basis of mandate, while Larkin *supra* E-3 – E-4 argues that that *de facto* directors do owe fiduciary duties to the company.

⁶⁸⁰ S 214 of the South African *Companies Act* provides that actions of *de facto* directors, prior to the defect in their appointment being discovered, would nonetheless be valid. *De facto* directors thus clearly do enjoy power despite their appointment being defective.

⁶⁸¹ Larkin *supra* E-6. Havenga *Fiduciary Duties* 309 supports this argument.

⁶⁸² Havenga *Fiduciary Duties* 309.

⁶⁸³ *Supra*.

5.4.3.3.3 *Non-executive Directors*

No statutory distinction is drawn between executive and non-executive directors.⁶⁸⁴ In South Africa this distinction is recognised, however, by the judiciary,⁶⁸⁵ as well as the *King Report on Corporate Governance for South Africa 2002*.⁶⁸⁶

In *Howard v Herrigel*⁶⁸⁷ the court held that a distinction between executive and non-executive directors for the purposes of establishing the extent of, or liability for a

⁶⁸⁴ This position may change in the near future. Clause 10(c) of the *Companies Amendment Bill B - 2005*, published in *Government Gazette* No 27784 (13 July 2005), proposes a new s 269A(2)(c) in terms of which a director is defined as an independent non-executive director if he

- (i) is not involved in the day to day management of the business and has not in the last three years been employed (*sic*) as an executive manager or executive director of the issuer or its group;
- (ii) is not or does not represent a shareholder with the ability to control or significantly influence management or the board;
- (iii) is not a member of the immediate family of an individual mentioned in (ii);
- (iv) is not a professional advisor to the issuer or its group, except as a director;
- (v) is not a significant supplier to, or customer of the issuer or its group;
- (vi) has no significant contractual relationship with the issuer or its group; and
- (vii) has no business or other relationship that could be seen to materially interfere with the director's capacity to act independently.

⁶⁸⁵ See eg *Fisheries Development Corporation of SA Ltd v Jorgensen supra* 165; and *Cronje v Stone* 1985 3 SA 597 (T) 610.

⁶⁸⁶ Institute of Directors *King Report on Corporate Governance for South Africa 2002* (hereinafter *King II*) Ch 4 of Section 1 defines "executive director" as:

An individual involved in the day-to-day management and/or in the full-time salaried employment of the company and/or any of its subsidiaries (*id* par 7.1);

and a "non-executive director" as

[a]n individual not involved in the day to day (*sic*) management and not a full-time salaried employee of the company or of its subsidiaries. An individual in the full-time employment of the holding company or of its subsidiaries, other than the company concerned, would also be considered to be a non-executive director unless such individual by his/her conduct or executive authority could be construed to be directing the day-to-day management of the company and its subsidiaries (*id* par 7.2).

⁶⁸⁷ 1991 2 SA 660 (A).

breach of their fiduciary duties, is “unhelpful and even misleading”.⁶⁸⁸ Goldstone AJ also expressly stated that the “legal rules are the same for *all directors*”,⁶⁸⁹ whether the inquiry be related to negligence, reckless conduct or fraud. Commentators agree that holding the office of non-executive director does not safeguard such a director against personal liability.⁶⁹⁰

There is in principle no reason why a non-executive director should not incur liability equivalent to that of an executive director for a breach of fiduciary duties.⁶⁹¹

5.4.3.3.4 Puppet, Dummy or Stooge Directors and Shadow Directors

The term “puppet director” was explained by Hiemstra J in *S v Shaban*⁶⁹² as a person “placed on boards who pretend to have taken part in resolutions of which [he knows] nothing”,⁶⁹³ or “who pretends to take part in the management of a company whilst having no idea what it is to which he puts his signature”.⁶⁹⁴ The puppet director is expressly distinguished from the “nominee director” who “normally...knows what is going on and does not pretend that he applied his mind to resolutions whilst not even knowing that such a resolution has been recorded”.⁶⁹⁵

⁶⁸⁸ *Id* 678.

⁶⁸⁹ 578 (own emphasis).

⁶⁹⁰ See eg Davis *supra* 567; and Du Plessis “Wanopvatting oor die Aanspreeklikheid van Nieu-uitvoerende Direkteure” 1994 *TSAR* 137.

⁶⁹¹ The *obiter* statement by the court in *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC supra* 67, namely that “[e]ven in the case of a non-executive director a similar conflict of interests could arise in circumstances not difficult to imagine”, seems to confirm the judiciary’s stance that a director is subject to fiduciary duties and may be held liable in case of a breach thereof, whether he is an executive or non-executive director. See *infra* Ch 6 (Protection Afforded by the Duty of Care and Skill) par 6.3.3 for more information on the distinction between executive and non-executive directors insofar as their liability for a breach of the duty of care and skill is concerned.

⁶⁹² *Supra*.

⁶⁹³ *Id* 651 – 652.

⁶⁹⁴ *Id* 652.

⁶⁹⁵ *Id* 651.

In *S v De Jager*⁶⁹⁶ it was held that the appointment of puppet directors was a “sham”⁶⁹⁷ and that the court could disregard it. The previous directors who resigned and appointed the puppets, still controlled the company and occupied the position of directors and as such could still be defined as the directors of the company.⁶⁹⁸ This decision seems to offer judicial support for the recognition of “shadow directors” in South African law.⁶⁹⁹ Judicial recognition of this concept is limited, however, to persons previously appointed to the office of director.

Directors will thus not be able to escape liability by resigning and appointing puppets in their place, while still maintaining control over the affairs of the company. It is clear therefore that a claimant should be able to institute action against the shadow directors of a company, provided that they have been properly appointed to the office of director at some stage.

The question may be asked, however, whether “shadow directors” who were never officially appointed may incur similar liability. It is suggested that those controlling “puppet directors” may be held liable for a breach of fiduciary duties on the basis of an implied mandate given by the company, rather than the fact they are regarded as directors of the company.⁷⁰⁰ In light of the statutory recognition of the concept of the “shadow director”⁷⁰¹ it is not inconceivable that the judiciary may be willing to hold the “puppeteers” liable as directors, albeit shadow directors.

⁶⁹⁶ *Supra.*

⁶⁹⁷ *Id* 623.

⁶⁹⁸ *Ibid.*

⁶⁹⁹ “Shadow directors” are statutorily defined in Australia, New Zealand and England as persons in accordance with whose directions or wishes directors are accustomed to act.

⁷⁰⁰ Naude *Regsposisie van die Maatskappydirekteur* 107. He argues against referring to the “puppeteers” as directors, as this would lead to a situation where they would be in a position to attend board meetings and be entitled to directors’ remuneration.

⁷⁰¹ Statutory recognition is afforded to the concept of shadow directors in terms of s 219(4)(a) of the South African *Companies Act*. In terms of this provision an officer of a company will include “any person in accordance with whose directions or instructions the directors of the company have been accustomed to act”. This definition only applies for the purposes of subsection 1(b)(ii) of the same provision, however, dealing with the disqualification of persons from being directors where the Master has made a report upon the winding-up of a company that such directors or officers, in his opinion,

A further question in this regard is whether it is possible to institute action against the puppet directors. Since they were clearly appointed to the office of director and are in fact *de jure* directors, there is no reason why they should not incur liability for a breach of fiduciary duties.⁷⁰²

5.4.4 Pecuniary Penalty Orders

The Australian *Corporations Act* provides for civil penalties in case of contravention of certain provisions.⁷⁰³ Included in these provisions⁷⁰⁴ are those that contain a statutory statement of what may typically be regarded as fiduciary duties.⁷⁰⁵

The relevance of these provisions being termed “civil penalty provisions” is that a court may make a declaration of contravention in case of a person having contravened one of these provisions.⁷⁰⁶ Once such a declaration has been made the *Australian*

have committed fraud in relation to the company. It does, however, indicate statutory recognition of the concept of a “shadow director”, which may play an important role in persuading the judiciary to accept a similar definition in cases on directors’ duties.

⁷⁰² Larkin *supra* E-8 and Naude *Regsposisie van die Maatskappydirekteur* 107 agree that puppet directors legally are directors and that there is no reason why they should not be fully subject to fiduciary duties. In this regard Larkin refers to *Selangor United Rubber Estates Ltd v Cradock supra*, where the court made the following statement with regard to its decision to hold the puppet directors liable:

They exercised no discretion or volition of their own and they behaved in utter disregard of their duties as directors to the general body of stockholders or creditors or anyone but C. They put themselves in his hands, not as their agent or adviser, but as their controller. They were puppets which had no movement apart from the strings and those strings were manipulated by C...They doubtless hoped for the best but risked the worst; and that worst has befallen them.

⁷⁰³ Gething “Do We Really Need Criminal and Civil Penalties for Contraventions of Directors’ Duties?” (1996) 24 *Australian Business Law Review* 375 377 - 378 regards civil penalty provisions as justified for answering the need for a range of sanctions to properly enforce directors’ duties; for ensuring that the law relating to the enforcement of those duties is just and is seen to be just; for giving the court ample scope to ensure that a proportionate sanction can be given in the circumstances of every contravention, and so forth. It is furthermore seen as an appropriate and necessary sanction, since it may be imposed at such a level that it makes committing the contravention unprofitable. See Gilligan; Bird & Ramsay “Civil Penalties and the Enforcement of Directors’ Duties” (1999) 22 *University of New South Wales Law Journal* 417 for more information on civil penalty provisions.

⁷⁰⁴ In terms of s 1317E(1)(a).

⁷⁰⁵ Ss 181; 182 and 183. See *supra* par 5.2.2 for more detail on these provisions.

⁷⁰⁶ In terms of s 1317E(1).

*Securities and Investments Commission*⁷⁰⁷ may seek a pecuniary penalty order,⁷⁰⁸ in terms of which a court may order a person to pay the Commonwealth a penalty of up to A\$ 200 000,⁷⁰⁹ provided that:

- (a) a declaration of contravention by the person has been made under section 1317E; and
- (aa) the contravention is of a corporation/scheme civil penalty provision; and
- (b) the contravention:
 - (i) materially prejudices the interests of the corporation or scheme, or its members; or
 - (ii) materially prejudices the corporation's ability to pay its creditors; or
 - (iii) is serious.

5.5 APPLICATION TO A DUTY TO CREDITORS

5.5.1 Sources

Although the same elements in respect of fiduciary duties seem to recur in all the jurisdictions discussed above, there is little indication as to how these elements relate to each other. One would therefore have to agree that this “linguistic fudging of the equitable obligations governing directors’ fiduciary position...has led to uncertainty”,⁷¹⁰ which could impact negatively on the extension of fiduciary duties to protect creditors’ interests.

Some argue that a codification of directors’ fiduciary duties could present a solution to the problem of uncertainty. At first glance such a step seems tempting for the clarity and judicial certainty that it provides. The most obvious argument in favour of a codification of duties pertains to the certainty and clarity provided by such a step. Doing away with the vagueness associated with fiduciary duties may benefit parties protected by it. Directors themselves may be in favour of codification, as this may

⁷⁰⁷ Hereinafter ASIC.

⁷⁰⁸ In terms of s 1317G.

⁷⁰⁹ S 1317G(1).

⁷¹⁰ Heath *supra* 377.

enable them to act in accordance with the law and with as little expense and delay in obtaining legal advice as possible.⁷¹¹

However, the apparent clarity and accessibility brought about by codification may be superficial.⁷¹² Statutory statements of duties will still have to be interpreted by the courts, which may give rise to a large body of judicial precedent relevant to the codified duties.⁷¹³ In an attempt to circumvent this from happening the legislature may word the duties such that legislative principles are regarded as exhaustive, leaving no room for judicial development. This approach can be criticised for two reasons. Firstly, legislation is to be interpreted and applied by the judiciary, which may lead to novel points being raised and the judiciary being expected to address these.⁷¹⁴

The certainty provided by an exhaustive codification must furthermore be balanced against the flexibility inherent to a common law duty.⁷¹⁵ The judiciary played an important role in the past in developing company law principles and should be allowed to continue to do so in keeping with modern needs, without being hampered by legislation that is too restrictive.⁷¹⁶ As the legal principles pertaining to fiduciary

⁷¹¹ According to Linklater “Codifying Directors’ Duties: Better in Principle than in Practice” (2002) 23 *The Company Lawyer* 261 research indicated that for this particular reason the majority of directors are in favour of a statutory statement of their duties.

⁷¹² Clarke “Doubts from the Dark Side – The Case Against Codes” 2001 *Journal of Business Law* 605 608 discounts the argument of improved clarity on the basis that plain language is a myth and that legislation therefore seldom renders the law more accessible or clear.

⁷¹³ Linklater *supra* 261. See also Clarke *supra* 609 who refers to this as the “encrustation” of codes.

⁷¹⁴ *Ibid.*

⁷¹⁵ Arden “Reforming the Companies Acts: The Way Ahead” 2002 *Journal of Business Law* 579 583 refers to the tension between making the law accessible on the one hand and making it flexible on the other. She concludes that it is now thought more important that directors should have access to a statutory statement of their duties than that the courts should be able to develop the duties significantly further. The Department of Trade and Industry’s *South African Company Law for the 21st Century: Guidelines for Corporate Law Reform* (May 2004) 40 also acknowledges that, while there is “merit in considering a statutory standard”, the “benefits of such a statutory standard for conduct will need to be evaluated against the constraints it will place on the development of common law”.

⁷¹⁶ Clarke *supra* 607 agrees that the law is in a continuous state of development and that “every statute, code or even restatement is by its very nature dated. It is corseted by lines of thinking current when it was stitched together”. Santow “Codification of Directors’ Duties” (1999) 73 *Australian Law Journal* 336 347 believes that continuous changing societal expectations and the occurrence of unforeseen

duties are capable of being developed by the courts in order to keep up with the continuously evolving needs that these principles have to fulfil,⁷¹⁷ this is indeed a serious concern.

It is furthermore doubtful whether the true content of fiduciary duties is capable of proper codification.⁷¹⁸

It is therefore submitted that the common law basis of fiduciary duties be retained.⁷¹⁹

5.5.2 Formulation

A broad distinction between directors' fiduciary duty to act in good faith in the best interests of the company on the one hand and their fiduciary duty to exercise their

situations are arguments against the displacement of a general law by statute. He accordingly feels that the important elements in modulating a general duty of care are "best left to evolve by judicial interpretation in accordance with community expectation".

⁷¹⁷ The law on directors' fiduciary duties is in a state of evolution. According to Sealy *Directors' Duties* 80 traditional equitable rules could, for practical purposes, be regarded as "yesterday's law". This view is supported by the fact that traditional principles in respect of fiduciary duties are replaced by new doctrines, such as the "proper purposes" doctrine usurping the traditional "*bona fides*" test (*id* 82); the "corporate opportunities" doctrine replacing traditional no conflict rules, etc.

⁷¹⁸ De Mott "Beyond Metaphor: An Analysis of Fiduciary Obligation" 1988 *Duke Law Journal* 879 923 – 924 rightly notes:

Fiduciary obligation has a number of characteristics that classify it among the law's most exotic species. Its origin in Equity and its continuing tie to Equity's legacy make it unusually context-bound as a legal obligation. The considerable variety of relationships in which parties are bound by fiduciary obligation further complicates the analysis. Determining whether fiduciary obligation applies in a particular context and what requirements inhere in the imposition of fiduciary obligation demands recognition of this situation-specificity.

Also see Butcher *Directors' Duties: A New Millennium, A New Approach?* (2000) 338; and Santow *supra* 347 who warns that "a codification in an unsettled area can be...*incapable of adapting to an almost infinite range of corporate circumstances*" (own emphasis).

⁷¹⁹ If it is decided that a statutory statement of directors' fiduciary duties is necessary, it is submitted that such a statement should follow the model presented in terms of s 42 of the *Close Corporations Act*, namely that it should operate "[w]ithout prejudice to the generality of the expression 'fiduciary relationship'" (s 42(2)).

powers for a proper purpose is accepted in jurisdictions such as Australia.⁷²⁰ A similar distinction is not drawn clearly in South African law.⁷²¹

It is proposed that directors' fiduciary duties should be distinguished with reference to the remedies that exist in cases of a breach of fiduciary duties. Two main remedies are available, namely personal liability of those responsible, or the setting aside of the impugned transaction.⁷²² On the basis of the two very different remedies that exist depending on the particular breach in question, it seems conceptually sound to distinguish between directors' duty to act in good faith and in the best interests of the company, a breach of which could lead to personal liability, and their duty to exercise their powers for a proper purpose, a breach of which could lead to the transaction in question being set aside.⁷²³

⁷²⁰ These two duties are referred to in separate subsections, namely s 181(1)(a) and s 181(1)(b) of the *Australian Corporations Act*.

⁷²¹ Commentators emphasise various aspects of fiduciary duties in their formulation of what these duties entail, as was indicated *supra* par 5.2.1, while the approach of the legislature indicates a distinction between the duty to act honestly and in good faith (in terms of s 42(2)(a) of the *Close Corporations Act*) or the duty to act *bona fide* in the best interest of the "company" (in terms of s 60(1A)(a) of the *Banks Act*, where this duty is formulated with reference to the fact that directors must act in the best interest of the *bank*) on the one hand, and the duty to avoid a conflict of interests on the other (in terms of s 42(2)(b) of the *Close Corporations Act* and s 60(1A)(b) of the *Banks Act*).

⁷²² See discussion *infra* par 5.4 for more detail on the consequences of a breach of fiduciary duties.

⁷²³ Varess "The Buck Will Stop at the Board? An Examination of Directors' (and Other) Duties in Light of the HIH Collapse" (2002) 16:1 *Commercial Law Quarterly* 12 22 agrees that these are two "conceptually separate limitations" which "hinge on different issues", since the good faith test relates to a combination of subjective and objective issues, while the proper purpose test focuses on purely objective matters. Worthington *supra* 122 also notes the conceptual differences between these two duties. She views the duty to act *bona fide* in the interests of the company as a fiduciary duty, however, while the duty to act for proper purposes is seen as an equitable restriction controlling the exercise of power by all donees of limited powers. According to Worthington's view the former is owed to the company, while the latter is owed to everybody affected by the use of power for an improper purpose. Although it is submitted that the duty to act in good faith in the best interests of the company should be distinguished from the duty to act for proper purposes, Worthington's suggestion that this distinction should form the basis of an extension of directors' duties to safeguard the interests of creditors, since the duty to act for a proper purpose is apparently enforceable by anybody, while the duty to act in good faith in the best interest of the company should remain a duty owed to "the company", is not accepted as a proper platform for extending directors' duties to creditors for a number of reasons. It firstly neglects to explain how the duty of care could be extended to include creditors' interests, as was done in *Peoples Department Stores Inc (trustee of) v Wise* [1998] QJ No 3571 (QSC (Bankruptcy and Insolvency Division)); it also provides for a very limited remedy, namely the setting aside of the transaction in question; it is contrary to the existing conceptual principle that directors' duties, including the duty to act for a proper purpose, are owed to "the company"; and lastly ignores the fact that a duty to consider the interests of creditors is accepted in some jurisdictions as having become part of the general law on directors' duties.

Other obligations that are typically termed fiduciary duties, for example the duty to avoid a conflict of interests, the duty to maintain an unfettered discretion and the duty not to exceed the limitations of powers, may be regarded as manifestations of the broad-based fiduciary requirement that directors have to act in good faith in the best interests of the company.

A distinction between directors' duty to act *bona fide* in the best interest of the company and their duty to act for a proper purpose, viewed solely from the perspective of extending directors' fiduciary duties to include creditors' interests, also makes sense.

Creditors are vulnerable to a breach of those duties that may typically be regarded as manifestations of the broad-based requirement that directors must act in good faith in the best interest of the company. They are also in need of the remedy generally provided in such cases, namely personal liability on the part of the directors who acted in breach of their duties to the company for failing to consider the interests of creditors. It is therefore submitted that this arm of directors' fiduciary duties could be applied to provide protection for the interests of corporate creditors.

It is also submitted that the fiduciary duty to exercise directorial powers for a proper purpose should not be extended to creditors. This submission is firstly based on the fact that this duty is aimed at maintaining the balance of power between directors and shareholders.⁷²⁴ The extension thereof to creditors will therefore not be conceptually sound. Furthermore, the remedy afforded in case of a breach of this duty, namely the setting aside of the particular act of a director, will not offer the financial protection that creditors desire.

⁷²⁴ Parkinson *supra* 137 describes the aim of the duty to act for a proper purpose as protecting the democratic shareholder controls from being subverted by management, and safeguarding the shareholders' financial interests in a take-over situation.

5.5.3 Relevant Elements of Fiduciary Duties

5.5.3.1 Acting in Good Faith in the Best Interests of the Company

Any meaningful extension of directors' fiduciary duties to include the interests of creditors clearly requires a deviation from the orthodox approach with regard to the phrase "in good faith in the best interests of the company", in terms of which the interests of the company are automatically equated with the interests of its shareholders.

In order to facilitate the extension of directors' duties to creditors, it is submitted that the interests of the company should be defined with reference to either the interests of its shareholders, or those of its creditors, depending on the company's financial position.⁷²⁵ If a company is financially stable there should in principle be no objection to the interests of the company being equated with those of its shareholders. If a company is in financial or economic distress, or where a particular act may cause the company's financial situation to be jeopardised,⁷²⁶ the interests of creditors should be paramount and the "interests of the company" should be defined with reference to the interests of its creditors.⁷²⁷

This suggestion raises the question, however, as to whether the *content* of directors' fiduciary duties would undergo a change if it were accepted that they do indeed owe a duty to creditors. This question deals with the issue of what is expected of directors in practice in the proper discharge of their duty to consider the interests of creditors and whether an obligation to consider the interests of creditors would place a positive duty on directors to manage the company in the best interests of the creditors.

⁷²⁵ According to Worthington *supra* 121, the extension of directors' fiduciary duties to include creditors' interests is most often achieved by a "manipulation of the concept of 'interests of the company'".

⁷²⁶ See discussion *infra* Ch 7 (Point in Time When the Duty Arises) for more detail on the circumstances that would warrant a shift from shareholders being the primary corporate constituents to creditors becoming the primary corporate constituents.

⁷²⁷ See discussion *infra* Ch 8 (Beneficiary of the Duty) for particulars on how the beneficiary of the duty to creditors should be defined.

One may broadly distinguish between two possibilities in this regard.⁷²⁸ First, the duty to creditors can be construed broadly, in which case directors are required to take positive steps to maximize creditors' interests once the company becomes insolvent.⁷²⁹ A narrow view of the duty, however, entails that directors are only expected to treat creditors equally and not to use corporate assets to prefer themselves or shareholders.⁷³⁰

In deciding which of the above viewpoints is most suitable for an extension of directors' duties to creditors, it is submitted that the possibility that bears the closest resemblance to existing fiduciary duties should enjoy preference. This submission is based on a number of reasons. The first is that a duty to creditors will be more readily accepted if it were to fit with existing principles of company law. It will secondly have the advantage that a duty to creditors will develop alongside the general development of directors' fiduciary duties. Such an approach will also be more advantageous for its inherent simplicity. Directors will be required to conduct themselves in a particular manner, whether their fiduciary duties are to consider the interests of the shareholders, or the creditors. The possibility of confronting them with one set of duties under particular circumstances and another set of duties under another set of circumstances⁷³¹ is thus prevented.

⁷²⁸ Lin "Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors" (1993) 46 *Vanderbilt Law Review* 1485 1512.

⁷²⁹ *Ibid.*

⁷³⁰ *Ibid.* Millner *supra* 210 – 214 refines the distinction further and suggests that are three possibilities. The first is the "narrow view" in terms of which a duty to creditors entails nothing more than a prohibition against self-dealing and insider preferences. The second or "intermediate view", with reference to *In re Ben Franklin Retail Stores Inc* 225 BR 646 (Bankr ND III 1998), places an obligation on directors to minimise loss upon insolvency, by, for example, not inducing creditors to lend money even after the company is insolvent, thereby causing it to sink deeper into insolvency as liabilities grow. The last possibility, the so-called "expansive view", requires directors to maximize the long-term wealth creating capacity of the company, as was suggested in *Credit Lyonnais Bank Netherland, NV v Pathe Communications Corporation* No 12150, 1991 WL 277613 (Del Ch Dec 31, 1991), reprinted in (1992) 17 *Delaware Journal of Corporate law* 1099 1157

⁷³¹ That is, circumstances with regard to the company's financial position, which is not always easy to determine. The issue here relates to the fact that directors' duties to consider the interests of creditors become pertinent only upon the company experiencing financial or economic distress. See *infra* Ch 7 (Point in Time When the Duty Arises) for more detail.

It may rightly be asked, however, whether defining the “interests of the company” with reference to the interests of its creditors will serve any purpose whatsoever, if such a step will have no impact on what is expected of directors in terms of their fiduciary duties. The importance of redefining the interests of the company becomes clearer in regard to directors’ duty to maintain an unfettered discretion and their duty to avoid a conflict of interests.⁷³² Redefining the interests of the company with reference to the interests of the creditors also facilitates the enforcement of extended fiduciary duties by creditors.⁷³³

The broad view, in terms of which directors are required to minimize loss upon insolvency, or maximize the long-term wealth creating capacity of the company for the exclusive benefit of creditors, does not fit comfortably with existing principles as to what fiduciary duties entail. It is therefore submitted that the most acceptable of the viewpoints referred to above is the narrow one, namely that directors, in complying with an extended duty to include creditors’ interests, must avoid self-dealing and insider preferences.

This does not mean, however, that directors are under no obligation to ensure that creditors’ interests are protected when the company is in financial distress, or that they may engage in risky ventures when the company is on the brink of insolvency. Rather than trying to force such an obligation under the head of *fiduciary duties*, it is submitted that any obligations in this respect will fit more comfortably with what is required of directors in terms of their duty to act with care and skill.⁷³⁴

⁷³² See discussion *infra* par 5.5.3.2 and par 5.5.3.3.

⁷³³ See discussion *infra* Ch 8 (Beneficiary of the Duty) for more detail on the model that is proposed in this regard.

⁷³⁴ It must be kept in mind that USA directors are subject to fiduciary duties, which are divided into the duty of loyalty (which closely resembles what we know as fiduciary duties) and the duty of care (see discussion *supra* par 5.2.6). This explains why Millner *supra* 210 – 214 suggests that a duty to minimise loss upon insolvency could fall under “fiduciary duties”. See *infra* Ch 6 (Protection Afforded by the Duty of Care and Skill) for further discussion on how the duty of care and skill could serve to protect the interests of corporate creditors.

It is also submitted that neither shareholders nor creditors stand to benefit from directors having to “act in good faith in the interests of the company” should director conduct be assessed in a purely subjective manner. In this regard one has to agree that such a duty will then indeed impose only a “weak control on managerial discretion, since any plausible assertion that a course of action is designed to increase the company’s financial well-being will be enough to protect it from attack”.⁷³⁵

A suggested solution is that a hybrid objective-subjective approach be followed when judging director conduct.⁷³⁶ The advantage of this approach is that directors’ subjective honest belief that a particular act is in the best interests of the company may be tested objectively against the surrounding facts.

5.5.3.2 Maintaining an Unfettered Discretion

As indicated earlier, directors of subsidiary companies in the majority of jurisdictions referred to in this study are still subject to the traditional duty of maintaining an unfettered discretion, in terms of which the director owes his duties to the company on whose board he serves. Any exercise of managerial discretion should not be influenced by a desire to further the interests of the nominator holding company or the group overall.

At first glance one might assume that this approach offers protection to the interests of the creditors and shareholders of the subsidiary alike. Closer inspection, however, reveals a number of shortcomings in the protection that creditors are afforded in terms of the entity approach, should the traditional equation of the interests of a company with those of its shareholders be accepted.

The first problem relates to the way in which this duty is enforced. Should a director sacrifice the interests of the subsidiary to promote the welfare of the holding company or group, action may be taken against the director by the company itself through its board of directors or general meeting of members, or derivatively by a minority

⁷³⁵ Parkinson *supra* 96.

⁷³⁶ As was for example done by the Australian judiciary in *Teck Corporation Ltd v Millar supra*; and *Lyford v Commonwealth Bank of Australia supra*.

member. In the case of a wholly-owned subsidiary, where membership of the company comprises only the holding company and other wholly-owned subsidiaries, it is clear that no action will be taken against directors who breached the fiduciary duties that they owe to the subsidiary.⁷³⁷

A second problem is directly related to the equation of the company's interests with those of its shareholders. In case of a subsidiary, and even more so in case of a wholly-owned subsidiary, the majority or sole shareholder is in fact the holding company. By furthering the interests of the holding company, even to the detriment of corporate creditors, the director will in fact be complying with his duties to the subsidiary, as he is acting in the best interests of the shareholders of the subsidiary.

A strict application of the traditional principle therefore does not seem to offer protection to the interests of creditors of the subsidiary.

One is furthermore inclined to agree with a large number of commentators that the practical reality of the situation faced by nominee directors of subsidiaries should not be ignored and that they should be provided with some leeway in this respect. Depending on the courts to provide such guidelines does not seem to be the answer as “the degree to which the courts are prepared both to identify and to distinguish the interests of so-called group companies is very much a matter of conjecture”.⁷³⁸

The only real solution to resolve the dilemma of the subsidiary director thus lies in a legislative response, as was done in Australia and New Zealand. In terms of the approach followed in these two jurisdictions the entity concept is retained, while directors of a subsidiary are afforded some freedom to consider the interests of the holding company or group overall.

⁷³⁷ Gouvin *supra* 303 – 304 recognizes this problem.

⁷³⁸ Finn *supra* 52.

It cannot be emphasised enough, however, that any legislation in this respect must provide for the protection of creditors' interests alongside permission for directors to sacrifice the interests of the subsidiary in line with the wishes of its shareholders.

This may be done in one of two ways. The first is the Australian approach in terms of which directors are statutorily permitted to sacrifice the interests of the wholly-owned subsidiary, provided that adequate funds are and remain available to discharge its debts. Where a wholly-owned subsidiary is insolvent or could be rendered insolvent when directors promote the interests of the holding company over those of the subsidiary, the traditional principle still applies. In such a case directors will be required to act in the best interests of the company on whose board they exercise their managerial discretion. Any meaningful protection of creditors' interests by way of fiduciary duties will then also be possible only if it is accepted that the "best interests of the company" be defined with reference to the interests of creditors.

The Australian provision only covers nominee directors of wholly-owned subsidiaries. One may argue that its scope should be broadened to include nominee directors of subsidiary companies,⁷³⁹ but that subjugating the interests of the subsidiary to those of its holding company or the group, must in addition to the requirements mentioned above, be subject to the approval of other shareholders to ensure that the holding company does not abuse its power as majority shareholder.⁷⁴⁰

A second possibility is through statutory recognition of an agency approach, in terms of which directors of the subsidiary are regarded as "agents" of the holding company.⁷⁴¹ In terms of this approach the duties of the directors of the subsidiary,

⁷³⁹ As is done in terms of s 131(3) of the New Zealand *Companies Act*.

⁷⁴⁰ S 131(3) of the New Zealand *Companies Act* contains such a requirement.

⁷⁴¹ Gouvin *supra* 324 – 337 identifies and analyses four approaches that may be followed in response to the dilemma faced by directors of subsidiary companies, namely the *ad hoc* approach; the contractarian approach; the modification of the horizontal conflict approach; and an approach based on agency law. According to him the first three are problematic and the answer to the dilemma faced by nominee directors lies in the agency approach.

were they truly independent, are imposed on the holding company as “principal”.⁷⁴² This approach retains the general idea of the subsidiaries being separate entities, while allowing for recognition of the practical reality that directors of a subsidiary cannot truly operate independently from the holding company. This approach, in effect, transplants fiduciary duties traditionally owed by the *directors* of the subsidiary, to the *holding company* of the subsidiary.

The same result can be attained in terms of a different formulation, namely through statutory recognition of the holding company as a “shadow director”⁷⁴³ and the imposition of liability on the holding company for breaches of fiduciary duties by the director of the subsidiary, in its capacity as shadow director.

From the point of view of corporate creditors, specifically those of a subsidiary, any of the possibilities above seem to offer increased protection for their interests, provided that it is accepted that it is their interests which should enjoy prime consideration once the company is experiencing financial or economic distress.⁷⁴⁴ At the same time the practical reality that nominee directors in subsidiaries cannot truly operate independently is recognised.

⁷⁴² Gouvin *supra* 332.

⁷⁴³ The concept of “shadow director” is provided for by s 9 of the Australian *Corporations Act*; s 126(1)(b) of the New Zealand *Companies Act*; as well as s 741(2) of the English *Companies Act*. See *supra* par 5.4.3.3.1 for more detail.

⁷⁴⁴ Another way in which the interests of creditors of a subsidiary may be protected, is through acceptance of the “enterprise approach”, as suggested by Austin “Problems for Directors Within Corporate Groups” 133 n 1 in Gillooly (ed) *The Law Relating to Corporate Groups* (1993) 141 – 142. Austin distinguishes between “entity law”, in terms of which the corporation is defined as above and “enterprise law”, which recognises the economic unity of the corporate group. Should the principles underlying enterprise law be applied rather than those embodied in entity law, creditors would become creditors of the enterprise, rather than of a single entity in the group. As a consequence creditors would not be prejudiced by intra-group transactions. It is submitted, however, that a total deviation from the entity approach in favour of the enterprise approach is unlikely, as it would entail too drastic a departure from existing company law principles. According to Dine *The Governance of Corporate Groups* (2000) 46 recent cases furthermore indicate that the enterprise doctrine has recently lost rather than gained ground. In the absence of statutory principles to the contrary (eg s 588V(1) of the Australian *Corporations Act* and s 271 of the New Zealand *Companies Act*, in terms of which the “pooling” of assets of companies in a group becomes possible upon winding-up) the basic notion of the entity concept, namely that creditors of a subsidiary should still look to the subsidiary for payment of their debts, should therefore be retained.

5.5.3.3 Avoiding a Conflict of Interests

It is clear that proper compliance with directors' duty to avoid a conflict of interests may go a long way towards providing protection for the interests of corporate creditors. Case law in respect of this duty is also well-developed and the courts show no hesitation in holding directors who are in breach of this particular duty liable.⁷⁴⁵

One potential problem that may prevent this duty from properly protecting creditors' interests is once again the traditional equation of the interests of the company with those of its shareholders. Directors are required to avoid their own interests conflicting with those of the company. If it is accepted that the interests of the company are indeed those of its shareholders, creditors will clearly be left with no protection in situations where the directors are also the sole shareholders.

In order to ensure that corporate creditors' interests are adequately protected in terms of an extension of this duty, it is once again submitted that corporate interests should be defined with reference to those of the creditors of the company, once the company is experiencing financial difficulty.⁷⁴⁶ In this regard one would hope that the view expressed in *Winkworth v Edward Baron Development Co Ltd*,⁷⁴⁷ namely that

[a] duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves *to the prejudice of the creditors*⁷⁴⁸

will gain some acceptance.

⁷⁴⁵ Well known South African cases in which directors were held liable for not avoiding a conflict of interests include *Robinson v Randfontein Estates Gold Mining Co Ltd supra*; *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC supra*; and *Cyberscene Ltd v i-Kiosk Internet and Information (Pty) Ltd supra*.

⁷⁴⁶ See *infra* Ch 7 (Point in Time When the Duty Arises) for more detail on the stage when creditors' interests should become paramount.

⁷⁴⁷ [1987] 1 All ER 114.

⁷⁴⁸ *Id* 118.

5.5.4 Consequences of Breach

5.5.4.1 Remedy

5.5.4.1.1 Personal Liability

In the vast majority of cases concerning directors' duties to creditors, the claim was for recovery of funds or property of the company which were diverted to the controllers of the company, or to an associated company.⁷⁴⁹ This is similar, if not identical, to the remedy that is sought in many instances by shareholders where the directors have breached their fiduciary duties.

The question is whether creditors should, in addition to standard remedies, be entitled to claim damages on behalf of the company. The arguments referred to above against adding damages to traditional remedies,⁷⁵⁰ seem equally applicable should directors' duties be extended to include their interests. As was noted, an extension of directors' duties to creditors may be more palatable if it does not deviate too drastically from existing principles.

Creditors stand to enjoy significant additional protection if directors' duties were extended to include their interests, even if the extent of personal liability is simply to hold directors accountable for the profit that they made at the expense of the company, or the loss that they caused. This remedy may remain unavailable to creditors if it imposes too draconian a sanction on directors, in other words paying damages in addition to the traditional remedies. In light of these arguments it is submitted that the extent of directors' personal liability for a breach of fiduciary duties, even in instances where the creditors are considered to be the primary beneficiaries of these duties, should not extend to making good damages suffered by the company.

⁷⁴⁹ See discussion *supra* Ch 4 (Judicial Framework) for an analysis of the cases in which directors' duties to creditors were in issue. Directors' duty to exercise their powers for a proper purpose did not feature prominently and the remedy of setting aside an impugned transaction does not seem to impact on the position of corporate creditors too extensively.

⁷⁵⁰ *Supra* par 5.4.3.1.

5.5.4.1.2 Pecuniary Penalty Order

Although a pecuniary penalty order may be granted by the court where a contravention “materially prejudices the corporation’s ability to pay its creditors”,⁷⁵¹ creditors do not stand to benefit directly from such an order, as the penalty is a civil debt payable to ASIC.⁷⁵² One may argue, however, that creditors benefit indirectly from the statutory provision for pecuniary penalty orders for a breach of fiduciary duties, as it might serve as a deterrent. Such a step, however, requires legislative intervention as it is not provided for in the current common law framework of fiduciary duties.

5.5.4.2 Basis of Liability

It is submitted that the suggestion that liability for a breach of fiduciary duties should be the *ex lege Aquiliae* should not be accepted and that the current legal principle that liability for a breach of fiduciary duties is *sui generis*, should be retained. This submission is based on a number of arguments, of which only some are pertinent to the protection of creditors’ interests.⁷⁵³

The first of these arguments is that it is quite possible that the acceptance for a delictual basis of liability for a breach of fiduciary duties will lead to fiduciary duties becoming indistinguishable from the duty to act with care and skill. Some fiduciary duties may even disappear. It is submitted that such a development will be undesirable, as these two categories of duties are conceptually very different⁷⁵⁴ and one has to agree that the “delictual element of wrongfulness may not suffice to maintain the distinction in degree of these respective duties”.⁷⁵⁵

⁷⁵¹ S 1317G(1)(b)(ii).

⁷⁵² S 1317G(2).

⁷⁵³ Arguments against this suggestion, eg the fact that it is not supported by a number of subsequent cases, as well as the fact that it leads to uncertainty as to how a company should go about setting aside a transaction that resulted from an improper exercise of powers where the only available remedy is damages, remain valid, but are not relevant for the purposes of this discussion.

⁷⁵⁴ A factor that immediately jumps to mind in this regard is that a successful claimant in case of a breach of the duty of care and skill will be awarded damages. It was already indicated (*supra* par 5.4.1) that the remedy sought in case of a breach of fiduciary duties is not necessarily damages, indicating a crucial difference between these two types of duties.

⁷⁵⁵ Havenga *Breach of Fiduciary Duties: Liability* 371.

Apart from the conceptual differences that exist between these categories of duties, it is also possible that a removal of the distinction between them may result in fiduciary duties, which are generally regarded as more onerous than the duty of care and skill,⁷⁵⁶ becoming less onerous. This result is clearly unacceptable, as it would diminish the protection available to creditors in terms of directors' fiduciary duties.

A second reason why delictual liability for a breach of fiduciary duties is deemed unacceptable is that two elements of delict, namely damages and wrongfulness, may become obstacles in the successful enforcement of fiduciary obligations. It is quite possible that a director, in breach of his fiduciary duty to avoid a conflict of interests, obtained a benefit for himself that will not necessarily cause damage to the company.⁷⁵⁷ The company will be precluded from recovering this benefit from the director who failed to avoid a conflict of interests, as it will not be successful in proving damages for purposes of a delictual claim.⁷⁵⁸ Liability on a basis of a breach of fiduciary duties will thus be restricted to instances where the company suffered damages, thus once again narrowing the protection that creditors may enjoy in terms of fiduciary duties.

Finally, damage is not the only element of a delictual action that might present problems. The application of the element of wrongfulness effectively to enforce directors' fiduciary duties may result in uncertainty,⁷⁵⁹ which may also have a negative impact on the enforcement of fiduciary duties by creditors.

5.5.4.3 Defendant

South African company law recognises the *de jure* director. Directors who are effectively in control of the company although not technically occupying the position of director, in other words shadow directors, are recognised by the judiciary to the

⁷⁵⁶ *Id* 370 – 371 and authority there referred to.

⁷⁵⁷ See *id* 374 – 375 for further examples of liability for a breach of fiduciary duties in the absence of damages.

⁷⁵⁸ *Id* 375 asserts that this might lead to even greater uncertainty insofar as the enforcement of directors' fiduciary obligations is concerned.

⁷⁵⁹ *Id* 374 and preceding arguments.

extent that they were previously appointed as directors of the company and may consequently incur liability for a breach of fiduciary duties.

It also seems possible to hold persons in control of the company, but who were never appointed as directors, liable for a breach of common law fiduciary duties. This may be in terms of an implied mandate given by the company,⁷⁶⁰ or on the basis that they are recognised as “shadow directors”. Since the concept of “shadow directors” gained some statutory recognition,⁷⁶¹ the judiciary may possibly apply this definition and hold such persons liable for a breach of the fiduciary duties that they owed to the company as *directors*.

Some uncertainty remains, however, and it is proposed that the statutory definition of director should be amended to include express reference to a “shadow director”, as was done in Australia, New Zealand and England. This will remove any doubt with regard to the potential liability and basis of the liability of those in control of the company, whether previously appointed as directors or not.

5.6 CONCLUSION

In this chapter an attempt was made to indicate that it is possible to apply principles in regard to directors’ fiduciary duties in such a way that they offer meaningful protection to the interests of corporate creditors in this way.

This statement must be qualified, however, as it seems that particular fiduciary duties are more capable of providing protection for creditors’ interests than others. In this regard a distinction is drawn between directors’ duty to act in good faith in the best interests of the company and their duty to exercise powers for a proper purpose. It is submitted that creditors may benefit from an extension of directors’ duty to act in good faith in the best interests of the company, resulting in specific duties such as a

⁷⁶⁰ As suggested by Naude *Regsposisie van die Maatskappydirekteur* 107.

⁷⁶¹ In terms of s 219(4)(a) of the South African *Companies Act*, as discussed *supra* par 5.4.3.3.4.

duty to maintain an unfettered discretion and a duty to avoid a conflict of interests, but not necessarily from a duty to act for proper purposes.

The distinction referred to above is not made clear in terms of common law and it must be conceded that a codification of directors' fiduciary duties on this basis may facilitate the extension of the particular arm of fiduciary duties, as suggested, to creditors. Apart from apparent advantages that may at first glance appear tempting, codification carries the danger of restricting future development. The law on fiduciary duties is constantly evolving in order to keep up with the demands made on it by the modern company. This process may be halted by a complete codification of fiduciary duties and it is therefore submitted that the current common law basis of fiduciary duties be retained.

This does not mean, however, that limited legislative intervention is uncalled for in some areas. The unenviable position of the nominee director in a subsidiary company, especially, may be addressed through statutory relaxation of the duty to maintain an unfettered discretion, in terms of which these directors will be permitted to serve the interests of the holding company or group under particular circumstances. Care must be taken, however, that sufficient statutory protection is provided to the interests of creditors, as was done in Australia, for example.⁷⁶²

In order to ensure that creditors will be able to enjoy meaningful protection by way of an extension of directors' fiduciary duties, it is firstly suggested that directors' good faith should be assessed by way of a hybrid objective-subjective test, in terms of which directors' subjective honest belief is tested objectively against surrounding circumstances.

It is also submitted that the interests of the company should not automatically be equated with those of its shareholders. Continued acceptance of this doctrine may cause difficulties in extending directors' fiduciary duties to creditors and it is therefore submitted that creditors' interests should become paramount at some

⁷⁶² In terms of s 187(c) of the Australian *Corporations Act*.

stage.⁷⁶³ This will make it easier to extend directors' duties to act in good faith in the best interests of the company; to maintain an unfettered discretion and to avoid a conflict of interests to creditors and will furthermore facilitate enforcement of fiduciary duties by creditors.⁷⁶⁴

The equation of the interests of the company with those of its creditors does raise the question, however, as to whether this will change what is expected of directors in terms of their fiduciary duties. In this regard it is submitted that the content of directors' fiduciary duties remain the same, whether aimed at indirectly protecting the interests of shareholders or of creditors. In terms of fiduciary duties to creditors directors are therefore placed under a negative obligation, namely to refrain from self-dealing and to avoid insider preferences.

This approach may make the extension of fiduciary duties to creditors more acceptable, as it does not deviate as much from existing legal principles as other approaches referred to in this chapter and will not burden directors with one set of duties under particular circumstances and another set under other circumstances. It also carries the advantage that creditors will enjoy the benefit of the continuous development of existing legal principles in regard to fiduciary duties along with shareholders. Unacceptable risk-taking by directors may furthermore be addressed by way of their duty to act with care and skill.⁷⁶⁵

It is also submitted that the remedy afforded in cases of a breach of fiduciary duties, specifically with reference to those duties that are suggested to be extended to creditors, may be valuable in safeguarding the interests of corporate creditors. Holding directors personally liable for the profit that they made at the expense of the company, or the loss that they caused, furthermore seems to be adequate and the additional imposition of personal liability for damages is not advised. Pecuniary

⁷⁶³ See discussion *infra* Ch 7 (Point in Time When the Duty Arises) for more detail on the situations that may give rise to the duty to creditors being "triggered".

⁷⁶⁴ See discussion *infra* Ch 8 (Beneficiary of the Duty) for more detail.

⁷⁶⁵ See *infra* Ch 6 (Protection Afforded by the Duty of Care and Skill) for further discussion.

penalty orders seem to offer limited protection as a deterrent measure, as any monies recovered thereby will not be for the benefit of creditors.

With regard to directors' personal civil liability it is furthermore submitted that the *sui generis* basis of liability in cases of a breach of fiduciary duties be retained. Suggestions that liability in such instances should rather be based on the *lex Aquiliae* are not accepted, as this may have numerous undesirable consequences.⁷⁶⁶

The persons who may incur liability for a breach of directors' fiduciary duties furthermore include *de jure* directors; *de facto* directors; non-executive directors; puppet directors, as well as shadow directors. In order to remove any uncertainty with regard to the identification and potential liability of shadow directors, it is suggested that the definition of director be amended to include specific reference to shadow directors, as was done in Australia, New Zealand and England.

In light of the above discussion it therefore seems that the existing legal principles pertaining to directors' fiduciary duties, may be applied successfully to provide protection to the interests of corporate creditors. Limited legislative intervention, as indicated, may serve to increase this protection, but is not essential.

The availability of such protection remains dependent, however, on the willingness of the judiciary to recognise that the interests of the company should not automatically be equated with those of its shareholders and that creditors' interests should enjoy prime consideration at a certain point in time.

A further issue that needs to be investigated is whether creditors stand to benefit from an extension of directors' duty of care and skill. This aspect is addressed in the next chapter.⁷⁶⁷

⁷⁶⁶ As discussed *supra* par 5.4.3.2.

⁷⁶⁷ *Infra* Ch 6 (Protection Afforded by the Duty of Care and Skill).

CHAPTER 6

PROTECTION AFFORDED BY THE DUTY OF CARE AND SKILL

SUMMARY

- 6.1 INTRODUCTION
 - 6.2 SOURCES AND FORMULATION
 - 6.3 RELEVANT ASPECTS
 - 6.4 CONSEQUENCES OF BREACH
 - 6.5 APPLICATION TO A DUTY TO CREDITORS
 - 6.6 CONCLUSION
-

6.1 INTRODUCTION

As early as 1742 the judiciary recognised that directors, in addition to having to act honestly and in good faith when exercising their powers, are required to act with diligence when managing the affairs of the company.⁷⁶⁸ Although it must be conceded that directors' fiduciary duties enjoyed much more attention in cases dealing with directors' duties to creditors,⁷⁶⁹ it seems fairly obvious that it is in the interest of creditors that directors act with care and skill in managing the affairs of the company and that this particular duty of directors may provide a valuable safeguard for the interests of corporate creditors.⁷⁷⁰

⁷⁶⁸ See *The Charitable Corporation v Sutton* (1742) 2 Atk 400 404 – 406, where Lord Hardwick LC accepted that a person, by accepting the appointment of director, “is obliged to execute it with fidelity and *reasonable diligence*” (own emphasis). Despite the fact that the outcome of the case suggests that it was arrived at by treating the breach complained of as a breach of fiduciary duties, rather than a breach of the duty of diligence as the language would suggest, Trebilcock “The Liability of Company Directors for Negligence” (1969) 32 *Modern Law Review* 499 499 – 500 notes that this case has been regarded as “something of a high point in the duty of care the law has demanded of directors”.

⁷⁶⁹ In only one of the cases analysed *supra* Ch 4 (Judicial Framework), the liability of directors to creditors was based on a breach of their duty of care and skill, namely the Canadian case of *Peoples Department Stores Inc (trustee of) v Wise* [1998] QJ No 3571 (QSC (Bankruptcy and Insolvency Division)), which was subsequently reversed on appeal in *Peoples Department Stores Inc (Trustee of) v Wise* (2003) 224 DLR (4th) 509.

⁷⁷⁰ Finch “Company Directors: Who Cares About Skill and Care?” (1992) 55 *Modern Law Review* 179 189 agrees that “[c]reditors no less than shareholders have certain interests in non-negligent direction, notably a concern that incompetence does not prejudice the company’s ability to repay”. See also

Unfortunately this duty has been largely neglected and has played a very subsidiary role to fiduciary duties for a long time.⁷⁷¹ The courts also display a very indulgent attitude towards directors insofar as compliance with their duty of care and skill is concerned and impose a very lax standard in determining compliance with the duty of care and skill.⁷⁷² These facts compel one to question the effectiveness of the duty of care and skill as a measure to protect the interests of corporate creditors.⁷⁷³

The focus of this chapter therefore is on addressing the question as to whether creditors would benefit from an extension of directors' duty of care and skill in order to protect their interests.

In an attempt to answer this question, some general background is firstly provided on the duty of care and skill. Aspects dealt with in the general discussion are the sources and formulation of the duty of care and skill;⁷⁷⁴ particular aspects of the duty of care and skill that seem to detract from the protection that may be offered in terms of this duty;⁷⁷⁵ and lastly the consequences of a breach of the duty of care and skill.⁷⁷⁶

Rider "Amiable Lunatics and the Rule in *Foss v Harbottle*" (1978) 37 *Cambridge Law Journal* 270 286 – 287 who observed that "[b]ad and incompetent management places shareholders, creditors, employees, suppliers and consumers at risk". Authors such as Farrar "The Obligation of a Company's Directors to Its Creditors Before Liquidation" 1985 *Journal of Business Law* 413 416 furthermore seem to prefer the extension of directors' duties to creditors on the basis of a duty of care, rather than fiduciary duties.

⁷⁷¹ Bishop "Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers" (1968) 77 *Yale Law Journal* 1078 1099 observes that "[t]he search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack".

⁷⁷² Numerous authors are critical of this leniency. See eg Finch *supra* 179 who remarked: "The common law operates to give directors a remarkable freedom to run companies incompetently"; as well as Naude *Die Regsposisie van die Maatskappydirekteur met Besondere Verwysing na die Interne Maatskappyverband* (1970) 155 and authors there referred to.

⁷⁷³ Trebilcock *supra* 18 emphasises that:

As any sort of assurance of protection to investors against mismanagement, the present law on a director's liability for negligence is wholly inadequate.

⁷⁷⁴ *Infra* par 6.2.

⁷⁷⁵ *Infra* par 6.3. These aspects include the way in which the elements of "care", "skill" and "diligence" relate to each other; the required standard; the distinction between executive and non-executive directors; and the reliance of directors on others.

The general principles as discussed above are analysed with the view to determine how they can be applied effectively to a duty to creditors. In areas where shortcomings were identified, some suggestions are offered as to how the current formulation of the duty of care and skill may be adapted to improve the protection afforded to creditors⁷⁷⁷ in terms thereof.⁷⁷⁸

6.2 SOURCES AND FORMULATION

6.2.1 South Africa

In South Africa, directors' duty to act with care and skill forms part of their common law duties. A director who was negligent in managing the affairs of the company may incur delictual liability based on the general principles of the *lex Aqualia*.⁷⁷⁹

In *Fisheries Development Corporation of SA Ltd v Jorgensen*⁷⁸⁰ Margo J rightly noted that there is a dearth of cases on the topic of directors' duty of care and skill.⁷⁸¹ South African courts and commentators thus tend to turn to English cases for some guidance on the content of this particular duty. A very important case in this regard⁷⁸² is that of *In re City Equitable Fire Insurance Co Ltd*,⁷⁸³ where the court laid down a number of principles in respect of directors' duty of care and skill.⁷⁸⁴

⁷⁷⁶ *Infra* par 6.4.

⁷⁷⁷ A more effective duty of care and skill would obviously benefit shareholders as well.

⁷⁷⁸ *Infra* par 6.5.

⁷⁷⁹ Naude *supra* 313.

⁷⁸⁰ 1980 4 SA 156 (W).

⁷⁸¹ *Id* 165 – 166.

⁷⁸² Numerous South African commentators rely on this case as being authoritative when discussing directors' duties of care and skill. See eg Cilliers and Benade *Corporate Law* (2002) par 10.31, n 60 – n 64; Havenga "The Business Judgment Rule – Should We Follow The Australian Example?" 2000 *SA Merc LJ* 25 26; McLennan "Duties of Care and Skill of Company Directors and Their Liability for Negligence" 1996 *SA Merc LJ* 94 96; Naude *supra* 157, n 2 – 6; Pretorius, Delpont, Havenga & Vermaas *Hahlo's South African Company Law Through the Cases* (1999) 280 – 281. It was also referred to and relied upon by the court in the *Fisheries Development Corporation of SA Ltd v Jorgensen supra* 165 166.

⁷⁸³ [1925] 1 Ch 407. According to Davies *Gower & Davies' Principles of Modern Company Law* (2003) (hereinafter *Gower*) 433 a stream of nineteenth century cases culminated in this decision, which renders it of particular importance. It is also regarded by Butcher *Directors' Duties: A New Millennium, A New Approach?* (2000) 41 as the *locus classicus* concerning the standard of care and

The court relied on these principles to provide the following exposition of directors' duties of care and skill in South Africa.

In determining whether a director acted with the necessary care, one must firstly have regard to the nature of the company's business and any particular obligations assumed by the director.⁷⁸⁵ In this respect a distinction is to be drawn between an executive director and a non-executive director.⁷⁸⁶ Directors are secondly entitled to assume that duties that may properly be left to some other official are performed honestly by that person and may rely on information and advice from management in the absence of reasons for questioning such information or advice.⁷⁸⁷ They are not hereby entitled to rely on such information blindly, but are still expected to exercise their own judgment in respect thereof.⁷⁸⁸

With regard to the required degree of skill a very subjective yardstick is used. Directors are not expected to possess any particular degree of business acumen, experience or even some proficiency with regard to the company's area of business. All that is expected of them in terms of their duty to display the necessary degree of skill is that they must exercise the care that may reasonably be expected of a person with *their specific knowledge and experience*.⁷⁸⁹

diligence required by the general law. Earlier cases on this topic include *The Overend & Gurney Company v Gibb* (1872) LR 5 HL 480; *In re Cardiff Savings Bank (Marquis of Bute's Case)* [1892] 2 Ch 100; *In re Kingston Cotton Mill Co (No 2)* [1896] 1 Ch 331; *Lagunas Nitrate Company v Lagunas Syndicate* [1899] 2 Ch 392; *Dovey v Cory* [1901] AC 477; and *In re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425.

⁷⁸⁴ These principles are listed *infra* par 6.2.4.

⁷⁸⁵ *Fisheries Development Corporation of SA Ltd v Jorgensen supra* 165.

⁷⁸⁶ *Id* 165.

⁷⁸⁷ *Ibid.*

⁷⁸⁸ *Ibid.*

⁷⁸⁹ *Id* 166.

The corresponding duty of members of a close corporation, and of directors of banks, is provided for by statute.⁷⁹⁰ Although not specifically applicable to directors of companies, these provisions provide valuable insight into how the duty of care and skill is viewed by the legislature and serve as an indication as to how this duty may develop in future.

In terms of section 43(1) of the *Close Corporations Act*

A member of a close corporation shall be liable to the corporation for loss caused by his failure in the carrying on of the business of the corporation to act with the degree of care and skill that may reasonably be expected from a person of his knowledge and experience.

Section 60(1A) of The *Banks Act* places directors of banks⁷⁹¹ under a statutory obligation to

(c) possess and maintain the knowledge and skill that may reasonably be expected of a person holding a similar appointment and carrying out similar functions as are carried out by the director, chief executive officer or executive officer of that bank; and

(d) exercise such care in the carrying out of his or her functions in relation to that bank as may reasonably be expected of a diligent person who holds the same appointment under similar circumstances, and who possesses both the knowledge and skill mentioned in paragraph (c) and any such additional knowledge and skill as the director, chief executive officer or executive officer in question may have.

It became apparent in other jurisdictions that the statutory formulation of director liability for wrongful or insolvent trading influenced the way in which the judiciary regarded directors' duty of care and skill.⁷⁹² Should the South African judiciary

⁷⁹⁰ In terms of the *Close Corporations Act* 69 of 1984 (hereinafter *Close Corporations Act*) and *Banks Act* 94 of 1990 (hereinafter *Banks Act*) respectively.

⁷⁹¹ This duty applies to directors, chief executive officers and executive officers of banks.

⁷⁹² In England the judiciary adopted the test contained in s 214(4) of the *Insolvency Act* 1986 dealing with directors' liability for wrongful trading as an accurate exposition of the common law in two cases, namely *Norman v Theodore Goddard* [1991] BCLC 1028 (CLD) and *In re D'Jan of London Ltd* [1994] BCLC 561 (Ch). According to Havenga *supra* 31 a deviation from the traditional approach regarding

proceed in a similar manner, cases dealing with director liability for reckless or fraudulent trading⁷⁹³ may also indicate how directors' common law duty of care and skill will be viewed in future. Principles enunciated in these cases, specifically pertaining to the conduct required of directors, are therefore referred to where relevant.⁷⁹⁴

6.2.2 Australia

In terms of section 180(1) of the Australian *Corporations Act*,⁷⁹⁵ directors have a statutory duty to

exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they

(a) were a director...of a corporation in the corporation's circumstances; and

(b) occupied the office held by, and had the same responsibilities within the corporation as the director...

This provision represents a partial codification of directors' duty of care.⁷⁹⁶ Common law principles pertaining to this aspect thus remain highly relevant and are referred to where necessary.

directors' duty of care and skill also took place in Australia by analogy with insolvent trading legislation.

⁷⁹³ In terms of s 424(1) of the South African *Companies Act*.

⁷⁹⁴ The developing interaction between directors' statutory liability for fraudulent or reckless trading and common-law liability for a breach of the duty of care and skill is conceded in *Philotex (Pty) Ltd v Snyman; Braïtex (Pty) Ltd v Snyman* 1998 2 SA 138 (SCA) 144. In this case, dealing with directors' statutory liability for reckless trading, the court justified its reference to the summary of directors' common law duty of care and skill in *Fisheries Development Corporation of SA Ltd v Jorgensen supra* as follows:

Although the focus there was upon the duty owed to the company, whereas here one is concerned with alleged recklessness *vis-à-vis* creditors, much of what was said there is applicable to the instant matter...

⁷⁹⁵ *Corporations Act* 2001 (hereinafter Australian *Corporations Act*).

⁷⁹⁶ The fact that the common law principles governing directors' duty of care and skill are still relevant, is evident from s 185 pertaining to the interaction of s 180 to s 184 with other laws and which expressly provides that:

Sections 180 to 184:

In addition, the way in which Australian directors' liability for a breach of their duty of care is viewed by the judiciary, may be influenced by the fact that the Australian *Corporations Act* provides for the application of a business judgment rule.⁷⁹⁷ The potential effect of this provision is addressed in more detail below.⁷⁹⁸

6.2.3 New Zealand

The standard expected of directors in New Zealand in respect of their duty of care is set out by section 137 of the *Companies Act*.⁷⁹⁹ This provision stipulates that:

A director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence, and skill that a reasonable director would exercise in

-
- (a) have effect *in addition to, and not in derogation of*, any rule of law relating to the duty or liability of a person because of their office or employment in relation to a corporation; (own emphasis)

and from a note to s 180(2) that:

This subsection only operates in relation to duties under this section and their equivalent duties at common law or in equity (*including the duty of care that arises under the common law principles governing liability for negligence*)...(own emphasis).

⁷⁹⁷ In terms of s 180(2), which reads as follows:

A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of subsection (1) and their equivalent duties at common law and in equity, in respect of the judgment if they:

- (a) make the judgment in good faith for a proper purpose; and
- (b) do not have a material personal interest in the subject matter of the judgment; and
- (c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
- (d) rationally believe that the judgment is in the best interest of the corporation.

The director's or officer's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.

S 180(3) continues to define a business judgment as "any decision to take or not take action in respect of a matter relevant to the business operations of the corporation".

⁷⁹⁸ *Infra* Ch 9 (Relief from Liability) par 9.2.3.2.

⁷⁹⁹ 1993 *Companies Act* (hereinafter *New Zealand Companies Act*).

- the same circumstances taking into account, but without limitation, -
- (a) The nature of the company; and
 - (b) The nature of the decision; and
 - (c) The position of the director and the nature of the responsibilities undertaken by him or her.

Despite the fact that the New Zealand *Companies Act* contains a statutory formulation of directors' duties, common law principles developed by the courts still play an important role when interpreting these provisions. They are therefore referred to where relevant.⁸⁰⁰

6.2.4 England

In England directors are subject to a common law duty of skill and care. The three well-known propositions formulated by Romer J in *In re City Equitable Fire Insurance Co*⁸⁰¹ until recently formed the basis of the duty of skill and care in England.⁸⁰²

According to these principles a director is firstly not expected to exhibit a greater degree of skill than may reasonably be expected of a person of his knowledge and experience in the performance in his duties.⁸⁰³ In the second place, a director is not required to pay continuous attention to the affairs of his company, but need only perform his duties, which are of an intermittent nature, at periodical board meetings that he only has to attend whenever he is reasonably able to do so.⁸⁰⁴ Finally, a

⁸⁰⁰ Jones *Company Law in New Zealand: A Guide to the Companies Act 1993* (1993) 103 regards the importation of a number of common law duties into the New Zealand *Companies Act* as an effort to make the law governing director conduct more accessible to business people. He continues to state that the common law propositions definitely have "relevance to an understanding of the duty of care set out in the 1993 Act" (*id* 108).

⁸⁰¹ *Supra*.

⁸⁰² They were relied on in *Huckerby v Elliott* [1970] 1 All ER 189 and were more recently also recited in the Privy Council in *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1990] 3 All ER 404 420.

⁸⁰³ *In re City Equitable Fire Insurance Co Ltd supra* 428.

⁸⁰⁴ *In re City Equitable Fire Insurance Co Ltd supra* 429. See also *In re Montrotier Asphalte Company (Perry's Case)* (1876) 34 LT 716, referred to by Trebilcock *supra* 505, where it was held that a director's "business or pleasure may call him elsewhere and it would be a most unheard of thing to say

director may assume, in the absence of grounds for suspicion, that duties that may properly be left to some other official are performed honestly by that person.⁸⁰⁵

Whether these principles still present the legal position with regard to directors' duty of care and skill is questionable,⁸⁰⁶ as courts in England nowadays are more inclined to impose a higher standard on directors in terms of their duty of care and skill.

A change in the way in which directors' duty of care and skill is perceived is signalled by *Dorchester Finance Co v Stebbing*.⁸⁰⁷ The court distinguished between a director's duty of skill and a duty of diligence and found that earlier cases in which the subjective yardstick was used, exclusively dealt with directors' duty to act with the necessary skill. Insofar as their duty to act with diligence is concerned, however, an objective test should be used.

In two later cases the distinction between a subjective duty of skill and an objective duty of diligence was dropped, with the court expressing the view that both of these duties should be judged objectively.⁸⁰⁸

that if anything wrong was done at a board meeting he being named among the directors but not present, he is liable for what is done in his absence".

⁸⁰⁵ *In re City Equitable Fire Insurance Co Ltd supra* 429.

⁸⁰⁶ Gower 432 observes, with some degree of relief it would seem, that the law relating to directors' duty of care and skill is "at last beginning to undergo a profound change". Loose, Griffiths & Impey *The Company Director: Powers, Duties and Liabilities* (2000) 151 are also of the opinion that although these standards have been applied until comparatively recently, "there are good reasons for believing that they no longer represent the law".

⁸⁰⁷ *Supra*.

⁸⁰⁸ See *Norman v Theodore Goddard supra* and *Re D'Jan of London Ltd supra*. The courts' change of approach may be attributed to various factors. See Gower 433. These include guidelines provided by the statutory formulation of directors' liability in case of wrongful trading; the emphasis put upon the importance of the role of the non-executive director in reports such as the *Cadbury Report* (Report of the Committee on the Financial Aspects of Corporate Governance, chaired by sir Adrian Cadbury *The Report of the Committee on the Financial Aspects of Corporate Governance* Gee and Co Ltd, London, 1992) and *Greenbury Report* (Report of a Study Group on Directors' Remuneration, under chairmanship of sir Richard Greenbury *Directors' Remuneration* Gee Publishing Ltd, London, 1995) and the public attitudes to corporate governance. In *Bishopsgate Investment Management Ltd v Maxwell (No 2)* [1994] 1 All ER 261 264 the court acknowledged, with reference to directors' participation in the management of the company, that the law "may be evolving in response to changes in public attitudes to corporate governance".

Section B5 of the White Paper on “Company Law Reform” published in March 2005⁸⁰⁹ furthermore suggests that directors’ duty of care and skill is to be codified as follows:

- (1) As a director of a company you must exercise reasonable care, skill and diligence.
- (2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with –
 - (a) the knowledge, skill and experience that may reasonably be expected of a director in your position; and
 - (b) any additional knowledge, skill or experience that you in fact have.

⁸⁰⁹ Available at www.dti.gov.uk/cld/review.htm, hereinafter referred to as the English *Company Law Reform Bill*.

It was initially suggested that some type of duty to creditors should be included among directors' statutory duties.⁸¹⁰ A decision was reached, however, not to include any duties in relation to creditors in the statutory statement, based on concerns that fears of personal liability may lead to excessive caution on the part of directors, which would run counter to the "rescue culture" that the English government is trying to promote.⁸¹¹

6.2.5 Canada

Directors of Canadian companies are required to act with care in discharging their managerial functions. Provisions in federal and provincial corporations statutes with

⁸¹⁰ See par 8 and par 9 of the Company Law Review Modern Company Law for a Competitive Economy Final Report (Vol I). Par 8, titled "Special duty where company more likely than not to be unable to meet debts", reads as follows:

At a time when a director of a company knows, or would know but for a failure of his to exercise due care and skill, that it is more likely than not that the company will at some point be unable to pay its debts as they fall due –

- (a) ...
- (b) he must, in the exercise of his powers, take such steps...as he believes will achieve a reasonable balance between –
 - (i) reducing the risk that the company will be unable to pay its debts as they fall due; and
 - (ii) promoting the success of the company for the benefit of its members as a whole.

Par 9 refers to a special duty that applies where there is "no reasonable prospect of avoiding insolvent liquidation" and reads as follows:

At a time when a director of a company knows, or would know but for a failure of his to exercise due care and skill, that there is no reasonable prospect of the company's avoiding going into insolvent liquidation –

- (a) ...
- (b) he must, in the exercise of his powers, take every step with a view to minimising the potential loss to the company's creditors that a person exercising due care and skill would take (excluding anything which would breach his duty under paragraph 1 or 5);...

⁸¹¹ Secretary for Trade and Industry *Modernising Company Law* (Cm 5553-I) par 3.11.

regard to this duty are very similar.⁸¹² Section 122(1)(b) of the *Canada Business Corporations Act*⁸¹³ is illustrative of these provisions⁸¹⁴ and reads as follows:

Every director and officer of a corporation in exercising their powers and discharging their duties shall exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

6.2.6 United States of America

Directors in the United States of America are also subject to a duty of care. In some states this is a common law duty. In the vast majority of states, however, the duty is partially codified in terms of a provision similar to section 8.30(a) of the 1984 *Model Business Corporations Act*.⁸¹⁵ This provision reads that:

A director shall discharge his duties as a director...

- (1) in good faith;
- (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
- (3) in a manner he reasonably believes to be in the best interests of the corporation.⁸¹⁶

The way in which the duty of care functions in the United States of America, especially insofar as directors' liability for a breach of the duty is concerned, is intrinsically linked to the operation of the business judgment rule.⁸¹⁷ Although

⁸¹² See Sarra & Davis *Director and Officer Liability in Corporate Insolvency* (2002) 32 n 3 for a list of these provisions.

⁸¹³ RSC 1985, c C-44 (hereinafter *CBCA*).

⁸¹⁴ Sarra & Davis *supra* 32.

⁸¹⁵ Hereinafter *MBCA*.

⁸¹⁶ S 8.30(b) was amended by the 1999 revised *MBCA*. The new provision requires directors to discharge their duties "with the care that a person in a like position would reasonably believe appropriate under similar circumstances" when "becoming informed in connection with their decision-making function or devoting attention to their oversight function".

⁸¹⁷ Balotti & Hinsey "Director Care, Conduct, and Liability: The Modern Business Corporation Act Solution" (2000) 56 *The Business Lawyer* 35 36 describe the business judgment rule as "the familiar and longstanding doctrine that serves as *the common law's principal guidepost on issues relating to director conduct and liability*" (own emphasis). The fact that requirements in respect of director conduct are separated from issues of liability for non-compliance with these requirements, is clearly illustrated by the 1999 amendments to the *Model Business Corporations Act* which distinguishes between "Standards for Conduct of Directors" (s 8.30) and "Standards of Liability for Directors" (s 8.31).

directors are expected to comply with a duty of care, only the principles embodied in the business judgment rule indicate whether a director should be held liable for non-compliance with this particular duty.⁸¹⁸

6.3 RELEVANT ASPECTS

6.3.1 Elements of “Care”, “Skill” and “Diligence”

6.3.1.1 *Duty of Care*

The single common denominator in all the jurisdictions referred to in this study is the element of “care” as part of directors’ duty of care and skill. Saying that directors are expected to act with care in managing the affairs of the company is uncontroversial.

6.3.1.2 *Duty of Skill*

Although the element of skill is accepted as part of the duty in the majority of jurisdictions discussed,⁸¹⁹ this element of the duty is problematic, for the simple reason that the office of director is not regarded as a profession⁸²⁰ and that directors are generally not expected to possess any particular qualifications or skills.⁸²¹ The rationale behind this fact lies therein that the legislature and the courts were satisfied

⁸¹⁸ See *infra* Ch 9 (Relief from Liability) par 9.2.3.1 for more detail on the business judgment rule.

⁸¹⁹ Namely South Africa, New Zealand, England and Canada.

⁸²⁰ Finch *supra* 189; McLennan *supra* 95.

⁸²¹ In terms of s 218(1) of the South African *Companies Act* certain categories of persons are expressly disqualified from holding the office of company director, eg minors; persons under legal disability; unrehabilitated insolvents; and dishonest persons. Apart from these limited statutory exclusions from the office of director, any person may be appointed as a company director. The viewpoint that a director is not required to have any particular skills could not be more clearly expressed than it was by Neville J in *In re Brazilian Rubber Plantations & Estates Ltd supra* 437:

[A director] is, I think, not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance.

Another telling illustration of how little was expected from directors in regard to the skills that they possess, is *In re Cardiff Savings Bank (the Marquis of Bute’s Case) supra*, where the Marquis of Bute became president of the Cardiff Savings Bank at the age of six months. South African courts hold a similar viewpoint. See eg *Fisheries Development Corporation Ltd v Jorgensen supra* 165 where the court stated, specifically with reference to a non-executive director, that he is not required to “have special business acumen or expertise, or singular ability or intelligence, or even experience in the business of the company”.

with leaving the choice of directors in the hands of the shareholders, who had only themselves to blame for foolish appointments.⁸²²

It can definitely be argued that this justification of a lack of skill on the part of directors is outdated in light of the way in which the face of the company has changed since these principles were formulated. It is clear that the large modern corporation makes use of professional executive directors in stead of the well-meaning non-executive director of the past, and that the time has come to pass for directors to be regarded merely as “amiable lunatics”.⁸²³

It is thus submitted that a certain degree of skill should be required of company directors.

Developments in South African law indicate that this viewpoint is gaining ground. *King Report on Corporate Governance for South Africa 2002*,⁸²⁴ for example, states that directors are required to “qualify themselves on a continuous basis with a sufficient (at least a general) understanding of the company’s business and the effect of the economy so as to discharge their duties properly”;⁸²⁵ and to be “informed about

⁸²² It was confirmed in *Turquand v Marshall* (1869) LR 4 Ch App 379 386 that as long as directors remained within the ambit of their powers, however ridiculous and absurd their conduct might seem, it was the misfortune of the company that they had chosen such foolish directors. No mention is made of the fact that creditors also have to bear the consequences of the shareholders’ appointment. See also *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd* [1927] 2 KB 9 (CA) 23 – 24 where the court confirmed that “[i]t is not the business of the court to manage the affairs of the company. That is for the shareholders and directors”.

⁸²³ A phrase coined by Danckwerts J in *Pavlidis v Jensen* [1956] 2 All ER 518 and used by Rider *supra*.

⁸²⁴ Institute of Directors *King Report on Corporate Governance for South Africa 2002* (hereinafter *King II*). Although *King II* technically does not have the force of law, but merely embodies principles of good governance, these principles may in practice be elevated to enjoy the status of legal principles, through reference thereto by the courts. See eg *De Villiers v BOE Bank Ltd* 2004 3 SA 1 (SCA) 13, where the court stated that “*principles of good governance* of companies dictated that resolutions should be properly taken at general meetings or meetings of directors after due and proper deliberation” (own emphasis). Also see Sealy “Directors’ Duties Re-examined” (paper presented at the Institute of Advanced Legal Studies, 26 June 2000) as referred to by Arsalidou “The Liability of Non-executive Directors for Negligent Omissions: A New Approach under Legislation?” (2002) 23 *The Company Lawyer* 107 109, who notes the trend that “today’s law on directors’ duties is being shaped, on the one hand...by the non-legal codes of good practice which are obligatory for listed companies”. The importance of *King II* should thus not be under-estimated.

⁸²⁵ In terms of par 2.3 of Ch 4 of Section 1 of *King II*.

the financial, industrial and social milieu in which the company operates”.⁸²⁶ Another such development is that directors of banks are required to “possess and maintain the knowledge and skill that may reasonably be expected of a person holding a similar appointment and carrying out similar functions as are carried out by the director”.⁸²⁷

6.3.1.3 Duty of Diligence

The element of diligence is specifically provided for in three of the jurisdictions discussed.⁸²⁸ Requiring a director to be diligent in performing his functions indicates a definite departure from one of the propositions stated in *In re City Equitable Fire Insurance Co Ltd*,⁸²⁹ namely that a director needs only to perform his duties at periodical board meetings that he only has to attend whenever he is reasonably able to do so.⁸³⁰

The fact that directors should be diligent and devote proper attention to the affairs of companies on whose boards they are appointed seems obvious. It is also supported by *King II* in terms of which directors are required to be “diligent in discharging their duties to the company [and] regularly attend all meetings”.⁸³¹

6.3.2 Required Standard

6.3.2.1 South Africa

A director is required to exercise the care that can *reasonably* be expected of a person with *his or her specific knowledge and experience*.⁸³² Although a measure of objectivity is provided for in that a director must at least display the degree of care that could *reasonably* be expected from somebody like himself, indicating that irrational behaviour in light of the particular knowledge and experience of the director is unacceptable, the standard laid down in *Fisheries Development Corporation of SA*

⁸²⁶ In terms of par 2.6 of Ch 4 of Section 1 of *King II*.

⁸²⁷ In terms of s 60(1A)(c) of the *Banks Act*.

⁸²⁸ These are Australia, New Zealand and Canada.

⁸²⁹ *Supra*.

⁸³⁰ *Supra* 429.

⁸³¹ In terms of par 2.11 of Ch 4 of Section 1 of *King II*.

⁸³² *Fisheries Development Corporation of SA Ltd v Jorgensen supra* 166 (own emphasis).

*Ltd v Jorgensen*⁸³³ seems to indicate the application of a subjective yardstick. The perception of subjectivity inherent to this duty is furthermore enforced by the fact that the extent of a director's duty of care and skill is dependent on the nature of the company's business and on any particular obligations assumed by the director.⁸³⁴

The judiciary introduced an objective/subjective yardstick when assessing director liability for reckless trading in terms of section 424(1) of the South African *Companies Act*. In *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman*⁸³⁵ the court declared:

The test for recklessness is objective insofar as the defendant's actions are measured against the standard of conduct of the notional reasonable person and it is subjective insofar as one has to postulate that notional being as belonging to the same group or class as the defendant, moving in the same spheres and having the same knowledge or means to knowledge.⁸³⁶

In applying the above general principles to section 424(1), the court concluded:

The enquiry will therefore be: what would the reasonable businessman having that additional knowledge, or having ready access to that knowledge, have done in the circumstances?⁸³⁷

Section 60(1A)(d) of the *Banks Act* furthermore places a director of a bank under a statutory obligation to exercise the care that “may *reasonably* be expected of a *diligent person* who holds the same appointment under similar circumstances”, and who possesses the knowledge and skill *reasonably expected of a person in a comparable position*, as well as “any such additional knowledge and skill as the

⁸³³ *Supra*.

⁸³⁴ *Fisheries Development Corporation of SA Ltd v Jorgensen supra* 165; with reference to *In re City Equitable Fire Insurance Co supra* and *Wolpert v Uitzigt Properties (Pty) Ltd* 1961 2 SA 257 (W).

⁸³⁵ *Supra*.

⁸³⁶ *Id* 143; with reference to *S v Van As* 1976 2 SA 921 (A).

⁸³⁷ *Id* 149.

director...may have”,⁸³⁸ indicating a definite departure from an exclusively subjective approach to the duty of care and skill .

6.3.2.2 Australia

Section 180(1) clearly provides for objective as well as subjective standards by which the conduct of a director should be measured to determine his compliance with the duty in terms of this provision. A director is required to exercise the care and diligence that a *reasonable person* would exercise, indicating an objective element.

The provision continues, however, by recognising subjective factors that should be taken into account when the conduct of the director is measured against that of the reasonable person, namely the fact that this reasonable person is a director;⁸³⁹ the particular circumstances in which the company finds itself;⁸⁴⁰ the particular office held by the director;⁸⁴¹ and the director’s specific responsibilities within the company.⁸⁴²

The above statutory formulation is in line with common law developments and pronouncements by the courts.⁸⁴³ Cases established that an objective test should be used as a point of departure to determine whether a director complied with his duty of

⁸³⁸ Own emphasis.

⁸³⁹ S 180(1)(a) of the Australian *Corporations Act*.

⁸⁴⁰ *Ibid.*

⁸⁴¹ S 180(1)(b) of the Australian *Corporations Act*.

⁸⁴² *Ibid.*

⁸⁴³ In *Deputy Commissioner of Taxation v Clark supra* par 93 the court stated:

Until a decade or two ago, the standard of skill and the standard of care of directors were each to be determined by what could reasonably be expected from a person with the knowledge and experience of the director concerned...Over a period of time that standard of care and skill came to be regarded as too low. By 1992 it had become clear that directors were expected to be proactive. *This was reflected in both amendment of the statutory duty and in the parallel development of the common law duty* (own emphasis).

care and diligence. A landmark judgment in this respect is *AWA Ltd v Daniels*⁸⁴⁴ and on appeal *Daniels v Anderson*,⁸⁴⁵ where the court stated:

The modern cases...set in the context of a legislative pattern of imposing greater responsibility upon directors, demonstrate that the director's duty of care is not merely subjective, limited by the director's knowledge and experience or ignorance or inaction.⁸⁴⁶

The courts did, however, also propagate the taking into account of subjective factors.⁸⁴⁷

6.3.2.3 New Zealand

The New Zealand *Companies Act* uses the yardstick of the “reasonable director” to determine whether a particular director's conduct falls short of the required standard.⁸⁴⁸ On the basis of the language used in this provision it seems that an objective standard is favoured. Secondly, this objective standard is higher than in many other jurisdictions where director conduct is often measured against that of a

⁸⁴⁴ (1992) 7 ACSR 759 864 – 865.

⁸⁴⁵ (1995) 37 NSWLR 438 500 – 501 and 505. The importance of this case is that it was specifically concerned with a breach of care, skill and diligence. The other Australian cases referred to primarily dealt with claims of insolvent trading under predecessors of s 588G of the Australian *Corporations Act*, namely s 556(1) of the *Companies Code* 1981 and s 592(1) of the *Corporations Law*, contained in Part 13 of the *Corporations Act* 1989. These judgments did, however, raise wider issues as to the standards of care, skill and diligence required of directors and therefore do merit discussion.

⁸⁴⁶ *Id* 503. Also see *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115. In *Australian Securities Commission v Gallagher* (1994) 11 WAR 105 116 the test was described as “*basically an objective one* in the sense that the question is what an ordinary person with the knowledge and experience of the defendant might be expected to have done in the circumstances if he was acting on his own behalf” (own emphasis). In *Deputy Commissioner of Taxation v Clark* [2003] NSWCA 91 par 109 the court emphasised that: “Although the standard of skill may vary in accordance with the particular skills of the director, *the core, irreducible requirement of skill involves an objective test*, such as ‘ordinary competence’...or ‘reasonable ability’...An equivalent *objective test applies to the core, irreducible requirement of diligence*, such as “reasonable steps to place themselves in a position to guide and monitor the management of the company”...(own emphasis).

⁸⁴⁷ In *Australian Securities Commission v Gallagher supra* 116, where the court described the test as “*basically an objective one*”, it was conceded that subjective elements such as the knowledge and experience of the particular person must be taken into account. Also see *Deputy Commissioner of Taxation v Clark supra* par 108, where it was stated that “[w]hat constitutes a breach of the standards of care and of diligence, in a particular case, will depend on a wide variety of circumstances including the precise nature of the business conducted by the company and the composition of its board.”

⁸⁴⁸ S 137.

“reasonable person”,⁸⁴⁹ or even a “reasonably prudent person”⁸⁵⁰ or “ordinarily prudent person”.⁸⁵¹ The term “reasonable director” is, however, not defined.⁸⁵²

Subjective elements are provided for in terms of the statutory standard. This is illustrated by the fact that a director is required to exercise the care, diligence and skill that a reasonable director would exercise in the *same circumstances* taking into account the *nature of the company*; the *nature of the decision*; the *position of the director*; as well as the *responsibilities undertaken by the director*.⁸⁵³

This statutory formulation of the standard of care expected of directors seems to be in line with common law principles⁸⁵⁴ as expressed in *Grayburn v Laing*,⁸⁵⁵ namely that:

Something more than mere carelessness will be necessary before liability can arise. The standard of care which is imposed is to be assessed in relation to the particular responsibilities of the director concerned towards the company, the nature of the company and the nature of the directorship.⁸⁵⁶

Directors’ statutory duty to exhibit the degree of skill of a reasonable director does not mean that a director is required to possess particular skills.⁸⁵⁷ A director is

⁸⁴⁹ As in Australia (s 180(1) of the Australian *Corporations Act*).

⁸⁵⁰ As in Canada (s 122(1)(b) of the *CBCA*).

⁸⁵¹ As in the USA (s 8.30(a) of the *MBCA*).

⁸⁵² According to Jones *supra* 120 the term is not capable of definition, because “what is expected of a reasonable director depends entirely on the circumstances in which the actions are taken”. This may result in the term “reasonable director” being regarded as an “ordinary person” or an “ordinarily prudent person” as defined in *In re City Equitable Fire Insurance Co Ltd supra* which leads Jones to conclude that the statutory standard is in effect no different from the common-law standard of care required of directors.

⁸⁵³ S 137 (own emphasis).

⁸⁵⁴ According to Jones *supra* 120.

⁸⁵⁵ [1991] 1 NZLR 482.

⁸⁵⁶ *Id* 490. These principles are similar to the propositions set out in *In re City Equitable Fire Insurance Co Ltd supra* and *Kuwait Asia Bank EC v National Mutual Life Nominees supra*.

⁸⁵⁷ Jones *supra* 120.

furthermore required to display the skill of a reasonable director in the *same circumstances*,⁸⁵⁸ indicating a subjective element to this particular element of the duty.

At common law the standard of skill expected of a director is measured in a largely subjective way. A director is firstly required to exhibit the degree of skill that may reasonably be expected from a person of *his or her knowledge and experience*.⁸⁵⁹ *National Mutual Life Nominees Ltd v Worn*⁸⁶⁰ serves as an indication that the court may go one step further and decide that the standard of skill is also to be determined with reference to the surrounding circumstances and responsibilities that the directors have undertaken.

The only area in which the statutory formulation of the duty of care imposes a higher standard than the common law duty is in respect of a director's duty to act with diligence.⁸⁶¹ With regard to this aspect of the duty there is "little room for subjectivity".⁸⁶² This would entail that a director is required to be informed as to the affairs of the company; make the necessary inquiries; and to seek competent advice when the need arises.⁸⁶³

The following statement from *Jagwar Holdings Ltd v Julian*⁸⁶⁴ indicates that a higher degree of diligence is supported by the courts:

⁸⁵⁸ S 137 (own emphasis).

⁸⁵⁹ As proposed in *In re City Equitable Fire Insurance Co Ltd supra* 429.

⁸⁶⁰ (1990) 5 NZCLC 66, 384, as referred to by Jones *supra* 121.

⁸⁶¹ In terms of the common law proposition put forward by Romer J in *In re City Equitable Fire Insurance Co Ltd supra* 429 a director is not expected to

give continuous attention to the affairs of his or her company. The duties are of an intermittent nature to be performed at periodical board meetings – a director is not bound to attend all board meetings.

⁸⁶² Jones *supra* 121.

⁸⁶³ *Id* 122.

⁸⁶⁴ (1992) 6 NZCLC 68,040, as referred to by Jones *supra* 122.

If need be I would support those who question whether a person who accepts appointment of the directorate of a publicly listed company should now be exempt from any obligation to keep himself reasonably informed about its financial state...

6.3.2.4 England

The application of a dual objective/subjective standard in terms of directors' duty of care and skill is supported by the proposed English *Company Law Reform Bill*. This is indicated by the fact that a director will be required to exercise *reasonable* care, skill and diligence,⁸⁶⁵ which means the care, skill and diligence exercised by a *reasonably diligent person* with the knowledge, skill and experience that may *reasonably* be expected of a director in that position,⁸⁶⁶ as well as any additional knowledge, skill and experience that he in fact has.⁸⁶⁷

6.3.2.5 Canada

Section 122(1)(b) indicates a clear departure from the common-law position, in terms of which a director is only expected to exercise the degree of care, skill and diligence that could reasonably be expected from him, to a situation where a director is required to act with the care, diligence and skill of a "reasonably prudent person".⁸⁶⁸ A departure from the clearly subjective standard at common law is thus brought about by this provision, although an argument can be made that the phrase "in comparable circumstances" reimports the subjective standard of the common law.⁸⁶⁹

⁸⁶⁵ S B5(1).

⁸⁶⁶ S B5(2)(a).

⁸⁶⁷ S B5(2)(b). Reference to the specific knowledge, skill and experience that the director has indicates an element of subjectiveness. These subjective elements, however, increase the burden that is placed on particularly knowledgeable directors.

⁸⁶⁸ This provision resulted from recommendations made by a task force appointed by the Canadian government, chaired by Robert W Dickerson, in a report published in 1971 entitled *Proposals for a New Business Corporations Law for Canada* (the *Dickerson Report*). The report, with reference to *In re City Equitable Fire Insurance Co supra*, recognised how low the prevailing legal standard of care for directors is, and admitted to having sought to raise it significantly by the introduction of the objective yardstick "a reasonably prudent man" (Part 9.00 "Directors and Officers", vol 1 par 242 p 83).

⁸⁶⁹ Gray *The Annotated Canada Business Corporations Act 1995* (1994) 207.

In *Peoples Department Stores Inc (trustee of) v Wise*⁸⁷⁰ the court interpreted section 122(1)(b) to have “partly objectified” a standard that was previously purely subjective.⁸⁷¹ According to the court the partial objectification lies in the element of diligence and not in the element of skill. If a director possesses certain skills by *his* experience and knowledge he is required to apply them with reasonable diligence.⁸⁷² A director who does not have “the skill”, must be diligent and seek professional advice.⁸⁷³

Skill is thus still judged subjectively, whereas diligence is assessed objectively.⁸⁷⁴ The court was silent on the required degree of care that should be displayed by directors in exercising their managerial powers.

6.3.2.6 *United States of America*

Regarding the standard that directors have to comply with in exercising their duty of care generally, section 8.30 of the 1999 revised *MBCA* incorporates a subjective as well as an objective standard. In terms of this provision a director, “when becoming informed in connection with their decision-making function or devoting attention to their oversight function” is required to conduct his or her management functions “with the care that a person in a like position would reasonably believe appropriate”.⁸⁷⁵ The subjective frame of reference pertains to the actual belief held by the director, whereas the objective frame of reference relates to the fact that the belief must fall within the bounds of sound discretion, and must not be irrational.⁸⁷⁶

⁸⁷⁰ *Supra*.

⁸⁷¹ *Id* par 156.

⁸⁷² *Ibid*.

⁸⁷³ *Id* par 157.

⁸⁷⁴ This interpretation is in line with the decision in *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498, although the court in *Peoples Department Stores (trustee of) v Wise supra* did not expressly refer to this case.

⁸⁷⁵ S 8.30(b). This provision’s predecessor read that a director shall discharge his duties as director “with the care an ordinarily prudent person in a like position would exercise under similar circumstances” (s 8.30(a)(2) of the 1984 *MBCA*) and “in a manner he reasonably believes to be in the best interests of the corporation” (subsection (3)). This provision also contained both the objective and subjective elements referred to. It was amended, however, to remove the phrase “ordinarily prudent person”.

⁸⁷⁶ Balotti & Hinsey *supra* 51.

The language used by the courts seem to indicate an objective yardstick insofar as directors' duty of care in respect of their overseeing function specifically is concerned.⁸⁷⁷ Language usage may be misleading, however, and a closer analysis of these cases reveals that directors were held liable in the non-decision making context only upon "an express abdication of responsibility or upon obvious and prolonged failure to exercise oversight or supervision".⁸⁷⁸

In a non-decision making context, directors are thus regarded to have complied with their duty of care if they have not totally abandoned their duties. This may lead to a conclusion that the duty of care with regard to the overseeing function of directors is not so much concerned with care or skill, as it is with *diligence* on the part of the directors in performing their functions. Section 8.31 of the 1999 revised *MBCA* supports this inference by allowing for an action against directors whose conduct involved a sustained failure to devote attention to their oversight function, but not for any other type of breach of the duty of care.

6.3.3 Distinction Between Executive and Non-Executive Directors⁸⁷⁹

6.3.3.1 South Africa

The extent of a director's duty of care and skill is dependent on the nature of the company's business and on any particular obligations assumed by the director.⁸⁸⁰ In this respect a distinction is made between the so-called executive director, who is

⁸⁷⁷ Hansen "The Duty of Care, the Business Judgment Rule, and The American Law Institute Corporate Governance Project" (1993) 48 *The Business Lawyer* 1355 1359.

⁸⁷⁸ *Id* 1359 n27; 1360 n 30, with reference to *De Pinto v Providence Sec Life Ins Co* 374 F 2d 37 (9th Cir 1967); *Lutz v Boas* 171 A 2d 381 (Del Ch 1961); *Harman v Willbern* 374 F Supp 1149 (D Kan 1974); *Neese v Brown* 405 S W 2d 577 (tenn 1974); and *Francis v United Jersey Bank* 432 A 2d 814 (NJ 1981).

⁸⁷⁹ Apart from a distinction between executive and non-executive directors, the law also recognises *de facto* directors; puppet, dummy or stooge directors; and shadow directors. See discussion *supra* Ch 5 (Protection Afforded by Fiduciary Duties) par 5.4.3.3 for more information on various types of directors. The principles with regard to the liability that they may incur in case of a breach of fiduciary duties, as discussed *supra* par 5.4.3.3, are also applicable in the context of a breach of the duty of care and skill and are not repeated in this section.

⁸⁸⁰ *Fisheries Development Corporation of SA Ltd v Jorgensen supra* 165G, with reference to *In re City Equitable Fire Insurance Co supra* and *Wolpert v Uitzigt Properties (Pty) Ltd supra* 267.

actively involved in the management of the company's affairs, and the non-executive director.⁸⁸¹

In *Fisheries Development Corporation Ltd v Jorgensen*⁸⁸² the court made the following telling statement with regard to the non-executive director:

[The non-executive director] 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 board meetings, and at any other meetings which may require his attention. He is not, however, bound to attend all such meetings, though he ought to whenever he is reasonably able to do so.⁸⁸³

It was already mentioned that the way in which the courts regard directors' duty of care and skill may be influenced by decisions regarding director liability for reckless or fraudulent trading,⁸⁸⁴ as is the case in other jurisdictions.⁸⁸⁵ Two cases that may play a role in influencing the way in which the judiciary assesses the role and liability of non-executive directors are *Howard v Herrigel*⁸⁸⁶ and *Cronje v Stone*.⁸⁸⁷

In *Howard v Herrigel*⁸⁸⁸ the court declared that the phrase "any person who was knowingly a party to the carrying on of the business"⁸⁸⁹ does not mean that a person has to be involved in the taking of positive steps in the carrying on of the business. It may be enough to support or concur in the conduct of the business. Non-executive directors are therefore not necessarily safe to assume that they are protected from

⁸⁸¹ See discussion *supra* Ch 5 (Protection Afforded by Fiduciary Duties) par 5.4.3.3.3 for more detail on the distinction between executive and non-executive directors, as well as the extent to which this distinction is recognised in terms of South African company law.

⁸⁸² *Supra*.

⁸⁸³ *Id* 165.

⁸⁸⁴ In terms of s 424(1) of the *Companies Act* 61 of 1973 (hereinafter South African *Companies Act*).

⁸⁸⁵ See examples referred to *supra* par 6.2.1.

⁸⁸⁶ 1991 2 SA 660 (A).

⁸⁸⁷ 1985 3 SA 597 (T).

⁸⁸⁸ *Supra* 674.

⁸⁸⁹ S 424(1).

personal liability by refraining from participating actively in the management of the company's affairs.

Further statements by the court in *Howard v Herrigel*,⁸⁹⁰ for example that “it is unhelpful and even misleading to classify company directors as ‘executive’ or ‘non-executive’ for purposes of ascertaining their duties”; that “it is not helpful to say of a particular director that, because he was not an ‘executive director’, his duties were less onerous than they would have been if he were an executive director”; and that “[w]hether the inquiry be one in relation to negligence, reckless conduct or fraud, the legal rules are the same for all directors”,⁸⁹¹ indicate that the court might not rely too heavily on the non-executive status of a director when assessing his performance.

The willingness of the judiciary to hold a non-executive director personally liable in terms of section 424(1) of the South African *Companies Act* in *Cronje v Stone*,⁸⁹² furthermore supports the inference that directors will not always be able to evade personal liability by hiding behind their non-executive status.

6.3.3.2 Australia

The statutory formulation of directors' duty to act with care and diligence does not necessarily indicate that the position of executive directors is different from that of non-executive directors. The fact that the degree of care and diligence required from a director is determined, amongst other things, by the office held by him or her and the responsibilities of that particular director⁸⁹³ does, however, lead one to conclude that the scope of directors' duty of care and diligence is influenced by whether they hold the office of executive or non-executive director.

This statement is supported by statements of the court to the effect that:

⁸⁹⁰ *Supra*.

⁸⁹¹ *Id* 678.

⁸⁹² *Supra*.

⁸⁹³ S 180(1)(b) of the Australian *Corporations Act*.

The degree of skill required of an *executive director* is measured objectively. In contrast...*non-executive directors* are not bound to give continuous attention to the affairs of the corporation.⁸⁹⁴

Non-executive directors should, however, not derive too much comfort from statements such as these. Failure by directors to be sufficiently informed of the company's affairs, so as to be able to take appropriate steps should grounds for suspicion arise, may result in extensive personal liability for both executive and non-executive directors.⁸⁹⁵

A director should therefore not rest easy in the belief that non-participation in management of the company's affairs offers a possible defence against personal liability as was illustrated by the more recent case of *Deputy Commissioner of Taxation v Clark*.⁸⁹⁶ In this case the court was concerned with a woman who was appointed as a director of a company at the behest of her husband. She has never been a director of any other company; did not have any business experience; and spent her time mainly by being a housewife and mother. She admitted, in fact, that from time to time she signed company documents without them having been explained to her, usually with "a frying pan in one hand and...signing with the other".⁸⁹⁷

In deciding whether or not she had "good reason" for not taking part in the management of the company,⁸⁹⁸ thus relieving her from statutory liability in terms of

⁸⁹⁴ Per Rogers CJ in *AWA Ltd v Daniels supra* 762. Some confusion may be caused by the fact that the executive director's *skill* is referred to, whereas the non-executive director's duty of *diligence* is apparently under discussion. The fact remains, however, that a distinction is made between what is expected of executive directors and non-executive directors.

⁸⁹⁵ In *Commonwealth Bank of Australia v Friedrich supra* failure resulted in a part time non-executive and unpaid director being held liable for A\$97m. The non-executive status of a director was also considered to be immaterial in *Vrisakis v Australian Securities Commission* (1992 – 1993) 9 WAR 395 where the fact that the director was a non-executive director was the basis of his defence.

⁸⁹⁶ *Supra*.

⁸⁹⁷ *Id* par 10.

⁸⁹⁸ With reference to the statutory defence provided by s 588FGB of the *Corporations Act*. Although this case to a large extent dealt with directors' statutory duties and defences provided by s 588G, the

section 588FGA of the Australian *Corporations Act*, the court per Spigelman CJ made the following statement:

[T]here is no justification for a doctrine which would hold sleeping directors to be ‘de facto non-directors’, who should be relieved of their liabilities. Although, as a practical matter, the conduct of such directors may never meet the requisite standard of participation in management, such conduct should not be excused as a “good reason” in law.⁸⁹⁹

6.3.3.3 New Zealand

Neither the New Zealand legislature, nor the New Zealand judiciary makes an express distinction between so-called executive or full-time directors and non-executive or independent directors. Section 137 of the New Zealand *Companies Act* does, however, indicate that the “*position of the director and the nature of the responsibilities undertaken by him or her*”⁹⁰⁰ are factors that should be taken into consideration when establishing whether a director acted with the requisite degree of care, skill and diligence. This seems to leave room for drawing a distinction between what is expected of directors depending on the nature of the office held by them.

6.3.3.4 England

Insofar as a director’s duty of diligence is concerned, the law draws little distinction between executive and non-executive directors. Once it is established that a director did not even seek to check that the company was managed in accordance with

court emphasised that the “scope and purpose of the section to be interpreted...can only be understood in the light of prior legislation as applied in the case law. For over two decades there has been a symbiotic interaction between legislative change and judicial decision” (par 52). The court then continued by using principles regarding what is to be expected of directors in terms of their duty of care and diligence, as an aid to determine whether the defendant director had “good reason” for not participating in management as per the statutory defence.

⁸⁹⁹ *Id* par 167. This statement was confirmed by Hodgson JA par 174 who said:

A director’s non-participation in the management of the company will usually involve a breach of that duty, whether the director is aware of this or not; although...there will not be a breach of duty if the illness or other good reason is such as to make the non-participation reasonable.

Also see the minority judgment of Kirby P in *Metal Manufacturers v Lewis* (1988) 13 NSWLR 315 318 – 319; *Commonwealth Bank of Australia v Friedrich supra*; *Group Four Industries Pty Ltd v Brosnan* (1992) 59 SASR 22; and *Statewide Tobacco Services Ltd v Morley* [1993] 1 VSR 451, where the court expressed similar sentiments.

⁹⁰⁰ S 137(c) (own emphasis).

principles of company law, it will be of little relevance whether he was an executive or non-executive director.⁹⁰¹ One could therefore say that the days of the old-school non-executive director who “lent his name, sometimes his presence, and perhaps his connection, to the board” are over.⁹⁰²

It must be conceded, however, that there will be differences in the standards expected of different directors when it comes to the actual conduct of the company’s affairs.⁹⁰³ This does not necessarily mean that non-executive directors will be in a more favourable position to escape liability for a breach of the duty of care and skill. In fact, the holding of office as non-executive director by reason of particular expertise, may mean that that specific director will be required to exhibit more skill in that field than directors appointed for other reasons.⁹⁰⁴

6.3.3.5 Canada

The Canadian legislature does not distinguish between executive and non-executive directors insofar as their statutory duty of care, diligence and skill is concerned. The *CBCA* does specify, however, that every director is subject to a duty of care, diligence and skill that a “reasonably prudent person would exercise in *comparable circumstances*”.⁹⁰⁵ “Comparable circumstances” may refer to the particular circumstances in which the director finds himself, which include the nature of the office held by him and the extent of the duties assumed by him.

6.3.3.6 United States of America

Once again a clear statutory distinction is not drawn between the position of executive and non-executive director in terms of statutory provisions. Reference made to the care exercised by a person in a “like position” under “similar circumstances” in section 8.30(a)(2) of the *MBCA* may lead one to conclude that the particular position

⁹⁰¹ *Dorchester Finance Co Ltd v Stebbings supra* 505.

⁹⁰² Loose, Griffiths & Impey *supra* 151. Cases pertaining to the disqualification of non-executive directors, eg *In re Continental Assurance Co of London plc* [1996] BCC 888 and *In re Park House Properties Ltd* [1998] BCC 847, as referred to by Arsalidou *supra* 110, indicate that the courts are taking a firmer stance against inactive non-executive directors.

⁹⁰³ *Id* 156.

⁹⁰⁴ *Id* 155.

⁹⁰⁵ S 122(1)(b) (own emphasis).

assumed by a director will play a role in establishing whether he complied with his duty of care.

The American judiciary furthermore distinguishes between the decision-making role and the overseeing role of directors. In respect of the first, the business judgment rule defines the content of the duty of care. In respect of the latter, however, the business judgment rule is not applicable. This distinction may, to a large extent, influence the manner in which the potential liability for breach of duty of care of executive and non-executive directors is assessed. Non-executive directors are traditionally less involved in active decision-making and more in an overseeing context. This may result in the business judgment rule not being applicable in many instances when determining the liability of non-executive directors for a breach of the duty of care.⁹⁰⁶

6.3.4 Reliance on Others

6.3.4.1 South Africa

Directors may, in the absence of reasonable grounds for suspicion, assume that duties that may properly be left to some other official are performed honestly.⁹⁰⁷ They are also entitled to rely on information and advice from management in the absence of reasons for questioning such information and advice.⁹⁰⁸ This does not mean that directors are entitled to rely on such information blindly – they are still expected to exercise their own judgment, having given the relevant advice or information due consideration.⁹⁰⁹

6.3.4.2 Australia

Directors are afforded statutory room to rely on others in discharging their management functions, by way of a rebuttable presumption. In terms section 189(a) of the Australian *Corporations Act* a director's reliance on information or advice from particular persons is taken to be reasonable, unless the contrary is proved.

⁹⁰⁶ See discussion *infra* Ch 9 (Relief from Liability) par 9.2.3 for more detail on the business judgment rule.

⁹⁰⁷ *Fisheries Development Corporation of SA Ltd v Jorgensen supra* 166; *Triptomania Twee (Pty) Ltd v Connolly* 2003 3 SA 558 (C) 563, with reference to *In re City Equitable Fire Insurance Co* [1925] Ch 407 429 and *Norman v Theodore Goddard* [1991] BCLC 1028 (CLD).

⁹⁰⁸ *Ibid.*

⁹⁰⁹ *Ibid.*

A director is, however, not entitled to rely on the advice or opinions of others blindly. The reliance must have been in good faith, having made an independent assessment of the information or advice and taking into account the director's knowledge of the corporation and the complexity of the structure and operations of the corporation.⁹¹⁰ Should a particular director be a specialist in a particular field, one may assume that the other directors, taking into account their knowledge, or more particularly, lack thereof relating to this matter, are entitled to rely on the opinion of the expert director.⁹¹¹

The persons who can be relied on in terms of section 189(a) are an employee of the corporation, reasonably believed to be reliable and competent;⁹¹² a professional adviser regarding matters reasonably believed to fall within that person's professional or expert competence;⁹¹³ another director or officer regarding matters within that person's authority;⁹¹⁴ or a committee of directors on which the director did not serve in relation to matters within the committee's authority.⁹¹⁵

6.3.4.3 New Zealand

The New Zealand legislature made express provision for the common law proposition that a director is entitled to rely on information supplied by others in the New Zealand *Companies Act*. In terms of this provision a director is entitled to rely on the reports,

⁹¹⁰ S 189(b).

⁹¹¹ This is in line with the reasoning in *Dempster v Mallina Holdings Ltd* (1994) 13 WAR 124, where the court decided that a director was not negligent to trust another director, who was in charge of the operation, at its face value without making independent enquiries himself. Baxt "When Can a Naïve Executive Director Escape Liability for Being Naïve and Foolish? When the Director Relies on Others!" (1995) 13 *Company & Securities Law Journal* 150 151 warns, however, that a foolish but honest director will not always escape liability in such cases, as it will depend on the factual situation that is to be considered. See Comerford & Law "Directors' Duty of Care and the Extent of 'Reasonable' Reliance and Delegation" (1998) 16 *Company & securities Law Journal* 103 109 – 115 for an exposition on cases pertaining to delegation to and reliance on others by directors.

⁹¹² S 189(a)(i).

⁹¹³ S 189(a)(ii).

⁹¹⁴ S 189(a)(iii).

⁹¹⁵ S 189(a)(iv).

statements and information of professionals, experts and employees,⁹¹⁶ provided that the director acts in good faith, makes proper inquiry when appropriate, and has no knowledge that the reliance is unwarranted.⁹¹⁷

Jones's analysis of this provision indicates that the ability to rely on others may decrease directors' potential liability in case of a breach of the duty of care.⁹¹⁸ It may, on the other hand, at least be seen to place a limited duty of inquiry on directors.⁹¹⁹ The statutory formulation does not, however, contain a more onerous duty than the common-law principles stated in *In re City Equitable Fire Insurance Co Ltd*.^{920 921}

6.3.4.4 England

The English judiciary stated that a director can neither be expected to watch the subordinate officers of the corporation, nor to verify the calculation of the auditor himself, as the business of life cannot go on if the directors cannot trust those who are put in a position of trust for the express purpose of attending to the details of management.⁹²² A director who is deceived by his own officers will thus not incur liability based on negligence.

This entitlement is, however, qualified by duties to supervise and inquire into the conduct of the company's affairs.⁹²³ Reliance on or delegation to others will also not exonerate directors from liability if such reliance was on or if such delegation was to obviously incompetent or unsuitable persons.⁹²⁴ Blind reliance on information

⁹¹⁶ S 138(1).

⁹¹⁷ S 138(2).

⁹¹⁸ Jones *supra* 128.

⁹¹⁹ *Ibid.*

⁹²⁰ *Supra.*

⁹²¹ Jones *supra* 128.

⁹²² *Dovey v Corey supra* 486.

⁹²³ Loose, Griffiths & Impey *supra* 157.

⁹²⁴ *Id* 156.

provided by and opinions of others may thus result in a breach of the duty of diligence, making a director vulnerable to liability on the basis of such a breach.

6.3.4.5 Canada

Canadian directors are statutorily permitted to rely on information provided by others in terms of the *CBCA*, provided that they acted in good faith.⁹²⁵ In terms of the relevant provision, directors who relied on financial statements of the corporation represented to them by an officer of the corporation; or on a written report of an auditor of the corporation fairly to reflect the financial condition of the corporation;⁹²⁶ or on the report of a person whose profession lends credibility to statements,⁹²⁷ will not be held liable for decisions made on the basis of that information.

Powers of directors may furthermore be delegated to officers, but directors must exercise due care in selecting competent officers.⁹²⁸

6.3.4.6 United States of America

Directors are fully protected if they rely in good faith on reports made by officers.⁹²⁹ For a report to qualify as such, however, it must, at a minimum, be pertinent to the subject matter upon which a board is called to act.⁹³⁰ Directors are furthermore not protected in cases of blind reliance on such reports.⁹³¹

The above principles gained statutory recognition in the 1999 revised version of the *MBCA*. In terms of the revised section 8.30 directors “who [do] not have knowledge that makes reliance unwarranted”⁹³² may rely on certain categories of persons. These include “officers or employees of the corporation whom the director reasonably

⁹²⁵ S 123(5).

⁹²⁶ S 123(5)(a).

⁹²⁷ S 123(5)(b).

⁹²⁸ *R v Bata Industries Ltd* (1992) 9 OR (3d) 329 (Ont Crt (Prov Div)).

⁹²⁹ *Smith v Van Gorkom* 488 A2d 858 (Del 1985).

⁹³⁰ *Ibid.*

⁹³¹ *Ibid.*

⁹³² S 8.30(c).

believes to be reliable and competent”;⁹³³ “legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise”;⁹³⁴ and a committee of the board of directors of which the director is not a member.⁹³⁵ A director is not entitled to rely on these persons blindly and must be able to indicate that he reasonably believed that the particular person or committee merits confidence.⁹³⁶

6.4 CONSEQUENCES OF BREACH

6.4.1 South Africa

A director who is in breach of his duty of care and skill to the company may be held personally liable for the damages suffered by the company as a result of the breach.⁹³⁷ Such liability is based in delict,⁹³⁸ which entails that a successful plaintiff must be able to prove that the director in question committed a wrongful act that caused damages to the plaintiff and that the director acted intentionally or negligently.⁹³⁹

6.4.2 Australia

Directors have a statutory duty to act with care and diligence in terms of section 180(1) of the Australian *Corporations Act*, which is regarded as a so-called “civil penalty provision”.⁹⁴⁰

Directors who fail to comply with their duty of care and diligence may incur statutory liability to the corporation. Section 1317H of the Australian *Corporations Act*

⁹³³ S 8.30(e)(1).

⁹³⁴ S 8.30(e)(2).

⁹³⁵ S 8.30(e)(3).

⁹³⁶ S 8.30(e)(1) – (3).

⁹³⁷ *Lagunas Nitrate Co v Lagunas Syndicate supra* 435; *In re Brazilian Rubber Plantations and Estates Ltd supra* 437; *In re City Equitable Fire Insurance Co Ltd supra* 428 – 429; *Ex parte Stubbs: In re Wit Extensions Ltd* 1982 1 SA 526 (W) 532; *Du Plessis v Phelps* 1995 4 SA 165 (C) 170.

⁹³⁸ *Ex parte Stubbs: In re Wit Extensions Ltd supra* 532; *Du Plessis v Phelps supra* 170.

⁹³⁹ Neethling, Potgieter & Visser *Law of Delict* (2001) 4 indicate that all of the elements of a delict, namely an act, wrongfulness, fault, harm and causation, must be present. If any of these elements is missing, no delict was committed and there is no liability.

⁹⁴⁰ S 1317E(1)(a).

specifically provides that a court may order a person to compensate the corporation if the person has contravened a civil penalty provision⁹⁴¹ and damage resulted from the contravention.⁹⁴² “Damage” includes “profits made by any person resulting from the contravention or the offence”.⁹⁴³

The further importance of the fact that section 180(1) is a civil penalty provision is that a court must, once it is satisfied that a person has contravened a civil penalty provision, make a declaration of contravention.⁹⁴⁴ Once such a declaration has been made by the court, the Australian Securities and Investments Commission⁹⁴⁵ is free to seek a pecuniary penalty order in terms of which the delinquent party may be ordered to pay a pecuniary penalty of up to A\$200 000.⁹⁴⁶ Although a pecuniary penalty order may be granted by the court where a contravention “materially prejudices the corporation’s ability to pay its creditors”,⁹⁴⁷ creditors do not stand to benefit directly from the order, as the penalty is a civil debt payable to ASIC.⁹⁴⁸ One may argue, however, that creditors benefit indirectly from the statutory provision for pecuniary penalty orders for a breach of the duty of care and diligence, as it may encourage directors to comply with these duties in managing the affairs of the company.

Section 1324 of the Australian *Corporations Act* furthermore provides for injunctive relief. This provision makes it possible for ASIC or a person whose interests have been affected, to apply for an injunction where somebody is engaged in, or planning, a contravention of the Australian *Corporations Act*.⁹⁴⁹ It is also possible to obtain an

⁹⁴¹ Subs (1)(a).

⁹⁴² Subs (1)(b).

⁹⁴³ S 1317H(2).

⁹⁴⁴ S 1317E(1).

⁹⁴⁵ Hereinafter ASIC.

⁹⁴⁶ S 1317G.

⁹⁴⁷ S 1317G(1)(b)(ii).

⁹⁴⁸ S 1317G(2).

⁹⁴⁹ S 1324(1).

injunction where a person refuses or is failing to do something that is required in terms of the Australian *Corporations Act*.⁹⁵⁰ The fact that injunctive relief may be obtained by “a person whose interests have been affected” leaves the door open for creditors to apply for this type of relief. Subsection 10 furthermore empowers the court to order a person do pay damages, in stead of or in addition to the grant of the injunction.

6.4.3 New Zealand

Directors failing to comply with their duty of care, diligence and skill may be held liable on a statutory basis and will have to compensate the company for the damages that their conduct caused.

6.4.4 England

Director liability for failing to comply with their duty of care and skill seems to be based on common-law principles of negligence. The remedy envisaged in case of a breach of the duty is payment of damages to the company.

6.4.5 Canada

In Canada director liability for a breach of this particular duty is also based on statute and the relief is mainly compensatory in nature.

6.4.6 United States of America

Section 8.30, describing standards of conduct required of directors, is not the operative test for determining whether a director is liable for damages for failing to exercise reasonable care. The proper test for determining director liability is the business judgment rule. This is made very clear by the 1999 amendments to the *MBCA*. In terms of these amendments a distinction is drawn between standards of conduct⁹⁵¹ and standards of liability,⁹⁵² the latter essentially codifying the business judgment rule.⁹⁵³

⁹⁵⁰ S 1324(2).

⁹⁵¹ S 8.30.

⁹⁵² S 8.31.

⁹⁵³ Balotti & Hinsey *supra* 56 are of the opinion that this framework “reflects the substantive core of the business judgment rule”.

In determining whether the common law business judgment rule is applicable, it is important to distinguish between directors' duty of care in a decision-making context, and the duty of care in a non-decision making or oversight context.⁹⁵⁴ In the first instance the business judgment rule will apply to alter and to limit the duty, while the business judgment rule will enjoy no application in the latter instance.⁹⁵⁵

In respect of the duty of care in a decision-making context, the business judgment rule provides that a director acting in good faith and with due care in the *process* of decision making will not be found liable, even though the decision itself might not be one that the ordinarily prudent person would have made.⁹⁵⁶ The duty of care in a decision-making context could thus be seen as process due care alone.⁹⁵⁷

This is clearly illustrated by the well-known case of *Smith v Van Gorkom*⁹⁵⁸ in which the directors were held liable because they did not follow the appropriate *process* by not taking adequate steps to become informed about the proposed merger. Whether the steps taken were adequate will be measured against principles of gross negligence.⁹⁵⁹

When, on the other hand, directors are not required to make a business decision⁹⁶⁰ or where they are required to do so, but fail to make the decision, the business judgment rule will not apply.⁹⁶¹

⁹⁵⁴ Hansen *supra* 1356.

⁹⁵⁵ *Ibid.*

⁹⁵⁶ *Ibid.* The business judgment rule therefore comprises both a procedural and a substantive element. According to Balotti & Hinsey *supra* 37 the procedural element "establishes a presumption that the directors 'acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company'", while the substantive element "prevents judicial review of the merits of the decision and protects the decision from challenge".

⁹⁵⁷ Hansen *supra* 1356.

⁹⁵⁸ *Supra.*

⁹⁵⁹ *Aronson v Lewis* 473 A2d 805 (Del 1984) 812 n 6.

⁹⁶⁰ Ie in a non-decision making or oversight context.

⁹⁶¹ Hansen *supra* 1359.

Section 8.31 of the 1999 revised *MBCA*, dealing with the standards of liability, describes procedural steps to be followed for specified aspects of director conduct that will be actionable.⁹⁶² The majority of these aspects are related to what is traditionally referred to as a breach of directors' fiduciary duties. Important for the purposes of this chapter, however, is section 8.31(a)(2)(iv). In terms of this provision conduct involving a sustained failure by the director to devote attention to the oversight function, or a specific failure to devote timely attention to a demonstrable need for inquiry when particular facts and circumstances of significant concern materialise, will be actionable.

In those states where the amended *MBCA* was accepted and introduced into legislation, director liability for failing to comply with required standards are therefore determined in accordance with section 8.31. In other states the common law business judgment rule still seems to be the only available device to determine whether directors may in fact be held liable for failing to comply with the required standards.

In terms of the 1999 revision of the *MBCA* a person who seeks to hold a director liable for failing to act with the necessary care, will furthermore be required to prove two facts. The first of these is that the corporation or its shareholders suffered harm measurable in monetary damages. The plaintiff must secondly also be able to show that the harm suffered was proximately caused by the challenged conduct.⁹⁶³

An action for damages against directors is, however, not the only remedy available under circumstances where a director is suspected of breaching his duty of care and the corporation may also apply for injunctive relief.⁹⁶⁴

⁹⁶² Balotti & Hinsey *supra* 56.

⁹⁶³ S 8.31(b)(1).

⁹⁶⁴ See Radin "The Director's Duty of Care Three Years After *Smith v Van Gorkom*" (1988) 39 *The Hastings Law Journal* 707 728 – 744 for a detailed discussion of cases in which the court found a lack of due care and was willing to provide injunctive relief. These include *EAC Industries Inc v Frantz Manufacturing Co* 11 Del J Corp L 608 (Del Ch); *Sealy Mattress Co of New Jersey, Inc v Sealy, Inc*

6.5 APPLICATION TO A DUTY TO CREDITORS

6.5.1 Sources

Directors' duty to act with care and skill forms part of their common-law duties in South Africa.⁹⁶⁵ One may probably argue that this fact contributes to the lack of protection afforded in terms of such a duty, in that the party or parties to be protected by it are rarely certain of what exactly can be expected of directors in terms of this duty. This may result in hesitancy to commence with action against directors on what *might* constitute conduct in breach of this duty.

The obvious solution to this shortcoming is a codification or partial codification of directors' duty of care and skill, as is the case in Australia, New Zealand, Canada and the majority of states in the United States of America.⁹⁶⁶

The point was already made in a previous chapter that one must carefully consider arguments in favour of and against a codification of directors' duties before taking such a step.⁹⁶⁷ The conclusion was reached that a codification of fiduciary duties will be undesirable, since the judiciary seems to be quite capable to develop this area of the law in order to ensure that fiduciary duties remain relevant in the modern corporation. An exhaustive codification of fiduciary duties will hinder this ongoing process.

Unfortunately the same cannot be said in respect of directors' duty of care and skill where common-law principles have remained stagnant. In respect of directors' duty of care and skill codification may provide the opportunity for following the modern trend of a more onerous and clearer duty of care and skill, without having to wait for a

[1987 Transfer Binder] Fed Sec L Rep (CCH), 93 331 (Del Ch July 20, 1987); *Hanson Trust PLC v ML SCM Acquisition, Inc* 781 F 2d 264 (2d Cir 1986); *Edelman v Fruehauf Corp* 798 F 2d 882 (6th Cir 1986); *Buckhorn, Inc v Ropak Corp* 656 F Supp 209 (SD Ohio).

⁹⁶⁵ As is the position in England and particular states in the USA.

⁹⁶⁶ And as is proposed for England in terms of the English *Company Law Amendment Bill*.

⁹⁶⁷ See discussion *supra* Ch 5 (Protection Afforded by Fiduciary Duties) par 5.5.1 and sources there referred to.

case dealing with this topic to come before a court whose judgment might or might not provide for progress in this area of the law.

One may also argue that a codification of the duty of care and skill is not totally foreign to South African law, in light of section 43(1) of the *Close Corporations Act* which provides for a codification of the duty of care and skill owed by the members⁹⁶⁸ of a close corporation,⁹⁶⁹ as well as section 60(1A)(c) and section 60(1A)(d) of the *Banks Act*, in terms of which the duty of care and skill of directors of banks is codified.

Apart from the proponents and opponents of codification, there are those who believe that codification will have no effect whatsoever.⁹⁷⁰ Rogers CJ, in delivering judgment in *AWA Ltd v Daniels*,⁹⁷¹ seems to be of the opinion that there is no distinction between standards of care owed under common law and those owed under statute and stated that “[t]he legal label may change but the contents of the bottle will remain the same”.⁹⁷²

⁹⁶⁸ Since a close corporation does not have directors but is managed by its members, members are subject to duties similar to the common-law duties of directors of a company, in their management of the close corporation.

⁹⁶⁹ S 43(1) provides:

A member of a corporation shall be liable to the corporation for loss caused by his failure in the carrying on of the business of the corporation to act with the degree of care and skill that may reasonably be expected from a person of his knowledge and experience.

This statutory definition of the duty of care and skill is identical to one of the principles enunciated by the court in *Fisheries Development Corporation of South Africa Ltd v Jorgensen supra* 166, but is less exhaustive than the explanation of the duty of care and skill provided by the court. It cannot therefore really be said to clarify the duty of care, and whether it may indeed be regarded as a proper “codification” is debatable.

⁹⁷⁰ See eg Sealy “Directors’ Duties in the New Millennium” (2000) 21 *The Company Lawyer* 64 who doubts whether a statutory statement of directors’ duties “will make any difference of substance to the law that we know”.

⁹⁷¹ *Supra*.

⁹⁷² *Id* 873. A contrary view is expressed by Ipp J in *Vrisakis v Australian Securities Commission supra* 428, according to whom there are differences, eg damages that have to be proved for common law liability, whereas s 229(2) of the *Companies Code*, 1981 and s 232(3) of the *Corporations Law*,

Even if the above were true, a codification of directors' duties may still be advantageous in that it will increase directors' potential liability through no other factor than "expectation".⁹⁷³ Beneficiaries who are more aware of duties incumbent on directors will have greater expectations than before. This will not necessarily result in a greater number of actions against directors, but may improve directors' standard of conduct where their increased knowledge of their duties and of the higher expectations of beneficiaries of the duties can serve as an incentive to take steps to mitigate adverse consequences arising from non-compliance with their duties.⁹⁷⁴ Codification may thus serve "to ensure that there are not too many bad directors".⁹⁷⁵

6.5.2 Formulation

The comparative study indicated that the duty of care and skill is not formulated in a universal way. In some jurisdictions it is simply referred to as a duty of care;⁹⁷⁶ in others as a duty of care and skill;⁹⁷⁷ a duty of care and diligence;⁹⁷⁸ or a duty of care, diligence and skill.⁹⁷⁹ The question may be asked as to which of these elements may serve to protect creditors' interests, and whether the content of the duty will change, depending on whether it is a duty for the benefit of shareholders, or of creditors.

contained in Part 13 of the *Corporations Act*, 1989, the predecessors of the current s 180(1), do not make any mention of damages that have to be proved.

⁹⁷³ Jones *supra* 123.

⁹⁷⁴ *Ibid.*

⁹⁷⁵ A point conceded by Menzies "Directors' Duties" (1959) 33 *Australian Law Journal* 156 174 who is of the opinion that an Act of Parliament will not necessarily produce good directors, but will at least be able to limit the number of bad directors.

⁹⁷⁶ As in the USA.

⁹⁷⁷ As in South Africa and England.

⁹⁷⁸ As in the statutory statement of the duty in Australia. Some voiced criticism against this formulation, as it dispensed with the element of skill and thus places a less onerous duty on directors than the common-law duty of care, skill and diligence.

⁹⁷⁹ As in New Zealand and Canada.

It is firstly submitted that creditors may benefit from directors having a duty to act with the necessary care in managing the affairs of the company. This is also the only element of the duty that is universal to all the jurisdictions discussed and it is therefore obvious that it must form part of any formulation of this particular duty of directors.

Directors who act with care, but who are not properly qualified and who do not possess the necessary skills for the position, may still cause a lot of damage. It is therefore secondly submitted that the duty of skill should also be provided for in a formulation of directors' duty of care and skill.

It is furthermore submitted that these two elements of the duty of care be kept separate,⁹⁸⁰ in order to avoid any confusion that may result from an intermingling of the requirements of each.

It is also clear that directors must be diligent in the performance of their duties. The duty of diligence may be said to be subsumed by the duty of care, however, which makes an express duty of diligence as part of directors' duty of care seem unnecessary.⁹⁸¹

6.5.3 Relevant Aspects

6.5.3.1 Required Standard

In the immediately preceding discussion it was suggested that a formulation of directors' duty of care should contain express reference to the elements of care and skill. The degree of care required from directors and the amount of skill that a director should possess will, however, greatly influence the protection that is afforded to creditors in terms of such a duty.

6.5.3.1.1 Duty of Care

⁹⁸⁰ As was done in the *Banks Act*. S 60(1A)(c) provides for directors' duty of skill and s 60(1A)(d) for the duty of care.

⁹⁸¹ The duty of diligence is provided for in the *Banks Act* in the subsection dealing with the duty of care, in that a director is required to display what may reasonably be expected of a *diligent* person.

As was mentioned already, according to the decision in *Fisheries Development Corporation Ltd v Jorgensen*⁹⁸² a largely subjective yardstick is proposed to determine whether a director acted in breach of his duty to act with care. This approach may be criticised for numerous reasons.⁹⁸³

In general it may be criticised for being outdated. A subjective yardstick does not relate to the backdrop of the modern commercial world in which directors are “appointed to their positions and paid large...sums of money for the expertise which they assert they can bring to the business”.⁹⁸⁴ These principles were also formulated primarily with reference to non-executive directors, or as some would have it “part-time officers, adornments to the corporate Christmas tree”⁹⁸⁵ – a perception of directors that is clearly not in line with the role and function of the executive director in the modern corporation.⁹⁸⁶

A purely subjective yardstick is furthermore clearly not in line with developments in other jurisdictions, as well as locally. One must recognise the fact that the jurisdictions discussed in this contribution are all, some to a greater degree than others, moving in the direction of a minimum objective standard when judging director conduct. In South Africa corporate governance guidelines in terms of *King II*,⁹⁸⁷ as well as the judiciary’s approach to the interpretation of section 424(1) of the

⁹⁸² *Supra* 166.

⁹⁸³ See Riley “The Company Director’s Duty of Care and Skill: The Case for an Onerous but Subjective Standard” (1999) 62 *Modern Law Review* 697 for a contrary viewpoint.

⁹⁸⁴ Gower 433. Also see Farrar & Hannigan *Farrar’s Company Law* (1998) (hereinafter Farrar) 392 who refer to the emphasis placed on corporate governance today, as well as an increasing number of disqualifications in England on grounds of unfitness, which encompasses both incompetence and negligence.

⁹⁸⁵ Farrar 391.

⁹⁸⁶ Gower 433 observes that this particular proposition by Romer J in *In re City Equitable Fire Insurance Co Ltd supra* seems to have been formulated with non-executive rather than executive directors in mind.

⁹⁸⁷ In par 2.3 of Chapter 4 entitled “Role of the Executive and Non-executive Director” of Section 1 of *King II*, it is proposed that executive as well as non-executive directors must “in line with modern trends worldwide, not only exhibit the degree of skill and care as may be reasonably expected from persons of *their* skill and experience...but must also exercise both the care and skill any *reasonable*

South African *Companies Act*,⁹⁸⁸ have opened the door for a more objective standard.⁹⁸⁹

With specific regard to the position of corporate creditors, the subjective yardstick may be faulted for being based on the notion of the supremacy of shareholder rights, as well as their perceived role in exercising control over directors. The courts justified their leniency towards directors' with regard to compliance with their duty of care and skill on the basis that it was shareholders who elected the directors and that they had to live with their decision if they decided to appoint incompetent amateurs. It was also the shareholders who could rectify the situation by removing the directors from office.⁹⁹⁰

The reasoning that shareholders appointed the directors and should not bother the courts if the consequences of appointing foolish and incompetent directors are visited upon them is clearly unfair towards corporate creditors. Creditors will have to suffer the consequences of havoc wreaked by foolish and incompetent directors along with shareholders, without having any say in their appointment in the first place.

This basis also presupposes active shareholders. It must be noted, however, that the modern shareholder, be it an individual or an institutional shareholder, is well-known for his apathy and remains largely uninterested in exercising the rights and enforcing the remedies showered upon him.⁹⁹¹

persons would be expected to show in looking after their own affairs as well as having regard to their *actual knowledge and experience*" (own emphasis).

⁹⁸⁸ In *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman supra* 143 149 the judiciary made it clear that the alleged "recklessness" of a director for the purposes of this provision should be assessed by using the objective measuring stick of the reasonable person. Subjective elements, such as the fact that the directors are qualified auditors, may play a role in increasing the standard expected of a director.

⁹⁸⁹ *King II* par 2.3.

⁹⁹⁰ Farrar 393; Gower 433.

⁹⁹¹ See *supra* Ch 2 (Conceptual Justification) par 2.4.5 for more detail.

Even authors who make a strong case in favour of a subjective standard, concede that objectivity is important when creditors' interests become the focus point.⁹⁹²

A strong case can thus be made for the application of an objective yardstick as a minimum requirement for director conduct. Care must be taken, however, to define the objective yardstick in such a way that it does not infringe upon directors' risk-taking ability unnecessarily.⁹⁹³ It may also prove problematic to define an objective yardstick that will apply to all directors of all companies.⁹⁹⁴

It is submitted that the above concerns may be addressed through the taking into account of subjective factors in determining directors' liability for a breach of their duty of care and skill.⁹⁹⁵

A further question in respect of the standard of care expected of directors, and one that is particularly pertinent for the purposes of this study, is whether the degree of care expected of directors will vary depending on whether the duty is aimed at protecting the interests of shareholders or those of creditors. In practical terms this question addresses the issue of whether directors are to be confronted with two separate duties of care – one that is applicable when the duty is aimed at protection of shareholders' interests and one that is applicable when the duty is aimed at the protection of creditors' interests.

⁹⁹² Riley *supra* 700.

⁹⁹³ Finch *supra* 202.

⁹⁹⁴ Finch *supra* 203; Trebilcock *supra* 509 – 511.

⁹⁹⁵ This is the approach followed in the statutory statement of the duty of care of directors of banks. S 60(1A)(d) of the *Banks Act* provides that directors are required to exercise the care that may reasonably be expected from a diligent person, indicating an objective yardstick. Subjective factors that are to be considered, however, are the appointment of this person; the particular circumstances; as well as any additional knowledge and skill in addition to the minimum standard required in terms of statute. The statutory statements of the duty in both Australia, in terms of s 180(1) of the Australian *Corporations Act*, and New Zealand, in terms of s 137 of the New Zealand *Companies Act*, enumerate a number of subjective factors that should be considered when assessing director conduct and may serve as valuable guidelines in this regard. For various formulations of the yardstick see Finch *supra* 203 who, apart from her own suggestion, lists those of Romer J in *In re City Equitable Fire Insurance Co Ltd supra*; Trebilcock *supra* 511; and Mackenzie "A Company Director's Obligations of Care and Skill" 1982 *Journal of Business Law* 460 475 – 476.

This question has to be addressed in the context of directors' risk-taking ability. It is critical not to lose sight of the fact that corporate growth is achieved by exposing the assets of a corporation to risks. Directors who are forced to be too careful as a result of the sword of personal liability created by a very onerous duty of care constantly hanging over their heads, will be hindered in this task. An attempt must therefore be made at balancing creditors' aversion to risk and the economic necessity of allowing directors to take risks.

This balance may be achieved by a duty of care formulated in such a way that it is clear that directors' conduct should be assessed in light of the particular circumstances under which they have to operate. In case of a company that is in a precarious financial position, cognisance should be taken of the fact that directors are taking business risks with what is in effect creditors' money. Where shareholders' equity is already extinguished, or on the point of being extinguished, directors should refrain from engaging in very high risk activities in a desperate attempt to save the company. These shareholders, who have already lost everything, clearly will be in favour of directors engaging in such desperate measures, as they have nothing to lose in case of failure, but everything to gain in case of success. Creditors have a lot to lose in case of failure, however, and nothing to gain in case of success.

It is therefore submitted that directors' ability to take business risks should be curtailed by the fact that a company is not financially sound, providing protection for the interests of creditors who would have become the beneficiaries of directors' duties upon the company experiencing financial difficulty.⁹⁹⁶ This may be achieved through the inclusion of subjective considerations in the formulation of the duty of care once again, which will obviate the need for the formulation of a separate duty of care to creditors.

6.5.3.1.2 Duty of Skill

It was suggested already that the notion that directors are not required to possess any degree of skill or particular knowledge is outdated in light of the position of the

⁹⁹⁶ See discussion *infra* Ch 7 (Point in Time When the Duty Arises) for more detail on circumstances that would "trigger" the duty to creditors.

director in the modern company.⁹⁹⁷ The fact that creditors are exposed to foolish appointments made by shareholders, was also explained.⁹⁹⁸ Continued acceptance of the idea that directors do not need any particular skills or knowledge may thus cause immeasurable harm to creditors who did not have the opportunity to protect their interests through the appointment of skillful directors.

It is therefore submitted that directors should possess at least a certain minimum level of knowledge and experience. A problematic aspect in this regard is to determine an acceptable level of skill or knowledge, especially in light of the variety of companies that may have diverse needs.

An acceptable solution may be the formulation of a duty of skill in line with section 60(1A)(c) of the *Banks Act*, in terms of which directors of banks are required to possess and maintain the knowledge and skill that may reasonably be expected of a person holding a similar appointment and carrying out similar functions as the director in question. This formulation, while laying down that a reasonable level of knowledge and experience is required, accepts that the level will differ from director to director, thus allowing for some flexibility.

6.5.3.2 Distinction Between Executive and Non-executive Directors

It is accepted in most jurisdictions that the role, position or function of a director should be taken into consideration when determining compliance with his duty of care and skill.⁹⁹⁹ To a limited extent the fact that a person is an executive or a non-executive director may be pertinent in determining liability for a breach of the duty of care and skill. It should not lead to a categorisation of duties on the basis of a person holding either the office of executive director or non-executive director.

⁹⁹⁷ See discussion *supra* par 6.3.1.2.

⁹⁹⁸ *Supra* par 6.5.3.1.1.

⁹⁹⁹ See discussion *supra* par 6.2.2 – par 6.2.6.

One is thus inclined to agree with Goldstone J in *Howard v Herrigel*¹⁰⁰⁰ that the distinction between executive and non-executive directors is not particularly helpful in demarcating directors' duties.¹⁰⁰¹ This approach is supported as it helps to remove the perception that non-executive directors will not incur liability for breaching their duty of care and skill even if they failed to act in any meaningful way whatsoever. Clinging steadfastly to a distinction between duties based on the mere fact that a director occupied the office of executive or non-executive director may well result in creditors being deprived of a remedy against inert non-executive directors.

It is thus submitted that the distinction drawn between these two categories of directors in terms of *King II* should be regarded as no more than a corporate governance guideline aimed at creating independence of opinion at board level. It should in no way be a conclusive factor in determining the liability of a particular director for breaching his or her duty of care and skill.

6.5.3.3 *Reliance on Others*

One has to agree that commercial reality dictates that directors should be able to delegate to and rely on others if a company is to function properly.¹⁰⁰² Reliance on the opinion of experts is in fact required by *King II* in some instances¹⁰⁰³ and is allowed in all the jurisdictions referred to in this study.

Directors should, however, not be able to escape liability for failure to comply with their duty of care by abdicating any of their responsibilities.¹⁰⁰⁴

¹⁰⁰⁰ *Supra* 678.

¹⁰⁰¹ According to Cilliers & Benade *Corporate Law* (2000) par 10.10 n 21 the unique position of non-executive directors should be taken into consideration when determining the extent of their potential liability for a breach of their duties. This discussion is not aimed at denying that principle. The point advanced here is simply that a strict categorisation of duties and potential liability should not take place merely on the holding of the office of executive or non-executive director.

¹⁰⁰² Comerford & Law *supra* 104.

¹⁰⁰³ See par 2.3 of Ch 4 of Section 1 in terms of which directors are required to rely on expert advice where necessary and par 2.14 of the same chapter, in terms of which directors must "if in doubt about any aspect of their duties, obtain independent professional advice at the earliest opportunity".

¹⁰⁰⁴ Baxt *supra* 150 warns against this possibility, as indicated by the title of his contribution.

The issue that needs to be addressed, therefore, is the extent to which directors are entitled to rely on the opinion of or information provided by others and on whom they should be entitled to rely.

In this regard it is submitted that director conduct in this respect should be informed by their general duty of care.¹⁰⁰⁵ Directors who rely on others have to ensure that they act with the necessary care when placing their trust in the opinion of others.

A provision similar to the rebuttable presumption provided for by section 189 of the Australian *Corporations Act* would seem unnecessary. In terms of general rules of evidence, a person who alleges misconduct carries the burden of proof in respect thereof. This entails that a person alleging unreasonable reliance has to prove this fact. It is therefore submitted that such a provision should not be incorporated in our legislation as it is strictly speaking not necessary.

It also does not seem advisable to include a closed list of persons on whom directors are entitled to rely in a statutory statement of the duty of care and skill as in Australia, New Zealand and Canada. The requirement that directors must act with the necessary care when relying on others is sufficient to ensure that directors are held liable if they delegate to or rely on incompetent persons, or blindly rely on the advice of others.

6.5.4 Consequences of Breach

6.5.4.1 Basis of Liability

¹⁰⁰⁵ Comerford and Law *supra* 118 provide a set of guidelines to assess whether directors may be held liable for relying on others. Reliance or delegation must, in the first place, be reasonable. In order to determine whether reliance or delegation was reasonable under particular circumstances, a number of factors should be considered, eg the function that has been delegated. A second crucial factor is whether directors were or should have been “put on inquiry”. A director must thirdly subjectively believe in the ability of the person to whom a function was delegated, or on whose opinion was relied. This person must fourthly objectively be capable of performing the function delegated to him. The nature of the transaction is fifthly an element that should be considered. Transactions containing a greater element of risk would be expected to be carried out by the directors themselves, or would require them to take further steps to justify reliance. In the sixth place, mere passive reliance would not exonerate a director from liability. A director would still be required to take certain steps, the extent of which would depend on the circumstances of each case. A last factor that would play a role is the position held by the director.

An action against a director for breach of his duty of care and skill is based in delict. Before a plaintiff can succeed with a claim for damages based in delict, he must prove all the elements of a delict.¹⁰⁰⁶

In order to be successful with an action based on delict, the plaintiff must prove an act or omission on the part of the directors.¹⁰⁰⁷ The particular act or omission must furthermore have caused prejudice in a wrongful manner.¹⁰⁰⁸ Wrongfulness is determined with regard to two questions, namely whether a legally recognised individual interest has been infringed and whether such prejudice occurred in a legally reprehensible or unreasonable manner.¹⁰⁰⁹ The plaintiff also has to prove that there was intent or negligence on the part of the director who committed the wrongful act or omission.¹⁰¹⁰ In order to be successful the plaintiff must also convince the court that he suffered damage,¹⁰¹¹ and that the damage was caused by the wrongful conduct of the directors.¹⁰¹²

Creditors must therefore prove all of the above elements in order to be successful with a claim for damages against directors for breach of their duty of care and skill. It should not be too difficult to prove the requirements of conduct, damage and fault. The wrongfulness of the act will depend on whether an “individual interest” has been infringed and whether prejudice occurred in a “legally reprehensible manner”.

Since it is suggested that a duty to creditors is mediated through the company,¹⁰¹³ creditors will not have to show that it was their individual interests that were

¹⁰⁰⁶ Neethling, Potgieter & Visser *supra* 4 emphasise that there is “no question of a delict and consequently, no liability” if any of these elements is missing.

¹⁰⁰⁷ Neethling, Potgieter & Visser *supra* 27.

¹⁰⁰⁸ *Id* 35.

¹⁰⁰⁹ *Ibid*.

¹⁰¹⁰ Neethling, Potgieter & Visser *supra* 119.

¹⁰¹¹ *Id* 211.

¹⁰¹² *Id* 173.

¹⁰¹³ See discussion *infra* Ch 8 (Beneficiary of the Duty) par 8.5.

prejudiced. In order to prove wrongfulness, creditors who suffered as a result of directors breaching the duty of care and skill to the company will have to prove that the company's interest, defined with reference to the interests of company creditors, has been infringed.

Secondly, creditors will have to show that the prejudice occurred in a "legally reprehensible manner". The general norm to assess whether infringement was indeed unlawful, is the *boni mores* or legal convictions of the community.¹⁰¹⁴ The application of this norm entails the *ex post facto* balancing of the interests which the defendant promoted by his act, and those which he infringed.¹⁰¹⁵ Factors which will influence the balancing process include the nature and extent of the harm; the costs and effort of steps which could have been taken to prevent the loss; the degree of probability of the success of preventative measures; the nature of the relationship between the parties; knowledge on the part of the defendant that his conduct would cause harm; economic considerations, and so forth.¹⁰¹⁶

The requirement of wrongfulness may facilitate the extension of directors' duties to creditors, because the *boni mores* involve the balancing of interests promoted by the defendant against those interests which he infringed. An instance where the balancing test may be used extremely well is, for example, in case of a director who did not comply with his duty of care to the company for failing to consider the interests of creditors, by engaging in extremely risky activities while the company was in a precarious financial position in order to benefit shareholders. The interests of the creditors should be balanced against those of the shareholders to establish whether his conduct was reasonable. The way in which the *boni mores* test is applied thus makes the delictual requirement of wrongfulness extremely suitable for extending directors'

¹⁰¹⁴ Neethling, Potgieter & Visser *supra* 37 – 38 n 17.

¹⁰¹⁵ Neethling, Potgieter & Visser 39, with reference to *Coronation Brick (Pty) Ltd v Strachan Construction Co (Pty) Ltd* 1982 4 SA 371 (D) 384.

¹⁰¹⁶ Neethling, Potgieter & Visser *supra* 40.

duties to creditors, provided that the interests of the company is defined with reference to the interests of creditors.¹⁰¹⁷

The objective factors to be considered in order to determine reasonableness, for example the cost and effort of steps to prevent the loss; the probability of these being successful; knowledge on the part of the director that his conduct would have caused harm and so forth, also fit well into the context of determining whether a director acted unreasonably towards creditors and should incur liability as a result.

In the case of a director accused of being in breach of the duty of care and skill, the requirement of causation may present a problem, however.¹⁰¹⁸ A codification of directors' duties, as suggested previously,¹⁰¹⁹ may go some way towards addressing this problem, as director liability for a breach of the duty of care and skill will be based on a statutory provision that does away with the causation requirement.¹⁰²⁰

6.5.4.2 Suitability of Remedy

Judicial reluctance to apply an objective standard of reasonable care may be seen as partially resulting from the severity of the available sanctions.¹⁰²¹ Remedies that serve as “realistic alternatives to the all-or-nothing approach of current compensatory remedies”, such as injunctive relief, may address this problem.¹⁰²²

¹⁰¹⁷ It was already suggested that the interests of the company should be defined in this way upon the duty to creditors being triggered. See discussion *supra* Ch 5 (Protection Afforded by Fiduciary Duties) par 5.5.3.1.

¹⁰¹⁸ *International Shipping Co (Pty) Ltd v Bentley* 1990 1 SA 680 (A), a case dealing with an auditor's delictual liability toward creditors of a company, provide a good exposition of the requirements of a successful delictual action and is indicative of how the requirement of causation could jeopardise the successful outcome of a case based on the *actio legis Aquiliae*.

¹⁰¹⁹ See discussion *supra* par 6.5.1.

¹⁰²⁰ Similar to the way in which s 424(1) of the South African *Companies Act* provides for personal liability of directors and others for payment of company debts, without making a causal link between director conduct and their liability a requirement. See discussion *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.2.1 for a more detailed discussion of s 424(1).

¹⁰²¹ Cohn “Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule” (1983) 62 *Texas Law Review* 591 595.

¹⁰²² *Ibid.*

South African company law does not provide for the same type of injunctive relief as that provided for by section 1324 of the Australian *Corporations Act*. This is probably because a director in breach of the duty of care and skill will incur delictual liability, and a delictual action requires damages to be proved.

A remedy similar to section 1324 of the Australian *Corporations Act* may prove valuable in that creditors may prevent directors from continuing to manage a struggling company in a negligent manner, or from taking extremely high risks in a desperate attempt to rescue the company, thus protecting their own interests. The availability of such a remedy in case of a breach of the duty of care and skill is, however, dependent on statutory intervention.

6.5.4.3 Inadequate Information

A practical problem is that directors' breaches of the duty of care and skill are often discovered when it is too late.¹⁰²³ The first clear sign that the directors have been incompetent will more often than not be the failure of the company.¹⁰²⁴ It is suggested by some that more emphasis on the principle of disclosure may go some way towards addressing this problem.¹⁰²⁵

Creditors' inability to take preventative action is not the only consequence of a lack of information. They may, in addition, find it difficult to establish that a company's failure is due to negligence by its directors after the fact. Should creditors be afforded some way of approaching the court in case of a breach of an enhanced duty of care

¹⁰²³ Trebilcock *supra* 512.

¹⁰²⁴ *Ibid.* Also see Rider *supra* 286 who makes the same observation.

¹⁰²⁵ Trebilcock *supra* 513. Bidin "Corporate Law, Directors' Duties and Creditor Protection" (1998) 19 *The Company Lawyer* 188 191 also identifies creditors' inability to acquire and utilise information from the company as a major hurdle in creditor protection. She conceded that they are entitled to ordinary information from the Registrar of Companies, but found this to be inadequate, as important information relating to possible insolvency is normally obtained at a very late stage. This will make it impossible for creditors to make an effort at taking action to prevent directorial failures or negligent behaviour.

and skill,¹⁰²⁶ protection afforded in terms of such a duty may prove to be largely illusory if creditors are not able to discharge their onus of proof.¹⁰²⁷

An important aid in addressing these concerns is the *Promotion of Access to Information Act*.¹⁰²⁸ *PAIA* was enacted for the purpose of giving effect to the constitutional right of access to information¹⁰²⁹ by providing for access to information held by the state¹⁰³⁰ or another person, where this information is required for the exercise and protection of any rights.¹⁰³¹ The right to access to information is subject to “justifiable limitation, including, but not limited to, limitations aimed at the reasonable protection of privacy, commercial confidentiality and effective, efficient and good governance”.¹⁰³²

In terms of *PAIA* a requester has a right to be given access to any record of a private body if that record is required for the exercise or protection of rights.¹⁰³³ This provision thus creates the possibility that a creditor of a company will have the right to approach the company for any information, as long as the creditor is able to prove that he requires this information for the exercise or protection of a right.

This provision was interpreted in relation to the right of a shareholder to have access to books of record of a private company in *Davis v Clutchco (Pty) Ltd*.¹⁰³⁴ In this case the respondent justified his refusal to comply with the applicant’s request on various grounds. Relevant for the purposes of this study is the fact that the respondent

¹⁰²⁶ See *infra* Ch 8 (Beneficiary of the Duty) par 8.5.3 for further discussion on this point.

¹⁰²⁷ Radin *supra* 728 admits that a plaintiff may “have an extremely difficult time obtaining evidence that would prove his allegations...”.

¹⁰²⁸ Act 2 of 2002 (hereinafter *PAIA*).

¹⁰²⁹ S 32 of the *Constitution of the Republic of South Africa* 1996.

¹⁰³⁰ S 9(a)(i).

¹⁰³¹ S 9(a)(ii).

¹⁰³² S 9(b)(i).

¹⁰³³ S 50(1).

¹⁰³⁴ 2004 1 SA 75 (C).

averred that the applicant has no “right” as a shareholder to inspect the books of record of the company, as no such right was accorded to shareholders in terms of the *Companies Act*, at common law or in the respondent’s articles of association.

The court held that a shareholder such as the applicant must be permitted to “obtain access to information in the books of account *to safeguard his investment* in the company or to ensure that he has knowledge of the value of his shares”¹⁰³⁵ and that he has established that the records requested by him are “reasonably required...*to verify his concerns about financial mismanagement and take any resultant steps and to protect his investment in the company*”.¹⁰³⁶

Although this judgment was delivered in respect of the rights of a shareholder requiring particular information, the court’s emphasis on the applicant’s constitutional right to access to information where his interests are not adequately protected in terms of company law, may justify the conclusion that creditors will be afforded the same protection. Creditors, no less than shareholders, should be entitled to safeguard their investments in the company, to verify their concerns about financial mismanagement and to take any resultant steps.

The court’s partial justification of the shareholder’s entitlement to this information on the fact that the South African *Companies Act* does not provide “an equivalent process to safeguard his *proprietary interest* in the company”¹⁰³⁷ may present a problem to creditors. In terms of traditional company law dogma, shareholders, and not creditors, are regarded as the “owners” of the company, which led to them being afforded numerous rights in respect of control of management, the institution of actions on behalf of the company, and so forth. Should this principle be accepted as correct, creditors will not be entitled to the same rights as shareholders in terms of *PAIA*.

¹⁰³⁵ *Id* 86 (own emphasis).

¹⁰³⁶ *Ibid* (own emphasis).

¹⁰³⁷ *Ibid*.

This principle was criticised from a conceptual point of view, however.¹⁰³⁸ It is furthermore asserted that creditors replace shareholders as primary corporate constituents¹⁰³⁹ where the duty to creditors is triggered.¹⁰⁴⁰ Should this viewpoint be accepted, creditors should be able to access the protection afforded in terms of *PAIA*.¹⁰⁴¹

The provision of adequate information may also go some way towards enabling creditors to establish whether particular conduct of directors led to the demise of the company and to ascertain when the duty to consider their interests was triggered. This may aid them in discharging their onus of proof.

6.5.4.4 Judicial Reluctance

A last factor that may impede a successful action against negligent directors by creditors, is the judicial reluctance to impose liability on directors who seemingly failed to act with the necessary care and skill. This reluctance may be attributed to a number of factors.

The courts firstly have some difficulty in demarcating directors' duty of care and skill. Unlike the legal principles of directors' fiduciary duties, which to a large extent can be based on existing principles derived from other fiduciary relationships,¹⁰⁴² no

¹⁰³⁸ See discussion *supra* Ch 2 (Conceptual Justification) par 2.4.2 for more detail.

¹⁰³⁹ See discussion *infra* Ch 8 (Beneficiary of the Duty) par 8.5.

¹⁰⁴⁰ See discussion *infra* Ch 7 (Point in Time When the Duty Arises) for more detail on the circumstances that may give rise to a duty to creditors.

¹⁰⁴¹ The decision of the court *a quo* was, however, subsequently reversed in March 2005 by the Supreme Court of Appeal in *Clutchco (Pty) Ltd v Davis* 2005 3 SA 486 (SCA). The Supreme Court of Appeal made reference to measures of the South African *Companies Act* and common law aimed at the protection of shareholders and came to the conclusion that “[t]he machinery established by legislation and the common law for the protection of shareholders is in my opinion not lightly to be disregarded” (*id* par 17). The court decided that the respondent failed to lay a substantial foundation for his case and thus failed to show that the access which he sought was required for the exercise or protection of the rights which he asserted (*id* par 18). It cannot be said with certainty whether creditors will succeed where a shareholder failed. It should be noted, however, that the court reached its decision in light of the plethora of measures in terms of legislation and common law aimed at the protection of shareholders. It is submitted that creditors are not afforded equal protection by the law and should therefore have a better chance with obtaining information in terms of *PAIA*. Only time will tell, however, whether this will indeed be the case.

¹⁰⁴² Eg the fiduciary relationship that comes into existence in case of a trust or agency.

principles existed that could serve as guidelines for the way in which directors' duty of care and skill should be approached.¹⁰⁴³

Reluctance also stem from the fact that directors' functions entail exposing the assets of the company to calculated economic risks, the prudence of which courts are traditionally loath to judge upon.¹⁰⁴⁴

The courts also held the belief that the appointment of directors was a matter for the shareholders, as was the level of a director's performance thereafter.¹⁰⁴⁵ The courts may even have been hampered by a sense of commercial inadequacy when pronouncing on directors' business decisions.¹⁰⁴⁶

These factors lead some to note somewhat cynically that it is certainly doubtful "whether any system which would assign a substantial role to the courts could be seriously considered" as "[n]othing in their past record in this field suggests either a capacity or a willingness to discharge such a role".¹⁰⁴⁷

¹⁰⁴³ Naude *supra* 154.

¹⁰⁴⁴ *Burland v Earle* [1902] AC 83 93. Also see Iacobucci "A Wise Decision? An Analysis of the Relationship Between Corporate Ownership Structure and Directors' and Officers' Duties" (2002) 36 *Canadian Business Law Journal* 337 347; and Iacobucci "Directors' Duties in Insolvency: Clarifying What Is at Stake" (2004) 39 *Canadian Business Law Journal* 398 403.

¹⁰⁴⁵ This sentiment dates back as far as 1812 with the court making its perceived role very clear in *Carlen v Drury* (1812) 1 V & B 154 158, namely that "[t]his Court is not to be required on every Occasion to take the Management of every Playhouse and Brewhouse in the Kingdom". It is also confirmed in *Turquand v Marshall supra* 386 that as long as directors remained within the ambit of their powers, however ridiculous and absurd their conduct might seem, it was the misfortune of the company that they had chosen such foolish directors. No mention is made of the fact that creditors also have to bear the consequences of the shareholders' appointment. See also *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd supra* 23 – 24 where the court confirmed that "[i]t is not the business of the court to manage the affairs of the company. That is for the shareholders and directors".

¹⁰⁴⁶ *Butcher supra* 37. An illustrative statement in this regard was made by Scrutton LJ in *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd supra* 23 – 24, namely that "I should be sorry to see the court go beyond this and take upon itself the management of concerns which others may understand far better than the court does".

¹⁰⁴⁷ *Trebilcock supra* 515.

Authors in other jurisdictions observed a change in judicial attitude in this regard, however.¹⁰⁴⁸ The dearth of South African cases dealing with directors' liability for a breach of the duty care and skill makes it difficult to assess whether the same can be said in respect of the local judiciary. The approach of the court in respect of directors' statutory liability for reckless trading¹⁰⁴⁹ does cast a ray of hope, however, that the courts are assuming a more active role in judging director conduct. A codification of the duty of care and skill as suggested above,¹⁰⁵⁰ providing clearer guidelines in terms of what is expected of directors, as well as guidelines provided in terms of *King II*, may further advance the courts' ability and willingness to pronounce on director conduct.

6.6 CONCLUSION

One would think that creditors stand to benefit greatly from an extension of the duty of care and skill to protect their interests. The general discussion on the duty of care and skill revealed numerous shortcomings with regard to the *content* of the duty of care and skill, as well as the *enforcement* of the duty, however, that seem to detract from the protection afforded to the interests of creditors by this duty.¹⁰⁵¹

With regard to the content of the duty, criticism is levied against the yardstick used to measure directors' compliance with this duty; the distinction between what is expected of executive and non-executive directors; and the possibility that directors may rely on others to such an extent that they evade their obligations in terms of this duty. Some suggestions were made regarding these problem areas, with the view of increasing the protection that may be afforded in terms of the duty of care and skill.

¹⁰⁴⁸ See eg Butcher *supra* 65.

¹⁰⁴⁹ In terms of s 424(1) of the South African *Companies Act*. See eg the case of *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman supra*.

¹⁰⁵⁰ *Supra* par 6.5.1.

¹⁰⁵¹ These general shortcomings would obviously also detract from the protection that is offered for the interests of shareholders in terms of the duty of care and skill.

In respect of the yardstick applicable to the duty of care, it is submitted that adherence to a subjective yardstick is outdated and not in line with developments in other jurisdictions, or even developments in other areas of South African law. It is therefore proposed that directors' conduct should be assessed in an objective manner, namely the care that may reasonably be expected of a director, in order to determine whether they acted with the necessary care in managing the affairs of the company.

It is furthermore submitted that the notion that directors need not have any particular skills, knowledge or experience is not in line with the position of the director in the modern company. The legal principles with regard to the duty of skill should thus be phrased in such a way that it is clear that directors should possess and maintain an acceptable level of skill that is necessary for them to properly fulfil their managerial duties.

Furthermore, inert non-executive directors should not be allowed to escape liability merely because they hold the office of non-executive rather than executive director. Neither should directors be able to evade their obligations or liability in respect of a duty of care and skill by pleading reliance on others. While it is accepted that directors should be able to rely on and delegate to others, it is submitted that the extent of reasonable reliance should be informed by their duty of care, in order to prevent directors from abdicating all responsibility or placing too much faith in incompetent persons.

Insofar as the *enforcement* of the duty of care and skill is concerned, a number of hurdles were identified that may impede a successful action by creditors. These include the delictual basis of liability in case of a breach of the duty; the fact that the available remedy is limited to damages; a lack of information; and judicial reluctance to pronounce on directors' business decisions.

It was submitted that a codification of the duty of care and skill may to a large extent address the majority, if not all, of the problems that were identified with regard to the content of the duty, as well as the enforcement of the duty.

With specific reference to the enforcement of the duty of care and skill, it is suggested that a statutory basis for an action will remove the problem that creditors must be able to prove all the elements of delict in order to succeed with an action against negligent directors. Alternative remedies, such as injunctive relief, may also be provided for in terms of statute. Clearer guidelines and a wider variety of remedies may also go some way towards removing some of the reluctance on the part of the judiciary to pronounce on directors' business decisions. *PAIA* may go some way towards addressing the problem of inadequate information available to creditors, provided that creditors are seen as parties who are able to make use of the protection afforded in terms of this Act.

A statutory provision that is properly phrased may, apart from addressing concerns pertaining to the enforcement of a duty of care and skill, also address the problems that were highlighted in respect of the content of this duty.

Care must be taken, however, that a statutory statement of directors' duty of care and skill is formulated in such a way that it is relevant to a variety of companies functioning with diverse directors under different circumstances. This aim may be achieved by providing for subjective factors that may be taken into consideration when applying an objective yardstick. Examples of subjective considerations are the particular appointment assumed by the director, the functions of the director, as well as the circumstances under which the director is to fulfil his managerial duties.

The inclusion of subjective factors in a codified version of directors' duty of care and skill may also play a valuable role in that the particular financial circumstances of the company will dictate the degree of risk that directors are permitted to expose corporate assets to, thus obviating the need for a separate duty of care formulated specifically with creditors' interests in mind.

It is also submitted that a statutory statement should be formulated in such a way that a clear distinction is drawn between directors' duty of care and their duty of skill, as these are clearly two very different duties with different requirements. A formulation in terms of which these duties are seen as a single concept may intermingle different requirements and confuse the issue.

Sections 60(1A)(c) and 60(1A)(d) of the *Banks Act* provide a good example of how a duty of care and a duty of skill of company directors may be formulated. A clear distinction is drawn between the duty of care and the duty of skill, objective yardsticks are provided for and the consideration of subjective factors is permitted.

It is therefore submitted that creditors should be entitled to the benefits of a duty of care and skill, be it indirectly through improved managerial competence as a result of higher standards, or directly through a suitable remedy in case of a breach of the duty, especially in light of the fact that alternative remedies are not adequate.¹⁰⁵² Should the legislature decide against the codification of the duty of care and skill, the delictual element of wrongfulness seems to be able to facilitate the extension of directors' duty of care and skill to creditors.

The benefits rendered by the duty of care and skill in its current guise are seen to be largely illusory, however, and problem areas as identified should be addressed in order to ensure that creditors gain meaningful protection for their interests in this way. It is also submitted that the opportunity of enjoying direct benefits, such a duty should become available to creditors through the inclusion of subjective elements that are to be considered in assessing director compliance with the duty of care, specifically the financial state of the company in question. The duty of care to creditors is thus not seen as a continuous duty, but one that is triggered by the company in question being in financial or economical difficulty. More detail on this particular aspect will be provided in the next chapter.¹⁰⁵³

¹⁰⁵² With specific reference to s 424(1) of the South African *Companies Act*. Reasons why this provision is deemed inadequate for the protection of creditors' interests were discussed in detail *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.2.1.6.

¹⁰⁵³ *Infra* Ch 7 (Point in Time When the Duty Arises).

CHAPTER 7

POINT IN TIME WHEN THE DUTY ARISES

SUMMARY

- 7.1 INTRODUCTION
 - 7.2 DEFINING THE TRIGGERS
 - 7.3 FACTORS INFLUENCING PREFERENCE FOR A TRIGGER
 - 7.4 PRACTICAL APPLICATION OF THE TRIGGERS
 - 7.5 CONCLUSION
-

7.1 INTRODUCTION

Directors' duty to creditors hinges on the application of some sort of "trigger". In terms of this construction of the duty, the duty to creditors is not a continuous one, but comes into operation at the occurrence of a specific event or situation related to the company in question being in financial or economic distress.¹⁰⁵⁴

Cases dealing with directors' duties to creditors indicate that the courts distinguish three broad categories of triggers in respect of the ailing company. These are the fact that the company was insolvent when the impugned transaction took place;¹⁰⁵⁵ the fact that the company in question was neither clearly solvent, nor clearly insolvent, but verging on the

¹⁰⁵⁴ The majority of cases in which directors' duties to creditors are discussed, seem to indicate that the existence of a duty to creditors is dependent on the company experiencing distress. See discussion *supra* Ch 4 (Judicial Framework) par 4.3. In a relatively small number of cases, however, eg *Ring v Sutton* (1980) 5 ACLR 546; *Jeffree v NCSC* (1989) 15 ACLR 217; *In re Day-Nite Carriers Ltd* [1975] 1 NZLR 172; *In re Avon Chambers Ltd* [1978] 2 NZLR 638, the courts went further and recognised a duty to creditors despite the fact that the company was fully solvent at the time of the impugned transaction.

¹⁰⁵⁵ See eg *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 732 – 733; *Equiticorp Finance Ltd (in liq) v BNZ* (1993) 11 ACLC 952 1017; *In re New World Alliance Pty Ltd (rec and mgr apptd)*; *Sycotex Pty Ltd v Baseler* (1994) 122 ALR 531 550; *Liquidator of West Mercia Safetywear Ltd v Dodd* 1988 PCC 212 215; *Yukong Lines Ltd of Korea v Rendsburg Investments Corporation* [1998] 2 BCLC 485 503.

brink of insolvency at the time of the impugned transaction;¹⁰⁵⁶ and that a particular course of conduct rendered the company insolvent.¹⁰⁵⁷

Providing clear guidelines regarding the event or situation that will trigger the duty is of great importance for directors and creditors alike. Directors, on the one hand, naturally wish to know to whom they owe their duties in order to prevent liability for non-compliance therewith, while creditors, on the other hand, are anxious to know whether they are entitled to remedies resulting from a breach of directors' duties.

The question that needs to be answered is therefore which of the categories mentioned above, or combination of them, will be most suitable to indicate that directors are under an obligation to consider creditors' interests.

Before an answer is given to the above question, it is first of all important to determine how each of the various categories of triggers should be construed. This discussion therefore commences with an attempt at defining the categories of triggers applied by the courts,¹⁰⁵⁸ upon which the main arguments that may influence the choice of a trigger are highlighted.¹⁰⁵⁹

¹⁰⁵⁶ This trigger was phrased in a number of ways by the courts, eg the fact that the company is near insolvency (*In re New World Alliance Pty Ltd supra* 550); that solvency is doubtful (*Nicholson v Permakraft* [1985] 1 NZLR 242 249; *In re Horsley & Weight Ltd* [1982] 3 All ER 1045 1056); that the company is operating in the vicinity of insolvency (*Credit Lyonnais Bank Netherland NV v Pathe Communications Corporation* No 12150, 1991 WL 277613 (Del Ch Dec 30, 1991), reprinted in (1992) 17 *Delaware Journal of Corporate Law* 1099 1155); that there is a real risk of insolvency (*Grove v Flavel* (1986) 43 SASR 410 421); a threat of insolvency (*Equiticorp Finance Ltd (in liq) v BNZ supra* 982); or simply that its financial position is precarious or that it is experiencing financial difficulties (*Australian Growth Resources Corporation Pty Ltd v van Reesema* (1988) 13 ACLR 261 268 – 271; *Chew v The Queen* (1991) 4 WAR 395 450; *Equitycorp Industries Group Ltd v Attorney-General* [1988] 2 NZLR 481 549).

¹⁰⁵⁷ *Peoples Department Stores (trustee of) Inc v Wise* [1998] QJ No 3571 (QSC (Bankruptcy and Insolvency Division)) par 202.

¹⁰⁵⁸ *Infra* par 7.2.

¹⁰⁵⁹ *Infra* par 7.3.

Another aspect that needs to be addressed is the *practical effect* that the advent of a trigger may have on directors' common-law duties. Some regard it as a clear indication that a switch took place from directors having to consider shareholders' interests in discharging their duties to the company, to having to consider the interests of creditors in discharging their duties to the company. Others, however, provide for the possibility of a dual duty under certain circumstances, with the effect of the trigger being that directors will be under obligation to shareholders and creditors simultaneously, and in varying degrees depending on the exact financial position of the company in question. This aspect is analysed in more detail below.¹⁰⁶⁰

7.2 DEFINING THE TRIGGERS

7.2.1 Insolvency

7.2.1.1 General

Insolvency is normally determined with reference to two possible tests, namely the inability of a company to pay its debts as they become due,¹⁰⁶¹ or the fact that a company has an excess of liabilities over assets.¹⁰⁶² It has to be established which of these two tests could best be applied to determine directors' common law liability to creditors for failing to consider their interests, or perhaps even whether both are or neither is suited for this purpose.

Event though there are no judicial guidelines in South Africa as to what is to be understood by "insolvency" specifically in the context of directors' duties to creditors, there are various sources that the South African judiciary may look to for guidelines in this regard.

¹⁰⁶⁰ See *infra* par 7.4.

¹⁰⁶¹ Also referred to as "commercial insolvency"; "cash flow insolvency"; or the "equitable insolvency test".

¹⁰⁶² Also referred to as "factual insolvency"; "balance sheet insolvency"; or the "bankruptcy test".

The first of these is the opinion of courts in other jurisdictions as to what is to be understood by “insolvency” for the purpose of establishing whether creditors can hold directors liable for failing to take their interests into consideration.

Cases dealing with the interpretation of the statutory provision concerning directors’ statutory personal liability for reckless or fraudulent trading¹⁰⁶³ may also provide helpful insights as to how the South African judiciary may view “insolvency” for purposes of determining whether directors may incur common liability for failing to consider creditors’ interests.¹⁰⁶⁴

A last possible source of guidelines with regard to the meaning of insolvency are provisions of the South African *Companies Act*, other than section 424(1), specifically aimed at the protection of creditors.¹⁰⁶⁵

7.2.1.2 Definition of Insolvency in Cases dealing with Directors’ Duties to Creditors

7.2.1.2.1 Australia

In Australian cases on the subject, the court determined insolvency with reference to the ability of a company to pay its debts as they become due.¹⁰⁶⁶ The Australian judiciary

¹⁰⁶³ S 424(1) of the *Companies Act* 61 of 1973 (hereinafter South African *Companies Act*).

¹⁰⁶⁴ In many instances where the court was involved in an interpretation of this particular provision, even though it was sometimes not directly applicable, the question regarding the solvency of the particular company played an important role and pronouncements were made as to what is to be understood by “insolvency”. There are also South African decisions concerning the interpretation of s 344(f) and s 345 of the South African *Companies Act* pertaining to the winding-up of an insolvent company. See Cilliers & Benade *Corporate Law* (2000) par 27.36 – 27.39 and authority there referred to regarding the interpretation of these provisions. This study is not concerned with an acceptable definition of insolvency for the purpose of obtaining a winding-up order, however, but solely for the purpose of determining whether directors are personally liable to creditors. In this regard the courts’ interpretation of “insolvency” for the purposes of determining s 424(1) statutory personal liability thus seems to be a more suitable guideline.

¹⁰⁶⁵ Eg statutory provisions negating the application of common law principles of capital maintenance, ie ss 85-88; 90 of the South African *Companies Act*. Seeing that these common law principles were formulated for the purpose of protecting creditors (see *Trevor v Whitworth* (1887) 12 App Cas 409 423 – 424), statutory provisions to the effect that they seldom apply contain some other form of creditor protection. See discussion *infra* par 7.2.1.4.

¹⁰⁶⁶ See eg *Sheahan v Verco* (2001) 79 SASR 109 137; *Lyford v Commonwealth Bank of Australia* (1995) 130 ALR 267 275.

also indicated that a company's balance sheet position, namely whether there is a surplus of assets over liabilities, is not decisive of solvency,¹⁰⁶⁷ thereby enforcing the perception that commercial solvency is paramount when determining whether directors owed duties to creditors under particular circumstances.¹⁰⁶⁸

7.2.1.2.2 New Zealand

The New Zealand judiciary applied two yardsticks to determine insolvency in cases dealing with directors' duties to creditors: firstly, the balance sheet test, namely whether the company's liabilities exceeded its assets and secondly, the criterion of whether the company is able to pay its debts as they become due. The courts are not unanimous, however, as to whether balance sheet solvency is decisive, or whether the two tests should be used together.¹⁰⁶⁹

7.2.1.2.3 England

The English judiciary's uncertainty as to which criteria should be used to establish insolvency became obvious from statements made in *Brady v Brady*.¹⁰⁷⁰ The court first stated that the companies in question were "solvent *and* possessed of a very comfortable

¹⁰⁶⁷ *Lyford v Commonwealth Bank of Australia supra* 276.

¹⁰⁶⁸ This is in line with the definition of insolvency for the purposes of determining whether directors are statutorily liable for insolvent trading in terms of s 588G of the Australian *Corporations Act* 2001 (hereinafter *Australian Corporations Act*). Insolvency is defined in terms of s 95A of the Australian *Corporations Act*, which provides that a company is insolvent if it is unable to pay all its debts, as and when they become due for payment. See *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.2.2.1 for further discussion of the statutory personal liability of directors for payment of company debts in Australia.

¹⁰⁶⁹ The judgment in *In re Lake Tekapo Motor Inn Ltd (in liq)* (1987) 3 NZCLC 100,156 100,166; as well as the judgments of Richardson J and of Somers J in *Nicholson v Permakraft (NZ) Ltd supra* 255 – 256 seem to show support for the viewpoint that balance sheet solvency is decisive. Support for the viewpoint that these two tests should be used in conjunction can be inferred, however, from the judgment of Cooke J in *Nicholson v Permakraft (NZ) Ltd supra* 249, which was referred to with approval in *David Neil and Co Ltd (in rec) v Neil* (1986) 3 NZCLC 99,658 99,671; and from the judgment in *Hilton International Ltd v Hilton* [1989] 1 NZLR 442 475. The New Zealand statutory insolvent trading provisions, s 135 and s 136 of the *Companies Act* 1993, do not provide any clear guidance in this respect either, as both are applicable at all times and not only when the company is insolvent. See Goddard "Directors' Liability for Trading While Insolvent: A Critical Review of the New Zealand Regime" in Ramsay *Company Directors' Liability for Insolvent Trading* (2000) 186. Statutory guidelines as to the meaning of insolvency, being unnecessary, are therefore not provided. See *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.2.2.2 for further discussion of directors' statutory liability for insolvent trading in New Zealand.

¹⁰⁷⁰ [1988] 2 All ER 617.

surplus of assets over liabilities”,¹⁰⁷¹ thereby indicating that solvency refers to something else than an excess of assets over liabilities. The most obvious possibility that suggests itself is the ability of a company to pay its debts as they become due. Later on, however, the court remarked that the “companies were solvent *and* able to pay their debts as they fell due without the aid of assets being transferred”,¹⁰⁷² creating the impression that “solvency” does not refer to the ability of a company to pay its debts as they fall due.¹⁰⁷³

7.2.1.2.4 United States of America

The Delaware court expressly addressed the question of what is to be understood by “insolvency” in *Geyer v Ingersoll Publications Co.*¹⁰⁷⁴ The court decided that a duty to creditors arises when the company is “insolvent in fact”.¹⁰⁷⁵ Insolvency in fact is defined with reference to the ability of a company to discharge its debts promptly and to the fact that the company should have an excess of assets over liabilities.¹⁰⁷⁶ The court was very

¹⁰⁷¹ *Id* 630 (own emphasis).

¹⁰⁷² *Id* 632 (own emphasis).

¹⁰⁷³ The statutory English insolvent trading provision (or wrongful trading provision, as it is termed), s 214 of the *Insolvency Act* 1986, provides that directors may incur liability if the company has gone into insolvent liquidation and it appears that the company continued trading after a point in time before the commencement of the winding-up when the director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. Insolvent liquidation for the purposes of s 214 is defined in s 214(6) with reference to the balance sheet test of insolvency, namely whether the company has an excess of liabilities over assets. See *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.2.2.3 for more detail on directors’ statutory personal liability in England. This guideline only provides a definition of insolvency for the purposes of insolvent winding-up, but does not appear especially helpful in providing a definition of insolvency for determining whether a shift in directors’ duties occurred as a result of the insolvency of the company. Cooke and Hicks “Wrongful Trading – Predicting Insolvency” 1993 *Journal of Business Law* 338 furthermore indicate that there is some difficulty in identifying the statutory point in time beyond which trading should not continue, which is the actual point in time that may prove helpful in determining whether a shift in directors’ common-law duties took place.

¹⁰⁷⁴ 621 A 2d 784 (Del Ch 1992).

¹⁰⁷⁵ *Id* 787.

¹⁰⁷⁶ *Id* 789. The term “insolvency” is not defined under the *Delaware General Corporation Law* Del Code Ann tit 8 (1991) specifically, though various definitions can be found in other legislation. The various statutory definitions of insolvency, each applicable under very specific delineated circumstances, do, however, not provide much assistance in establishing a general guideline on what is to be understood by insolvency for the purpose of determining whether a shift in directors’ duties occurred.

clear on the point that it is not the institution of formal statutory proceedings that triggers the duty.¹⁰⁷⁷

7.2.1.3 Definition of Insolvency in Context of Application of Section 424(1)

7.2.1.3.1 Commercial or Factual Insolvency?

The South African judiciary hold conflicting viewpoints on the meaning of insolvency for the purpose of determining whether directors may be held personally liable for payment of company debts in terms of this provision.¹⁰⁷⁸

In terms of the first viewpoint, solvency should not simply be defined with reference to a company's ability to discharge its current liabilities, but should be defined in terms of the balance sheet of a company, namely whether there is an excess of assets over liabilities.¹⁰⁷⁹ Acceptance of this viewpoint may create havoc as there are apparently many South African companies functioning quite successfully despite being factually insolvent, because they are primarily funded by loan capital from members.¹⁰⁸⁰

In terms of the second viewpoint notice is taken of this commercial reality, and insolvency, for the purpose of determining directors' liability for insolvent trading, is

¹⁰⁷⁷ *Id* 787.

¹⁰⁷⁸ It should be noted that none of the decisions discussed in this section specifically dealt with the question of whether directors incurred liability in terms of s 424(1). In all the cases mentioned the court had to decide whether a compromise between the company and its creditors in terms of s 311 should be sanctioned by it. The court felt that the possible liability of directors in terms of s 424(1) was a factor on which creditors should receive full information, in order to enable them to assess the merits of the proposal in terms of s 311 and alternatives thereto. The meaning of s 424(1) was thus considered in this specific context only insofar as the cases mentioned in this section are concerned.

¹⁰⁷⁹ This viewpoint was reiterated in a number of cases, all of which were decided by Stegmann J, namely *Ex parte Lebowa Development Corporation Ltd* 1989 3 SA 71 (T) 95 – 97; *Ex parte De Villiers: In re MSL Publications (Pty) Ltd (in liq)* 1990 4 SA 59 (W) 86; *Ex parte De Villiers: In re Carbon Developments (Pty) Ltd (in liq)* 1992 2 SA 95 (W) 115.

¹⁰⁸⁰ According to McLennan "Abuse of Limited Liability, Insider Debts and Subordination Agreements" 1993 *SALJ* 686 689 it is a "notorious fact" that smaller companies, mostly private companies, are financed almost exclusively by loans and that the share capital is often a purely nominal amount. This practice was denounced by Stegman J in *Ex parte Lebowa Development Corporation supra* 114, who described it as a "social evil".

defined with reference to the inability of a company to pay its debts as they become due and payable.¹⁰⁸¹

The second definition of insolvency was finally endorsed by the Supreme Court of Appeal¹⁰⁸² in *Ex parte De Villiers: In re Carbon Developments (Pty) Ltd (in liq)*,¹⁰⁸³ the court being very clear on the point that “the mere carrying on of business by directors does not constitute an implied representation to those with whom they do business that the assets of their company exceed its liabilities” and that it in fact constitutes “no more than that the company will be able to pay its debts when they fall due”.¹⁰⁸⁴

This difference of opinion may rightly be attributed to the age-old problem of conflict between theory-based legal principles and the realities of the market place.¹⁰⁸⁵ The former approach, although attractive from a moral and legal theoretical perspective, may upset accepted commercial practices.¹⁰⁸⁶ The Appellate Division’s preference for the second approach, as indicated by *Ex parte De Villiers: In re Carbon Developments (Pty) Ltd (in liq)*,¹⁰⁸⁷ is based on its acceptance of the existing commercial practice and concern for detrimental consequences that may result from interference.¹⁰⁸⁸

¹⁰⁸¹ *Ex parte Strydom: In re Central Plumbing Works (Natal) (Pty) Ltd; Ex parte Spendiff: In re Candida Footwear Manufacturers (Pty) Ltd; Ex parte Spendiff: In re Jerseytex (Pty) Ltd* 1988 1 SA 616 (D) 623; *Cooper v A & G Fashions (Pty) Ltd; Ex parte Millman* 1991 4 SA 204 (C) 207.

¹⁰⁸² Or the Appellate Division of the Supreme Court as it was known at the time of the judgment.

¹⁰⁸³ 1993 1 SA 493 (A).

¹⁰⁸⁴ *Id* 504 E. This decision was followed in other cases. See eg *Ozinsky v Lloyd* 1995 2 SA 915 (A) 919; *Lordan v Dusky Dawn Investments (Pty) Ltd (in liq)* 1998 4 SA 519 (SE) 526.

¹⁰⁸⁵ As noted by De Koker *Die Roekelose en Bedrieglike Dryf van Besigheid in die Suid-Afrikaanse Maatskappyereg* LLD UOVS (1996) 59.

¹⁰⁸⁶ De Koker *supra* 60.

¹⁰⁸⁷ *Supra*.

¹⁰⁸⁸ De Koker *supra* 60.

This does not mean, however, that the potential danger for creditors created by this practice, as identified by proponents of the former approach, is non-existent or unimportant.¹⁰⁸⁹ Some mechanism should therefore be put in place to improve protection of creditors' interests under such circumstances. Debt subordination may play a valuable role in this regard.

7.2.1.3.2 Debt Subordination

The fact that a company is funded by loan capital from insiders, resulting in its factual insolvency, should not present serious problems while it is operating successfully and is able to discharge its debts as they become due. It does, however, become problematic should the company ever be wound-up because of its inability to pay its debts. Insider-creditors will then compete with external creditors for limited funds. This situation may be prevented by insider-creditors agreeing to defer their claims under such circumstances in terms of a debt subordination agreement, also known as back ranking of debts.¹⁰⁹⁰

Subordination of insider debt may thus be seen as a way to reconcile the objectives of the two approaches mentioned above.¹⁰⁹¹ Companies will still be permitted to trade while factually insolvent because of primarily being funded by insider loans, while creditors will be protected to an extent in that external creditors will not have to compete with insider creditors for limited funds should a company that is funded in this way become insolvent.

¹⁰⁸⁹ *Ibid.*

¹⁰⁹⁰ See Fourie "Subordination of Loan Accounts" 1992 *SA Banker* 22; Hyman "'Back-ranking' or 'Subordination Agreements'" 1977 *SA Company LJ* H8 – H21; Luiz & Van der Linde "Subordination Agreements: Are They Worth the Paper They Are Written On?" 1993 *SA Merc LJ* 100; Mwenda & Tauzin "Legal Problems Associated with Debt Subordination Agreements and the *Pari Passu* Principle of Insolvency Law" 1998 *TRW* 71; Southey "More on Subordination Agreements" 1990 *Accountancy* 188; Vermaas "Subordination Agreements and the Auditor's Duty to Report a Material Irregularity" 1993 *Codicillus* 19 for more information on debt subordination agreements.

¹⁰⁹¹ *Supra* par 7.2.1.3.1.

However, South African law does not currently provide for the obligatory subordination of debt in any way. Subordination of debt will thus only occur if a specific agreement to that effect is concluded.¹⁰⁹²

It may be asked whether subordination of debt should not automatically take place in companies that are under-capitalised; and how automatic subordination would impact on insolvency as a trigger for a duty to creditors.

In the United States of America, where the doctrine of equitable subordination is formally recognised, the automatic subordination of debts in under-capitalised companies was rejected.¹⁰⁹³ Subordination of debt is thus subject to the courts' discretion in bankruptcy proceedings to order that the claims of certain creditors not be paid until all or some of the other creditors are completely paid.¹⁰⁹⁴

The fact that automatic subordination is rejected in a jurisdiction where subordination is formally recognised and applied, does make one weary of blindly suggesting that the South African legislature should provide for automatic subordination in companies that are under-capitalized. In light of the fact that creditors of under-capitalized companies are extremely vulnerable, and that arguments against automatic subordination were not all that convincing,¹⁰⁹⁵ it is submitted, however, that automatic subordination of insider

¹⁰⁹² Subordination agreements are not regulated in terms of South African law in any way either. This issue needs to be addressed. See McLennan *supra* 705 – 710 regarding proposals for reform in this regard.

¹⁰⁹³ See Clark *Corporate Law* (1986) 69 – 71 for reasons why the automatic subordination of debt in companies that are inadequately capitalized was rejected in the USA, as well as his reasons for not regarding these arguments as convincing. He concludes, however, that a conservative approach to subordination is defensible for the reason that the benefits to be expected from automatic subordination are conjectural and that automatic subordination would imperfectly implement the principles behind fraudulent conveyance law, as it may lead to inadequate correction or overcorrection of transactions that are unfair.

¹⁰⁹⁴ Ie equitable subordination rather than automatic subordination.

¹⁰⁹⁵ Clark *supra* 69 – 71.

loans in companies that are primarily funded by such loans, should be regulated statutorily if the company is wound up due to its inability to pay its debts.¹⁰⁹⁶

A second question that needs to be answered in respect of debt subordination – whether it be equitable or automatic subordination – is the extent to which insider debts should be subordinated.¹⁰⁹⁷

In this regard a distinction can be made drawn “full” or “blanket subordination”, in terms of which all insider debts are subordinated to outsider debts, or “constructive distribution”, in terms of which creditors are only compensated for the portion of loss in the value of their claims against the company proximately caused by under-capitalization.¹⁰⁹⁸ The latter may prove to be too difficult to achieve in most cases, which would mean that one is in effect forced to use blanket subordination.¹⁰⁹⁹

7.2.1.4 Definition of Insolvency in Other Statutory Measures Aimed at the Protection of Creditors

Another possibility is that the South African judiciary, if confronted with a case dealing with directors’ duties to creditors, may rely on statutory measures aimed at the protection of creditors when defining insolvency as a trigger for the duty to creditors.

The statutory protection mechanisms referred to entail that a company may not acquire its own shares;¹¹⁰⁰ provide financial assistance for the acquisition of its own shares;¹¹⁰¹ make

¹⁰⁹⁶ A potential negative consequence of statutory subordination of insider loans on insolvent winding-up is that the position of insider creditors is seen to resemble that of shareholders so closely that the distinction is disregarded for tax purposes, resulting in interest on these loans not to be deductible. One can only hope that the suggested measure for protection of creditors’ interests will not be dealt such a blow.

¹⁰⁹⁷ Clark *supra* 68 distinguishes between two possibilities, namely full or blanket subordination, or constructive distribution, in terms of which creditors are only compensated for the portion of the loss in value of their claim against the company proximately caused by under-capitalization.

¹⁰⁹⁸ *Ibid.*

¹⁰⁹⁹ *Ibid.*

¹¹⁰⁰ S 85 of the South African *Companies Act*.

payments to its members;¹¹⁰² or acquire shares in its holding company,¹¹⁰³ unless it complies with what is commonly referred to as the solvency criterion and the liquidity criterion.¹¹⁰⁴ In terms of these criteria a company is only allowed to engage in the above type of activities if there are reasonable grounds for believing that the company is, or would after the transaction be, able to pay its debts as they become due in the ordinary course of business¹¹⁰⁵ and if the consolidated assets of the company fairly valued would after the payment exceed the consolidated liabilities of the company.¹¹⁰⁶

Should the above criteria be accepted as guidelines, it may very well mean that directors will only be exempt from having to consider creditors' interests in discharging their duties to the company if the company is able to maintain both factual and commercial solvency.

7.2.1.5 Suggested Definition of Insolvency

7.2.1.5.1 Balance Sheet and/or Commercial Insolvency?

Decisions in which insolvency was recognised as a trigger for the duty revealed that the courts, even in the same jurisdiction, are not always unanimous regarding the test to be applied for determining insolvency. The Australian judiciary is the most consistent in this respect, indicating a preference for commercial insolvency. The reason for this, however, may lie in the fact that this reasoning is in line with the statutory definition of insolvency in that jurisdiction.¹¹⁰⁷ Courts in other jurisdictions were not so consistent in their preference of a particular test. The impression created by decisions in other

¹¹⁰¹ S 38(2)(d) of the South African *Companies Act*.

¹¹⁰² S 90 of the South African *Companies Act*.

¹¹⁰³ S 89 of the South African *Companies Act*.

¹¹⁰⁴ See Cilliers & Benade *supra* par 20.09.

¹¹⁰⁵ S 85(4)(a); s 90(2)(a) of the South African *Companies Act*.

¹¹⁰⁶ S 85(4)(b); s 90(2)(b) of the South African *Companies Act*.

¹¹⁰⁷ S 95A of the Australian *Corporations Act* provides that a company is insolvent if it is unable to pay all its debts, as and when they become due for payment.

jurisdictions is that both factual and commercial insolvency are deemed to put creditors' interests at risk.

In a South African context, it is submitted that either balance sheet insolvency or commercial insolvency should indicate that directors are under obligation to consider the interests of creditors in discharging their duties to the company.¹¹⁰⁸ Two reasons may be advanced for this submission.

The first is that statutory measures in South African company law specifically aimed at the protection of creditors require a company to comply with both the solvency and liquidity criterion before it may engage in particular actions. This seems to indicate that the advent of both factual and commercial insolvency is regarded as placing creditors at risk.¹¹⁰⁹

The second is that one test should not be preferred to another on the basis that it is perceived to be clearer or less problematic, as both tests for insolvency have their own particular problems.

In case of the balance sheet test for insolvency, for example, one is confronted with difficulties such as the lack of clarity regarding the appropriate method of valuing corporate assets and liabilities.¹¹¹⁰ Uncertainty also exists as to how companies that are

¹¹⁰⁸ Authors hold differing viewpoints as to which test should be applicable. Keay "The Director's Duty to Take Into Account the Interests of Company Creditors: When Is It Triggered?" (2001) 25 *Melbourne University Law Review* 315 (hereinafter *Keay Directors' Duty to Creditors: Trigger*) 324 proposes that the cash-flow test for insolvency be applied in Australia, as this definition is statutorily endorsed in terms of s 95A(1) of the Australian *Corporations Act*. For support that either test could be applicable, see Millner "What Does it Mean for Directors of Financially Troubled Corporations to Have Fiduciary Duties to Creditors?" (2000) 9 *Journal of Bankruptcy Law and Practice* 201 219, who emphasises that insolvency in both the balance sheet and equity sense (ie commercial insolvency) has the effect that creditors are at risk of non-payment; as well as Riley "Directors' Duties and the Interests of Creditors" (1989) 10 *The Company Lawyer* 87 89.

¹¹⁰⁹ S 85(4), 90 and 38(2)(d) of the South African *Companies Act*; see discussion *supra* par 7.2.1.4.

¹¹¹⁰ Rao, Sokolow & White "Fiduciary Duty a la *Lyonnais*: An Economic Perspective on Corporate Governance in a Financially Distressed Firm" (1996) 22 *The Journal of Corporation Law* 63 identify the

factually insolvent because they are primarily funded by loan capital should be treated. Apart from these difficulties, balance sheet insolvency may be difficult to establish if there was a failure to keep proper financial records.¹¹¹¹

Criticism has also been levied at the commercial insolvency test for being vague¹¹¹² and for being imprecise insofar as it is used to establish whether a company is insolvent on any particular day.¹¹¹³

7.2.1.5.2 Objective Test

Establishing the liability of directors of insolvent companies for failing to consider the interests of creditors may be complicated if *knowledge* of insolvency on the part of the directors is required. The introduction of any notion of knowledge as an absolute requirement may have the effect that “the duty may well be tantamount to useless on many occasions”.¹¹¹⁴ A possible solution is that an objective element should be introduced, namely *ought* the director to have known that the company was insolvent.¹¹¹⁵

problem that there are no clear guidelines for valuing contingent claims and illustrate how inexact determining the point of insolvency may be by way of a hypothetical scenario. Wishart “Models and Theories of Directors’ Duties to Creditors” (1991) 14 *New Zealand Universities Law Review* 323 344 draws attention to the fact that accounting information “in many ways does not yield certain results”.

¹¹¹¹ A provision similar to s 588E(4) of the Australian *Corporations Act*, in terms of which a company is presumed to be insolvent if it has failed to keep financial records (s 588E(4)(a)), or if it has failed to retain financial records for a seven year period (s 588E(4)(b)), may go some way towards addressing this problem.

¹¹¹² Milman “Test of Commercial Solvency Rejected” (1983) 4 *The Company Lawyer* 231 232; Stilson “Re-examining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors’ Duties to Creditors” (1995) 20 *Delaware Journal of Corporate Law* 1 113.

¹¹¹³ Riley *supra* 88. This point of criticism is equally applicable to balance sheet insolvency, as it is possible for companies to fluctuate from being solvent to being insolvent and back again from day to day.

¹¹¹⁴ Keay *Directors’ Duty to Creditors: Trigger* 325.

¹¹¹⁵ *Ibid.* The introduction of an objective element is also advocated by authors such as McDonnell “Geyer v Ingersoll Publications Co: Insolvency Shifts Directors’ Burden from Shareholders to Creditors” (1994) 19 *Delaware Journal of Corporate Law* 177 208; Ziegel “Directors’ Fiduciary Obligation to Creditors: A Re-examination” 334 335 in Queen’s Annual Business Law Symposium 1995 *Corporate Restructurings and Insolvencies: Issues and Perspectives* (1996); and Cohen “Directors’ Negligence Liability to Creditors: A Comparative and Critical View” *The Journal of Corporation Law* 351 391.

This approach would be in line with pronouncements made by the court in this respect¹¹¹⁶ and it may have the added advantage of encouraging directors to take time and obtain assistance to establish the financial state of affairs in their companies. This in turn may mean that they will discover the plight of the company early enough to be able to do something about it.¹¹¹⁷

7.2.1.5.3 Under-capitalized Companies and Debt Subordination

Should factual insolvency as a trigger for a duty to creditors be accepted, it is submitted that insider debts that are subordinated should be disregarded when the solvency of a company that is primarily funded by insider loans is determined. It is furthermore submitted that only those debts that are automatically subordinated, or subordinated in terms of an agreement, may be disregarded in this respect. The doctrine of equitable subordination cannot serve a similar function for disregarding debts for the purpose of establishing whether a duty to creditors is triggered, as it will only be certain at the date of the court ruling whether debts are subordinated or not.

7.2.1.5.4 Insolvency in Fact

The decision by the Delaware court in *Geyer v Ingersoll Publications Co*¹¹¹⁸ that insolvency refers to “insolvency in fact”¹¹¹⁹ and not the institution of statutory proceedings is supported.¹¹²⁰

Even though it may be argued that the institution of statutory proceedings could definitely be regarded as a “bright line of demarcation”,¹¹²¹ providing both directors and creditors

¹¹¹⁶ An objective test was introduced in *In re Horsley & Weight Ltd supra* 1056. This objective test, namely whether the directors should have known, or ought to have appreciated that their conduct would cause loss to creditors or threaten the continued existence of the company, was referred to with approval by Cooke J in *Nicholson v Permakraft (NZ) Ltd supra* 250 and in the Canadian case of *Peoples Department Stores Inc (trustee of) v Wise supra* par 192.

¹¹¹⁷ *Keay Directors’ Duty to Creditors: Trigger* 326.

¹¹¹⁸ *Supra*.

¹¹¹⁹ *Id* 787.

¹¹²⁰ This viewpoint is also supported by authors such as Ziegel “Creditors as Corporate Stakeholders: The Quiet Revolution – An Anglo-Canadian Perspective” (1993) 43 *University of Toronto Law Journal* 511 530.

with a clear indication that creditors' interests are paramount, defining "insolvency" in this way will be contrary to generally accepted views of what constitutes "insolvency".¹¹²²

Another reason for supporting this decision is related to its application in a South African context. If the definition of insolvency as the institution of statutory proceedings were accepted, directors will only be under obligation to consider the interests of creditors once formal insolvent winding-up procedures have commenced, or once a company has been placed under judicial management. In both instances directors would have been divested of control of the company and requiring them to consider the interests of creditors at that particular stage would seem rather pointless.¹¹²³

The third and final reason for supporting this conclusion is related to the protection afforded to creditors in terms of a duty owed to them. Case law showed that creditors' interests were prejudiced by actions on the part of directors that took place *before* statutory proceedings were instituted. If a managerial duty to creditors were limited to actions of directors *after* the institution of statutory proceedings, creditors would in many instances be left without the remedy envisaged in terms of such a duty. In order to provide the best possible remedy to creditors by way of a managerial duty, it is therefore necessary to recognise that this duty arises before the institution of statutory proceedings.

¹¹²¹ Barnett "Healthco and the 'Insolvency Exception': An Unnecessary Expansion of the Doctrine?" (2000) 16 *Bankruptcy Developments Journal* 441 465.

¹¹²² A point that was made in *Geyer v Ingersoll Publications Co supra* 789.

¹¹²³ In terms of s 361(1) of the South African *Companies Act* a winding-up by court results in property of the company being under control of the Master until the appointment of a provisional liquidator, effectively taking control away from the directors. S 429 of the South African *Companies Act* contains similar directives in respect of a company placed under judicial management. *Cf* the position in, eg, the USA and Canada where directors retain their positions under a supervised reorganisation under Ch 11 of the US *Bankruptcy Code* 11 USC ss 101 – 1330 (1994).

7.2.2 “Doubtful Solvency”

7.2.2.1 General

This phrase refers to the stage in a company’s existence where it is not yet clearly insolvent, but where it is approaching insolvency, or where there is likelihood that it may become insolvent.¹¹²⁴

It proved problematic to provide insolvency with an exact meaning and the case is even more so in respect of “doubtful solvency”. Even the courts were hesitant to pinpoint an exact stage prior to actual insolvency at which creditors interests should become paramount.¹¹²⁵

It is imperative, however, that some guidelines are provided regarding the meaning of this phrase if it is to be considered as a trigger for the duty to creditors.

7.2.2.2 Definitions and Guidelines Provided by Commentators

There are two possible interpretations of the trigger specifically applied in *Credit Lyonnais Bank Netherland, NV v Pathe Communications*,¹¹²⁶ namely “vicinity of insolvency”.

In terms of the first interpretation of the phrase “vicinity of insolvency”, it is not the company’s closeness to insolvency that is relevant, but rather whether, under the circumstances, the “contemplated action would *cause* insolvency, meaning that insolvency is one of the reasonably expected outcomes”.¹¹²⁷ This particular interpretation of “vicinity of insolvency” thus seems to link this category of triggers to the third, namely

¹¹²⁴ This trigger is phrased in a number of ways by the courts in the various jurisdictions. See *supra* n 3.

¹¹²⁵ In *Kinsela v Russell Kinsela Pty Ltd (in liq)* *supra* 733 Street CJ said: “I hesitate to attempt to formulate a general test of the degree of financial instability which would impose upon directors an obligation to consider the interests of creditors.”

¹¹²⁶ *Supra*.

¹¹²⁷ Schwarz “Rethinking a Corporation’s Obligations to Creditors” (1996) 17 *Cardozo Law Review* 647 672 (own emphasis).

“actions causing insolvency”. This conclusion is supported by a summary of the position, namely that directors of insolvent companies are under obligation to creditors, as well as directors “whose actions have a reasonable expectation of resulting in insolvency”.¹¹²⁸

The practical application of this interpretation thus appears to be that the directors of a company on the verge of insolvency are only regarded as being under obligation to consider the interests of creditors insofar as their conduct or actions may actually cause the eventual insolvency of the company. They will therefore escape liability for other actions infringing on creditors’ interests, as long as these actions did not actually cause the insolvency of the company.

According to the second interpretation a company is in the “vicinity of insolvency” if it is close to insolvency without being clearly insolvent.¹¹²⁹

It is submitted that the first viewpoint with regard to this category of triggers is not acceptable. Concerns in this regard may best be illustrated by way of the following hypothetical scenario:

The directors of a company are aware of the fact that the company is experiencing financial difficulties, or in the “vicinity of insolvency”, although not clearly insolvent. The company is overdue on payment of some accounts, but in general manages to keep most of its creditors satisfied. Among the many liabilities of the company is an overdraft facility with a bank, for which the directors stood surety in their personal capacities. The

¹¹²⁸ *Id* 678.

¹¹²⁹ Jelisavcic “A Safe Harbor Proposal to Define the Limits of Directors’ Fiduciary Duty to Creditors in the ‘Vicinity of Insolvency’: *Credit Lyonnais v Pathe*” (1992) 18 *Journal of Corporation Law* 145 164. Jelisavcic suggests the application of failure predictive models to aid directors in determining objectively how close a company is to solvency. An analysis of these models is provided *id* 164 – 172. In light of the fact that companies are very diverse and that the degree of risk that they are exposed to may vary to a large degree, the practical use of these models is uncertain.

directors hope to rescue the company, but realise the greater likelihood of it going into insolvent winding-up.

In order to be on the safe side, they decide to slow down payment of other debts and use all available monies to clear the overdraft with the bank. Nine months later the company is wound-up due to its inability to pay its debts. The directors congratulate themselves on their own foresight, without which they would have been personally liable for repayment of the overdraft that they managed to reduce in the meanwhile. As a result of their decision there is little left, or less than what should have been left, for the other creditors of the company.¹¹³⁰

Should the first interpretation of “vicinity of insolvency” be adopted, it would entail that the directors of the above company would not be liable to creditors, as the conduct of the directors did not actually push the company over the brink of insolvency. Their conduct simply came down to preferring their own interests under circumstances where the company was close to insolvency. The near proximity to insolvency is, however, deemed to be irrelevant.¹¹³¹

Should “doubtful solvency” simply be defined as a “reasonable expectation of insolvency”, however, the creditors in the above example would not have been left without a remedy in terms of directors’ duty to them. The reasonableness of the expectation of insolvency may furthermore be determined at the hand of failure predictive models.¹¹³²

¹¹³⁰ Traditional insolvency law remedies, ie principles pertaining to voidable dispositions, are not available under these circumstances, as was indicated *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.3.

¹¹³¹ Schwarz *supra* 672 specifically states that [i]t is not the corporation’s closeness to insolvency that is relevant”.

¹¹³² As proposed by Jelisavcic *supra* 164. Much has been written on tools that may be applied in this regard; see eg Belcher “Predicting Company Failure” (1991) 7 *Insolvency Law & Practice* 64; Hall “Predicting Financial Distress” (2002) 56 *Journal of Financial Service of Professionals* 12; and Gibbons & Grenier “Identifying the Danger Signals: The Unified Approach” (1981) 86 *Commercial Law Journal* 495.

7.2.2.3 Suggested Definition of “Doubtful Solvency”

Defining “doubtful solvency” as a “reasonable expectation” of insolvency that may result in the winding-up of the company, without any reference as to whether particular conduct in fact *caused* the eventual insolvency of the company, seems preferable. It will safeguard creditors’ interests in cases of a breach of duty of care by directors, as well as a breach of fiduciary duties.

The fact that it is defined as a *reasonable* expectation of insolvency will be indicative of an objective test. Directors’ subjective belief in the continued success of the company will thus not be relevant, insofar as this belief is not supported by surrounding circumstances.¹¹³³ Defining “doubtful solvency” with reference to the reasonable foreseeability of the eventual demise of the company will also not be a concept that is foreign to South African law.¹¹³⁴

7.2.3 “Actions Causing Insolvency”

7.2.3.1 General

The scenario envisaged by this trigger is a solvent company becoming insolvent as a result of the fact that directors did not comply with their fiduciary duties or duty to act with care and skill. The financial situation of the company before the impugned transaction, or before the directors embarked on a particular course of conduct, will thus have to be compared with the financial situation of the company after the impugned transaction, or after the effect of the course of conduct embarked upon by the directors, can be assessed. If the company was solvent prior to the transaction, business venture, or

¹¹³³ The test that is applied to determine liability for negligent misrepresentation regarding ability to repay a debt as discussed by De Koker *supra* 61 seems similar to an extent. De Koker explains that a debtor negligently misrepresents his ability to repay a debt where the debtor, at the time of conclusion of the contract, honestly believes that he will be able to repay the debt. The debtor is so unreasonably optimistic in this belief, however, that it comes down to nothing but mere hope. De Koker indicates that the debtor’s subjective belief should comprise more than mere hope and that there should be grounds for this belief.

¹¹³⁴ In terms of s 197B of the *Labour Relations Act* 66 of 1995, as amended by s 50 of the *Labour Relations Amendment Act* 12 of 2002, certain duties are placed on an employer that is “facing financial difficulties that may reasonably result in the winding-up or sequestration of the employer”.

implementation of a new policy, but insolvent thereafter,¹¹³⁵ the directors may incur liability to creditors of the company.

7.2.3.2 Suggested Formulation of “Actions Causing Insolvency”

This formulation of the trigger will therefore entail that creditors will have to prove a number of elements in order successfully to hold directors liable. These elements include the fact that the company in question is insolvent; and that the insolvency of the company resulted directly from particular conduct of the directors, namely the fact that they did not comply with their fiduciary duties, or their duty to act with care and skill.

7.3 FACTORS INFLUENCING PREFERENCE FOR A TRIGGER

7.3.1 General

A preference for a particular trigger for the duty to creditors may be determined by a number of factors such as the need for precision; the effect that a duty to creditors will have on directors’ risk-taking ability; directors’ reaction to such a duty; a possible increase in cost; and the perceived reluctance of the judiciary to pass judgment on business decisions. In the choice of a trigger one should also take into consideration whether a trigger may be reconciled with a conceptual justification for a duty to creditors.¹¹³⁶

The importance and effect of these factors must be assessed before a conclusion can be drawn as to which trigger or triggers will best serve to indicate that a shift in directors’ duties has occurred.

¹¹³⁵ It is clear that, in order to establish director liability in terms of this trigger, the precise meaning of “insolvency” is once again very important. There seems to be no apparent reason why the meaning of insolvency as proposed *supra* par 7.2.1.5 may not be applied in this instance also.

¹¹³⁶ As was discussed *supra* Ch 2 (Conceptual Justification).

7.3.2 Need for Precision

Many authors emphasise the need for precision in their choice of a trigger.¹¹³⁷ The apparent importance of certainty or precision lies in the perception that it may temper concerns regarding the effect that a duty to creditors will have on directors' risk-taking ability and so forth.

Those who base their preference on the need for precision seem to favour triggers which can be determined on the basis of the company's actual state of solvency, namely "insolvency"¹¹³⁸ and "actions causing insolvency".¹¹³⁹ These triggers are regarded as more capable of providing certainty as a trigger such as "doubtful solvency".

It is debatable, however, whether these triggers do satisfy the need for precision, as an attempt at providing a clear definition of insolvency showed that there is much uncertainty regarding the actual meaning of insolvency.¹¹⁴⁰

A further difficulty with regard to the application of triggers that are related to the company's actual state of solvency, is the fact that a company may move in and out of insolvency as its fortunes fluctuate, making it very difficult to establish whose interests directors should consider in discharging their obligations to the company.¹¹⁴¹

¹¹³⁷ See eg Barnett *supra* 449; Cohen *supra* 379; Jelisavcic *supra* 159; Keay *Directors' Duty to Creditors: Trigger* 333; Schwarz *supra* 671; Tompkins "Directors' Duties to Corporate Creditors: Delaware and the Insolvency Exception" (1993) 47 *Southern Methodist University Law Review* 165 190.

¹¹³⁸ Cohen *supra* 379 justifies support for insolvency as a trigger "in order to avoid the difficulty and ambiguity of dating insolvency vicinities"; also see Nicholson "Recent Delaware Case Law Regarding Directors' Duties to Bondholders" (1994) 19 *Delaware Journal of Corporate Law* 573 591.

¹¹³⁹ Keay *Directors' Duty to Creditors: Trigger* 334.

¹¹⁴⁰ *Supra* par 7.2.1.

¹¹⁴¹ Sealy "Directors' Wider Duties – Problems Conceptual, Practical and Procedural" (1987) 13 *Monash University Law Review* 164 179. In a response to Sealy's concern Keay *Directors' Duty to Creditors: Trigger* 324 notes that this is exactly the type of company whose affairs should be run with consideration for the creditors' interests; it is likely to collapse without warning and that this might be a good reason for having a less definite point at which the duty is triggered.

The argument that “insolvency” and “actions causing insolvency” are infinitely preferable to a trigger such as “doubtful solvency” due to the fact that they answer the need for precision, thus seems to be unfounded.

The preference for “insolvency” or “actions causing insolvency” as triggers for the duty is not only based on the perceived preciseness of these concepts, but also on the fact that “doubtful solvency” is regarded as vague, ambiguous and uncertain.

As was indicated, “doubtful solvency” is not incapable of definition.¹¹⁴² A general positive attitude to doubtful solvency as a trigger for the duty to creditors may also be gathered from comments to the effect that company law can adjust to accept the notion of a duty to take account of creditors’ interests under such circumstances¹¹⁴³ and that one would expect a reasonable director to know “doubtful solvency” when he sees it.¹¹⁴⁴ It is furthermore possible to establish the vicinity of insolvency by making use of models that were developed to predict the insolvency of the company.¹¹⁴⁵ This concept is also not foreign to South African law.¹¹⁴⁶

7.3.3 Need for Risk-taking

It is feared that the application of “doubtful solvency” as a trigger for the duty will have a very adverse effect on the risk-taking ability of directors. The concern in this regard is that directors may be held responsible for actions that they do not perceive as erroneous,

¹¹⁴² *Supra* par 7.2.2.

¹¹⁴³ Sealy *supra* 188. He qualifies this positive stance, however, by recognising that such an adjustment will be dependent on the willingness of the court to accept a more “interventionist role” and to review directors’ commercial and policy decisions.

¹¹⁴⁴ Rao, Sokolow & White *supra* 64 n 78.

¹¹⁴⁵ With reference to a model developed by Altman in a long line of articles, cited by Jelisavcic *supra* 167 n 166, who also provides a concise summary of the model. See *id* 170 – 172.

¹¹⁴⁶ See s 197B of the *Labour Relations Act supra*.

especially under circumstances where the company is operating at or on the brink of insolvency.¹¹⁴⁷

Matters are worsened by the fact that a director may not even know at what point his primary duty is for the benefit of creditors, rather than of shareholders.¹¹⁴⁸ The undesirable result that may follow is that directors “may feel constrained to make overly-conservative decisions when they are unsure whether their corporation is in the ‘vicinity of insolvency’”.¹¹⁴⁹

The same argument may be applied in respect of “actions causing insolvency” as a trigger for the duty. Since the trigger “actions causing insolvency” seems to be more suited to cases in which creditors seek to hold directors liable based on a breach of duty of care, rather than a breach of fiduciary duties,¹¹⁵⁰ an obvious point of criticism against it relates to the effect that it may have on directors’ risk-taking ability. Directors operating under the continuous threat of personal liability, should the company become insolvent, will in all probability prove to be very risk averse.

It may thus be argued that insolvency will go further in promoting directors’ risk-taking ability than any of the other categories of triggers. Acceptance thereof as a trigger for the duty will entail that directors may embark on high-risk business ventures without having to worry unduly about the interests of creditors. It is only once the company in question is clearly insolvent that directors should reconsider embarking on any further risky courses of action.

¹¹⁴⁷ Rao, Sokolow & White *supra* 66.

¹¹⁴⁸ *Ibid.*

¹¹⁴⁹ Jelisavcic *supra* 159.

¹¹⁵⁰ Although it is not inconceivable that a breach of fiduciary duties may also render the company insolvent, it seems more likely that a breach of duty of care will give rise to liability to creditors under these circumstances, as was indicated in *Peoples Department Stores Inc (trustee of) v Wise supra*, the case in which this trigger was applied.

One's outlook regarding this aspect depends to a large extent on the premium that is placed on directors' risk-taking ability. It is inevitable that some measure of risk-taking ability will be sacrificed should the protection of creditors be considered important. It is also true, however, that high risks yield high returns and that this is why directors should be free to take risks.

When directors engage in extremely risky transactions when the company is insolvent or when its solvency is in doubt, it must be kept in mind, however, that any yields will be enjoyed by shareholders, while the risk is being funded by the creditors.¹¹⁵¹ Under such circumstances it does not seem unreasonable to expect directors carefully to consider the likelihood of success of high-risk transactions.¹¹⁵²

The balance that will be struck between the need for risk-taking and adequate protection of creditors is thus not a static concept, but will in all probability fluctuate depending on factors like the current economic climate; perceptions regarding the role and functions of directors; the number of high-profile corporate collapses, and so forth.

7.3.4 Director Reaction

A concern raised in respect of the extension of directors' duties to creditors, is that persons may be unwilling to take up the post of director, or that directors may resign, or prematurely commence with winding-up of companies for fear of personal liability. One may argue that concerns in this regard may be eased to an extent if insolvency is accepted as a trigger for the duty. Insolvency poses a high threshold for directors' common-law liability to creditors and will reduce the likelihood of personal liability, compared to other proposed triggers such as a risk of insolvency.

¹¹⁵¹ This so-called wealth transfer problem or moral hazard was already discussed *supra* Ch 2 (Conceptual Justification) par 2.4.4.

¹¹⁵² Also see De Koker *supra* 196 – 197 who, in a discussion of the reckless carrying on of the business of the company in the context of s 424(1) liability, recognises the unfair exposure of creditors' interests to risk when a last desperate attempt, often unrealistically optimistic, is made at rescuing a struggling company.

This argument only holds true insofar as insolvency is easy to define and to detect, which does not seem to be the case.¹¹⁵³ Directors, being in doubt as to whether a company is solvent due to uncertainty regarding the concept “insolvency”, may still decide to resign or commence with premature liquidation rather than expose themselves to the possibility, even though it might later appear to have been a remote possibility, of personal liability.

It is furthermore submitted that concerns regarding the reaction of directors to the extension of their common law duties to creditors should not be addressed through the sacrifice of a trigger, thereby reducing protection afforded to creditors in terms of the duty. By no means should this be seen as detracting from the importance of these concerns, but simply as a submission that these concerns should be addressed in other ways.

Directors, fearing personal liability when the going gets tough, may, for example, be provided with workable alternatives to resignation or premature liquidation. A properly functioning corporate rescue mechanism may prove invaluable in this regard.¹¹⁵⁴ The availability of measures providing relief from liability where appropriate may also play an important role in ensuring that honest and diligent directors do not incur undeserved personal liability.¹¹⁵⁵

¹¹⁵³ See discussion *supra* par 7.2.1.

¹¹⁵⁴ The South African *Companies Act* (Ch XV ss 427 – 440) does provide for a formal corporate rescue mechanism, namely “judicial management”. Olver “Judicial Management – A Case for Law Reform” 1986 *THRHR* 84 85 indicates that judicial management unfortunately proved to be very ineffective in rescuing struggling companies. One therefore has to agree with numerous commentators on this topic that reform in this area is essential. See the following sources for further detail in this regard: Burdette “Some Initial Thoughts on the Development of a Modern and Effective Business Rescue Model for South Africa” 2004 *SA Merc LJ* 241; Kloppers “Judicial Management – A Corporate Rescue Mechanism in Need of Reform?” 1999 *Stell LR* 417; and Kloppers “Judicial Management Reform – Steps to Initiate a Business Rescue” 2001 *SA Merc LJ* 359.

¹¹⁵⁵ See discussion *infra* Ch 9 (Relief from Liability) for more detail on measures that may provide relief from liability.

7.3.5 Increase in Cost

It may be argued that the application of insolvency as trigger will not entail the same increase in costs, as, for example, a “real risk of insolvency” or “doubtful solvency”. Insolvency, assuming once again that the meaning thereof is clear, should be easier to establish than “doubtful solvency” and should consequently involve less investigative exercises, or at least less costly investigative exercises on the part of directors.

On the other hand, it is also possible that additional costs may not only have negative consequences. Incurring costs for the purpose of establishing an accurate picture of the financial situation of a company, even if the only incentive for doing so relates to fear of personal liability, is not necessarily a bad thing – directors who realise timeously that a company is on thin ice financially will definitely be in a better position to do something about it.¹¹⁵⁶

7.3.6 Role of the Judiciary

An objective test applies in respect of all three possible categories of triggers for the duty.¹¹⁵⁷ This will require the courts to undertake an inquiry into the state of affairs of a company and pass judgment on business decisions made by directors under those circumstances.

Expecting the judiciary to engage in an *ex post facto* review of directors’ business decisions may prove problematic, since this is an activity that the courts are ordinarily perceived loath to engage in.¹¹⁵⁸

¹¹⁵⁶ The shareholders will fund these costs. It is also in their best interest, however, that such steps be taken.

¹¹⁵⁷ In respect of insolvency – the fact that the directors knew, or *ought have known* that the company was insolvent when they embarked on a particular course of action (see *supra* par 7.2.1.5.2); in respect of “doubtful solvency” – the *reasonable prospect* that the company may eventually end up in insolvent liquidation (see *supra* par 7.2.2.3); and in respect of “actions causing insolvency” – the fact that the directors did foresee or *should have foreseen* that their actions could cause the insolvency of the company (see *supra* par 7.2.3.2).

¹¹⁵⁸ Wishart *supra* 341 notes the problem that courts are traditionally reluctant to judge directors’ commercial and policy decisions with reference to numerous English cases, eg *Burland v Earle* [1902] AC 83; *Carlen v Drury* (1812) 1 V & B 154; 35 ER 61; and *Dovey & Cory* [1901] AC 477 488.

According to some this reluctance on the part of the judiciary seems to be waning with the courts demonstrating “a readiness to review the way in which companies operate and the merits of decisions which have been made at a managerial level”.¹¹⁵⁹ This development is welcomed by various commentators.¹¹⁶⁰

At the same time a warning is issued in this respect, namely that courts, when judging business decisions made by directors, have the luxury of hindsight,¹¹⁶¹ whereas directors are required to act with foresight. To circumvent this problem the courts will be required to take into account all relevant factors existing at the time that the directors made their decisions.¹¹⁶²

¹¹⁵⁹ *Keay Directors’ Duty to Creditors: Trigger 336*, with reference to cases such as *AWA Ltd v Daniels* (1992) 7 ACSR 465 and *Knightswood Nominees Pty Ltd v Sherin Pastoral Co Ltd* (1988) 15 ACLR 151.

¹¹⁶⁰ *Butcher Directors’ Duties: A New Millennium, A New Approach?* (2000) 184 is of the opinion that this development is to be welcomed, because judges’ perceived abandonment of their “well-documented reluctance to review directors’ judgmental and policy decision-making in favour of adopting a fresh approach that will permit of interference in the internal management of companies”, will “permit of further development in this area of the law and clarify many of the unresolved issues with which we are at present left to ponder”. Sealy *supra* 180 also identifies a benefit in the taking up of a new role by the courts, in that “they would be obliged to articulate more clearly the true reasons for their rulings rather than merely invoke as shibboleths the dicta collected uncritically from earlier cases”.

¹¹⁶¹ *Keay Directors’ Duty to Creditors: Trigger 336*.

¹¹⁶² *Keay Directors’ Duty to Creditors: Trigger 336*, with reference to a number of cases dealing with directors’ duties to creditors, eg *Nicholson v Permakraft (NZ) Ltd supra*; *In re Welfab Engineers Ltd* [1990] BCLC 833; *Linton v Telnet Pty Ltd* (1999) 17 ACLC 619; *Brady v Brady supra*, indicates that the courts are already doing this. He specifically refers to a comment made by Giles JA in *Linton v Telnet Pty Ltd supra* 475, that “[w]hile the net loss for the year ended 30 June 1993 could later be seen as the beginning of its decline, peril to creditors on a group basis as at August 1992 did not leap out from the figures” (emphasis added by Keay); and the taking into account of the commercial environment at the time of making a transaction alleged to constitute a breach of the duty to creditors, even though it occurred seven years in the past, in the case of *In re Welfab Engineers Ltd supra*. The South African judiciary seems to be equally aware of this danger. See eg the acknowledgement in *Ozinsky v Lloyd* 1992 3 SA 396 (C) 414 that the court “should always be careful in adjudging conduct with the wisdom of hindsight”.

7.3.7 Reconciling Triggers with Conceptual Justification for a Duty to Creditors

7.3.7.1 General

One of the arguments that were offered to justify the extension of directors' duties to creditors on a conceptual basis is that creditors are seen as the stakeholders with the ultimate financial interests in the company when the going gets tough.¹¹⁶³

A number of questions are raised, however, if it is accepted that a duty to creditors is justifiable on the basis that they become the equitable owners of the company upon insolvency due to the fact that shareholders' interests, not being represented by any surplus of assets over liabilities, are replaced by those of creditors. The first is how "insolvency" can be defined in any other way but with reference to a company's balance sheet position. The second is how a trigger such as "doubtful solvency" may be considered acceptable in light of the above justification of the duty. It will finally be difficult to explain a trigger such as "actions causing insolvency", which, by its nature, indicates that directors are considered to be under obligation to consider creditors' interests *even while the company is solvent*.

7.3.7.2 Insolvency and "Doubtful Solvency"

In addressing the first apparent contradiction, a distinction must be drawn between the theoretical justification of principles and the practical application thereof.

Justifying the extension of directors' fiduciary duties to include creditors on the basis that an excess of assets over liabilities points to shareholders as equitable owners of the company, while the opposite will indicate that creditors' interests are paramount, may work well enough in theory.

As was indicated already, the balance sheet solvency of a company is anything but an accurate concept due to uncertainty regarding methods to evaluate assets, and so forth.¹¹⁶⁴ It furthermore represents historical financial information.

¹¹⁶³ See discussion *supra* Ch 2 (Conceptual Justification) par 2.4.2 and par 2.4.4.

Recognising the inability of a company to pay its debts as an indication of its insolvency is therefore simply an acknowledgement of the gap between theoretical definitions and the practical application thereof, and even more than an acknowledgement: an attempt to bridge this gap.¹¹⁶⁵

By way of extension, the same argument may be applied in respect of “doubtful solvency” as a trigger for the duty. Insolvency, in whichever way it is defined in theory, may prove to be very difficult to establish in practice. The creditors of a company that is struggling to meet its obligations, even though it is uncertain whether it is in fact insolvent, are therefore the stakeholders with the ultimate financial interest in the company. They should not be deprived of the protection afforded by a managerial duty to them under those circumstances, because of difficulty surrounding the practical application of theoretical principles.

In this regard it should also be borne in mind that the beneficiaries of directors’ duties should also be determined at the hand of identifying the residual risk bearers in the company.¹¹⁶⁶ One is therefore inclined to agree that

the question posed by the court is not simply whether the company is insolvent, but that *given the distribution of risk does it continue to be appropriate to regard the interests of shareholders as exclusively reflecting the corporate interest.*¹¹⁶⁷

Creditors are clearly the residual risk-bearers should it become apparent that a company’s solvency is doubtful to such an extent that there is a reasonable prospect that it may go

¹¹⁶⁴ Wishart *supra* 345 identifies this problem and states that “accounting information is being called on to draw a definite line on which liability hangs yet which in many ways does not yield certain results”.

¹¹⁶⁵ Wishart *supra* 329 refers to it as “a trade off between complexity of definition and practicality of performance”.

¹¹⁶⁶ *Supra* Ch 2 (Conceptual Justification) par 2.4.4.

¹¹⁶⁷ Grantham “The Judicial Extension of Directors’ Duties to Creditors” 1991 *Journal of Business Law* 1 15; own emphasis.

into insolvent liquidation. It is therefore in that capacity that their interests should be protected by law.

7.3.7.3 “Actions Causing Insolvency”

In order to address the issue of reconciling the trigger of “actions causing insolvency” with a conceptual justification of directors’ duties to creditors, it is firstly submitted that the application of “actions causing insolvency” as a trigger for the duty is not so much related to the company being in *financial distress*, as to it experiencing *economic distress* caused by managerial slack.¹¹⁶⁸ This may ultimately cause the insolvency of the company, resulting in loss to creditors. Creditors will therefore be entitled to hold directors liable for failing to consider their interests, if insolvency occurs under these circumstances.¹¹⁶⁹

It must also be noted that the conceptual justification of a duty to creditors does not only rest on the argument of creditors becoming residual risk-bearers and consequently having the ultimate financial interest in the company where the company is in financial distress. It was also submitted that the importance of the perceived differences between so-called “equityholders” and “debtholders” is diminishing, in light of the blurring of boundaries between these groups of financial stakeholders in the company.¹¹⁷⁰

This conceptual argument seems especially pertinent in relation to the trigger of “actions causing insolvency”, as both shareholders and creditors will suffer the consequences if a company becomes insolvent as a result of director misconduct or negligence.

¹¹⁶⁸ Triantis “Insolvency Law: Treating the Illness, Not the Symptom” in Queen’s Annual Business Law Symposium 1995 *Corporate Restructurings and Insolvencies: Issues and Perspectives* (1996) 93 provides an explanation of the difference between financial and economic distress. Financial distress relates to a financial state, whereas economic distress relates to “the efficiency of the firm’s deployment of its assets and occurs when the assets are not being used in their most valuable use or configuration”. Economic distress is furthermore seen to be caused by managerial slack which includes lapses in managerial competence or effort; empire building, etc.

¹¹⁶⁹ This argument is in line with the approach followed in cases such as *Walker v Wimborne* (1975 – 1976) 137 CLR 1, where the court recognised that creditors will always be threatened by the possibility of future insolvency, thereby indicating acceptance of a continuing obligation to creditors.

¹¹⁷⁰ See discussion *supra* Ch 2 (Conceptual Justification) par 2.4.6.

7.4 PRACTICAL APPLICATION OF THE TRIGGERS

7.4.1 Insolvency and “Doubtful Solvency”

There is some uncertainty as to the practical implications of a duty to creditors being triggered.¹¹⁷¹

In terms of the first school of thought, the advent of a trigger will result in directors no longer being under obligation to consider the interests of shareholders in discharging their duties to the company, since a shift took place with directors now having to consider the interests of creditors as primary corporate constituents over those of shareholders.¹¹⁷²

The second school of thought holds the view that a duty to creditors being triggered will result in a dual duty, with directors being liable to creditors as well as to shareholders in varying degrees.¹¹⁷³ The way in which the second group envisages the operation of the

¹¹⁷¹ See in general Keay “Directors’ Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors” (2003) 66 *Modern Law Review* 665 671 who poses a series of questions in this regard, namely:

[A]re creditor interests to be regarded as one set of interests amongst others that are to be considered by directors? What importance should be attached to creditor interests? Are creditor interests to be considered to the exclusion of member interests when the duty applies?

Also see Miller “Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations” (1993) 23 *Seton Hall Law Review* 1467 1482; and Stilson *supra* 5 who recognises that “case law fails to address whether the duty to creditors gains ascendancy over, or operates as a complement to, traditionalist directorial obligations to stockholders”.

¹¹⁷² Dabner *supra* 114 states that upon insolvency “the rights of shareholders give way to those of creditors”. Also see McDonnell *supra* 185 who is quite clear on the point that the “directors of the corporation which becomes insolvent or in a failing condition no longer represent stockholders, but...become trustees, or quasi-trustees, of the corporation’s assets for the benefit of its creditors”; and Van der Weide “Against Fiduciary Duties to Corporate Stakeholders” (1996) 21 *Delaware Journal of Corporate Law* 27 61 who states that “creditors ought to be the sole beneficiaries of management’s fiduciary duty when a corporation becomes insolvent” seeing that a “bilateral fiduciary shield would entail prohibitively high costs of collective decision making, and managers should never be made trustees for the entire community of interests in a corporation”.

¹¹⁷³ Schulte “Enforcing Wrongful Trading as a Standard of Conduct for Directors and a Remedy for Creditors: The Special Case of Corporate Insolvency” (1999) 20 *The Company Lawyer* 80 85; Schwarz *supra* 666. Millner *supra* 217 also argues in favour of a dual duty upon insolvency. His concern seems to be with arguments that directors’ duties upon insolvency should consist only of arranging an orderly sale or

trigger is therefore closely linked to the exact degree of financial difficulty, entailing that the “greater the insolvency, the more those obligations would shift from shareholders to creditors, in a continuum”.¹¹⁷⁴ In terms of a dual obligation to creditors and shareholders, directors will have a duty to shareholders and creditors simultaneously in varying degrees, depending on the exact financial position of the company in question, and they will therefore be required to balance the rights of creditors and shareholders.

It is conceded by proponents of the second viewpoint that balancing the rights of creditors and shareholders is like “balancing ‘apples and oranges’”, as they are not “comparable commodities”.¹¹⁷⁵ A proposed solution to the above problem of having to balance non-comparable interests is that directors, in applying the balancing test, should have latitude to make their own good faith weighing of benefit and harm.¹¹⁷⁶

Another point of criticism against the way in which these commentators view the application of a trigger, is that directors will be required to determine the exact degree of financial distress of a company that is not clearly solvent with some accuracy in order to establish the extent to which they are under obligation to balance the interests of creditors and shareholders. As was indicated already, determining actual insolvency may prove to

liquidation for the benefit of creditors. He envisaged these arguments to be “weakened or defeated” by acceptance of the duty as a dual duty, entailing that shareholders’ interests do not become totally obsolete upon insolvency. A similar dual duty seems to be envisaged by the Canadian judiciary in one of the first cases in which the interests of creditors were recognised upon the company experiencing financial difficulty, namely *In re Trizec Corporation* [1994] 10 WWR 127 (Alta QB). In this case the court stated that

[a] specific duty to shareholders *becomes intermingled* with a duty to creditors when the ability of a company to pay its debts becomes questionable (*id* 139; own emphasis).

¹¹⁷⁴ Schwarz *supra* 672 n 114; see also Schulte *supra* 85 who is of the opinion that, upon questionable insolvency, a director must “transfer a degree of allegiance to the interests of the creditors”, with a further modification taking place upon “imminent insolvency”.

¹¹⁷⁵ Schwarz *supra* 675.

¹¹⁷⁶ *Ibid.*

be very problematic. Proving a specific degree of financial distress may prove to be even more so.

It furthermore raises questions with regard to the enforcement of the duty and the ratification of a breach of the duty. A model in terms of which a trigger results in directors having a duty to both shareholders and creditors in varying degrees, depending on the financial situation of the company, does not provide a clear indication as to who will be able to institute action against directors in case of a breach of the duty. It also fails to indicate whether the general meeting of shareholders will be able to ratify a breach of directors' duties.

Defining the duty as a fluctuating one, on the other hand, will provide a clear indication as to whether the general meeting of shareholders is entitled to ratify a breach of duties. As soon as the duty is triggered, a "shift" occurs resulting in creditors becoming the primary corporate constituents. An important consequence of this will be that the general meeting of shareholders will no longer be in a position to ratify a breach of directors' duties. It will also indicate that creditors should in some way be able to enforce directors' duties.¹¹⁷⁷

Shareholders and creditors will furthermore be provided with more certainty as to whose interests should have been considered by the directors – before the "shift" occurred the interests of shareholders should take precedence, while those of creditors become paramount after occurrence of the "shift". This may go a long way towards limiting directors' exposure to actions by dissatisfied corporate constituents.

Establishing clear boundaries for the duty may also aid directors in limiting possible liability for a breach of the duty. By viewing the duty as a fluctuating one, directors will at least be in a position to know when they are obligated, and to which corporate constituent, making it possible for them to comply with their duties and thus prevent

¹¹⁷⁷ See discussion *infra* Ch 8 (Beneficiary of the Duty) par 8.5 for more detail regarding the enforcement of a duty to creditors.

personal liability.¹¹⁷⁸ This point is especially pertinent in the context of the degree of risk to which the directors are permitted to expose the assets of the company.

The undesirable effect of a fragmentation of duties will also be prevented by the fact that directors are not under obligation to all corporate constituents at all times.¹¹⁷⁹

7.4.2 “Actions Causing Insolvency”

The meaning of “actions causing insolvency”, as discussed above,¹¹⁸⁰ indicates that the way in which this trigger operates is completely different from the other triggers previously discussed, in that the financial position of the company *at the time of* the impugned action or course of conduct is totally irrelevant. Directors may be held liable to creditors despite the fact that the company concerned was solvent when they failed to comply with their common-law duties, if it later appears that the company became insolvent as a direct result of the breach of duties.

Application of “actions causing insolvency” as a trigger for the duty therefore does not provide a “bright line of demarcation”, the crossing of which will result in directors having to consider the interests of creditors rather than those of shareholders in discharging their duties to the company.

The question that immediately presents itself, is how directors will be able to comply with their duties if they do not know at a particular stage whether these duties are regarded as for the benefit of the creditors or that of the shareholders of the company.

¹¹⁷⁸ Daniels “Must Boards Go Overboard? An Economic Analysis of the effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance” (1994 – 95) 24 *Canadian Business Law Journal* 229 256 emphasises the importance of “crystallized, rather than fuzzy, standards”. Even though this statement and subsequent arguments were made in the context of statutorily imposed liability, it rings equally true in respect of common law liability.

¹¹⁷⁹ This aspect was already fully expounded upon. See discussion *supra* Ch 2 (Conceptual Justification) par 2.5.2.

¹¹⁸⁰ *Supra* par 7.2.3.

In this regard it is submitted that the *content* of directors' duties will not have changed, as the company was solvent at the time when the alleged breach of duties occurred. Directors will thus be required to comply with their normal fiduciary duties and duty of care and skill to the company and will not be confronted with a situation where they are informed after the fact that they should have acted for the benefit of creditors and should have adapted their conduct in compliance with their common law duties accordingly.¹¹⁸¹

Insolvency is still regarded as an important point in time - not for the purpose of determining whether directors are under obligation to creditors, but for the purpose of determining whether creditors may institute action against directors for having failed to comply with their duties and for the purpose of determining whether particular conduct by directors was capable of being ratified by the shareholders in general meeting. While the company is solvent, creditors are powerless to enforce this duty. As soon as the company becomes insolvent due to directors' actions or decisions, however, creditors are in a position to hold directors liable for failing to comply with their common-law duties.

Directors of solvent companies will thus not be exposed to a multiplicity of actions and will not have to adapt their conduct in compliance with their duties in any way.

“Actions causing insolvency” is therefore not so much a trigger for identifying the beneficiary of the duty for the purposes of establishing the content of the duty, as it is a trigger for identifying the proper person to institute action against directors, based on their failure to comply with their duties.¹¹⁸² A further important consequence is that

¹¹⁸¹ It was submitted already that the content of directors' fiduciary duties remain the same, whether owed to shareholders or to creditors. See *supra* Ch 5 (Protection Afforded by Fiduciary Duties) par 5.5.3.1. The content of the duty of care and skill will furthermore only undergo a change upon the company being insolvent or where solvency is doubtful, as it is suggested that the degree of risk that directors are permitted to expose the company to will vary depending on the company's financial state of affairs.

¹¹⁸² One may thus argue that the concept of fluctuation between different stakeholders is still present in a sense. While the company is solvent, shareholders have the power to enforce directors' duties or to ratify a breach thereof. Once the company becomes insolvent, however, they lose their position of power, as it now becomes the turn of the creditors to institute action against the directors for failing to comply with their duties. The fact that this failure occurred while the company was still solvent is irrelevant.

director conduct causing the insolvency of the company will not be susceptible to ratification by the shareholders in general meeting.¹¹⁸³

7.4.3 Summary

7.4.3.1 Insolvency or “Doubtful Solvency” as Triggers

If a company is insolvent, a duty to creditors is triggered. This means that the creditors now comprise the group that stands to benefit from proper compliance with fiduciary duties. This shift from shareholders to creditors as the constituent to be protected in terms of *fiduciary duties* does not, however, indicate a change in the *content* of directors’ fiduciary duties.¹¹⁸⁴ The practical effect of the trigger is thus simply seen as an indication that creditors are now in a position to enforce these duties and that shareholders are precluded from ratifying a breach of these duties.¹¹⁸⁵

A practical problem in respect of insolvency as trigger, however, is the possibility that a company may not necessarily be clearly insolvent, but moving in and out of insolvency. In this respect it is submitted that it should be established whether such a company is “doubtfully solvent”, in other words whether there is a reasonable expectation of insolvency that may result in the company being wound up. Should that be the case, the duty to creditors is triggered.

This will ensure that creditors are not deprived of protection in terms of directors’ duties,¹¹⁸⁶ and also addresses the problem of directors being under obligation to shareholders one day and creditors the next – since the duty to creditors was triggered by the company being “doubtfully solvent”, a shift took place and directors’ duties will be to the creditors.

¹¹⁸³ A point that was clearly enunciated in *Peoples Department Stores Inc (trustee of) v Wise supra* par 193.

¹¹⁸⁴ *Supra* Ch 5 (Protection Afforded by Fiduciary Duties) par 5.5.3.1.

¹¹⁸⁵ See discussion *infra* Ch 8 (Beneficiary of the Duty) par 8.5 for more information on how creditors may enforce a duty owed to them, as well as information on how a breach of the duty should be ratified.

¹¹⁸⁶ *Key Directors’ Duty to Creditors: Trigger* 324 indicates that this is exactly the type of company whose creditors are in need of protection, as it is likely to collapse without warning.

A shift from shareholders to creditors as primary beneficiaries of directors' *duty of care and skill*, however, apart from indicating that creditors may now enforce this duty and that shareholders are powerless to ratify a breach thereof, will signal a change in the content of this particular duty insofar as directors' risk-taking ability is concerned.¹¹⁸⁷

7.4.3.2 “Actions Causing Insolvency” as Trigger

A duty to creditors triggered by “actions causing insolvency” may raise the issue as to how directors will be able to comply with the duty if they only become aware of the existence thereof upon insolvency. In respect of both fiduciary duties and the duty of care and skill it is submitted that the content of the duties will not have undergone a change. It is therefore not relevant that directors did not know whether the duty to the company is to be exercised for the benefit of shareholders or of creditors.

The importance of the trigger lies therein that directors who caused the insolvency of the company through a breach of their common law duties will be liable to creditors for having done so. Therefore, any ratification of the breach by shareholders will have no effect.

In this regard it is important to emphasise that this trigger is not envisaged as placing directors under a continuous obligation to ensure that the company remains solvent. It is only under circumstances where the company becomes insolvent *as a result of a breach of fiduciary duties or the duty of care and skill*, that directors will be liable to creditors. The purpose of the trigger is also not to prevent shareholders from ever ratifying a breach of directors' duties. They will only be deprived of this right in cases where the breach of duties actually caused the insolvency of the company.

7.5 CONCLUSION

Reference was made to the fact that many commentators prefer triggers such as insolvency and actions “causing insolvency” as triggers for the duty to creditors, based on

¹¹⁸⁷ As discussed *supra* par 7.3.3.

the argument that they are more certain and precise than a concept such as “doubtful solvency”. It was shown that it is a misconception that insolvency is capable of being defined and detected with absolute certainty and that “doubtful solvency” is incapable of definition.¹¹⁸⁸ The argument that insolvency or “actions causing insolvency” should be applied as triggers for the duty, while rejecting “doubtful solvency”, can therefore not be sustained on the sole basis of certainty or precision.

The fact that it is argued that none of the triggers should be preferred over another based on its so-called preciseness, as none appears to be absolutely certain, does not, however, mean that the need for precision is unimportant. Insofar as it is possible, the various categories of triggers should be defined as accurately as possible, thereby increasing certainty and precision.

It was submitted that “insolvency”, for the purpose of determining whether directors are under obligation to consider the interests of creditors, should be defined with reference to either balance sheet insolvency or commercial insolvency. Apart from being consistent with relevant statutory guidelines, this submission can be justified on the basis that both factual and commercial insolvency place creditors’ interests at risk.

With regard to factual solvency, it was furthermore submitted that directors of companies that are technically insolvent for being primarily funded by insider loans, should not be under any obligation to creditors, as long as the company is factually insolvent by reason only of the fact that it is primarily funded by insider loans, and, furthermore, that these insider loans are subordinated to external debt.¹¹⁸⁹

¹¹⁸⁸ See discussion *supra* par 7.2.

¹¹⁸⁹ See discussion *supra* par 7.2.1.5.3.

“Doubtful solvency” is defined with reference to a company which is experiencing financial distress to such an extent that there is a reasonable expectation that the company will end up in insolvent liquidation.

It therefore seems that all three categories of triggers are capable of being defined, providing some certainty as to when directors’ duties to creditors will arise.

Whether this will allay concerns pertaining to the adverse effect that some triggers may have on directors’ risk-taking ability, their reaction to a duty to creditors and an increase in cost, remains an open question.

In this regard it is submitted that the choice of a trigger should not be dominated by concerns pertaining to these issues. Sacrificing a trigger for the duty in an attempt to address concerns pertaining to director reaction, directors’ risk-taking ability and the incurring of additional costs will definitely decrease the protection afforded to creditors. It was also shown that this is not necessarily the best possible way to address these concerns. Add to that the fact that these so-called concerns may actually have desirable results, dispelling the notion that they are exclusively negative concepts, and it becomes clear that the rejection of any of the triggers based on fear of their impact on director reaction, directors’ risk-taking ability and a possible increase in cost, cannot be supported.¹¹⁹⁰

Another factor which may cause concern, is that it was suggested that the triggers of insolvency and “doubtful solvency” should contain an objective element in addition to knowledge, namely whether directors *should have known* that the company is insolvent, or that there is a reasonable prospect of it ending in insolvent liquidation. This will admittedly force the courts to engage in an *ex post facto* review of directors’ business

¹¹⁹⁰ See discussion *supra* par 7.3.

decisions – a result that some regard as problematic based on the perception that the courts are traditionally reluctant to do so.

Statutory insolvent trading provisions in some jurisdictions contain objective elements such as those discussed in this chapter. The courts are required to interpret these and did so without hesitation in some instances.¹¹⁹¹ Indications that the courts are assuming a more active role in this regard, venturing to comment on business decisions and economic factors, were also provided in the context of the cases dealing with directors' duties to creditors.¹¹⁹²

Only time will tell whether the South African judiciary will follow suit in respect of a directorial duty to creditors, and abandon the traditional reluctance with which it is supposed to approach a review of business decisions. Deciding in advance against certain triggers, or elements thereof, based on the assumption that the judiciary will be unwilling to pass judgment on business decisions, will, however, be rather premature at this stage.

As far as the practical effect of the advent of a trigger on directors' duties is concerned, a fluctuating duty, rather than a dual duty, is supported insofar as insolvency and "doubtful solvency" are concerned.

There is admittedly some appeal in the idea of linking the extent to which directors should be under obligation to consider the interests of creditors to the exact degree of financial distress experienced by the company. As was indicated already, however, creating this link by providing for a dual duty, with directors under obligation to consider the interests of both creditors and shareholders, may cause numerous practical problems and may expose directors to a multiplicity of actions.

¹¹⁹¹ See *supra* Ch 3 (Evaluation of Alternative Remedies) for more detail.

¹¹⁹² See discussion *supra* par 7.3.6.

It is submitted that this link should rather be created in terms of the *content* of the duty to creditors. This entails that the higher the financial distress, the lower the risk to which directors may expose creditors' money.¹¹⁹³

In respect of “actions causing insolvency” directors will simply be required to comply with their normal fiduciary duties and duty of care and skill. Practical problems such as determining whether creditors have *locus standi* to proceed with an action against directors, or determining whether the general meeting of shareholders may ratify a breach of the duty, are resolved in that creditors only become entitled to a remedy in terms of directors' duties once the company is insolvent. In this way directors will once again be protected against the undesirable effect of a multiplicity of actions by dissatisfied corporate constituents.

It thus appears that all three categories of triggers may be applied successfully in determining whether directors are under an obligation to consider the interests of creditors.

The conclusion may therefore be drawn that insolvency, “doubtful solvency” and “actions causing insolvency” should be accepted as triggers for the duty. This will greatly enhance the protection afforded to creditors in respect of a directorial duty. It may furthermore be justified from a practical perspective as well as on a conceptual basis.

Accepting that creditors are vulnerable and entitled to protection if a duty to them is triggered, as suggested, is one thing. In order for a duty to creditors to function effectively it is also imperative, however, to clarify how creditors may reap the benefits in terms of such a duty. A further issue that needs to be clarified is therefore the model of

¹¹⁹³ This seems to be in line with comments made in *Kinsela v Russell Kinsela Pty Ltd (in liq) supra* 733, namely that “the plainer it is that it is the creditor's money that is at risk, the lower may be the risk to which the directors...can justifiably expose the company”. *Keay Directors' Duty to Creditors: Trigger* 332 holds the same viewpoint.

the duty to creditors that should be followed in order to facilitate enforcement of directors' duties by creditors. This aspect is addressed in the next chapter.¹¹⁹⁴

¹¹⁹⁴ See *infra* Ch 8 (Beneficiary of the Duty).

CHAPTER 8

BENEFICIARY OF THE DUTY

SUMMARY

- 8.1 INTRODUCTION
 - 8.2 ORTHODOX VIEW
 - 8.3 JUDICIAL METHODS FOR EXTENDING DIRECTORS' DUTIES TO CREDITORS
 - 8.4 EVALUATION OF JUDICIAL METHODS
 - 8.5 SUGGESTED METHOD
 - 8.6 CONCLUSION
-

8.1 INTRODUCTION

Directors' legal obligation to consider the interests of creditors is often referred to in the generally accepted shorthand way of "directors' duties to creditors".¹¹⁹⁵ An analysis of case law dealing with directors' duties to creditors indicated, however, that the mere recognition of the fact that directors should consider the interests of creditors does not mean that they owe a direct duty to creditors.

Pronouncements by the courts indicate that different models are envisaged to effect the extension of directors' duties to creditors.¹¹⁹⁶ In some instances the court phrased or construed a directorial duty to creditors in a way that indicated a willingness to recognise a direct duty to creditors.¹¹⁹⁷ In others, however, the obligation to creditors is construed in an indirect way, with the court merely requiring directors to consider

¹¹⁹⁵ Keay "The Directors' Duty to Take into Account Creditors' Interests: When Is It Triggered?" (2001) 25 *Melbourne University Law Review* 315 317.

¹¹⁹⁶ See discussion *supra* Ch 4 (Judicial Framework) par 4.4.

¹¹⁹⁷ See eg *Winkworth v Edward Baron Development Co Ltd* [1987] 1 All ER 114 118; *Canbook Distribution Corporation v Borins* (1999) 45 OR (3d) 565 (Ont SCJ) par 18; *Lakehead Newsprint (1990) Ltd v 893499 Ontario Ltd* [2001] OJ No 1 (Ont SCJ) par 33; *Geyer v Ingersoll Publications Co* 621 A 2d 784 (Del Ch 1992).

the interests of creditors in discharging their duties to the company, who remains the primary beneficiary of directors' duties.¹¹⁹⁸

The question that needs answering is which of these methods applied by the judiciary will best serve to extend directors' duties to include creditors' interests. The answer to this question is critical for determining the creditors' standing to bring action against delinquent directors and for establishing which remedies are available to them.¹¹⁹⁹

Despite the fact that an overwhelming majority of cases on this topic seem to favour the indirect duty method¹²⁰⁰ and even though it is supported by numerous commentators,¹²⁰¹ the choice is not an obvious one, since both possibilities are beset with their own uncertainties.

Deciding which method is most suitable for extending directors' duties to creditors furthermore only provides partial clarity regarding the proper beneficiary of the directors' duties to creditors. Many authors have noted that creditors are not a homogenous group and that any particular company may have a great variety of

¹¹⁹⁸ See eg *In re New World Alliance Pty Ltd (rec and mgr apptd)*; *Sycotex Pty Ltd v Baseler* (1994) 122 ALR 531 550; *Lyford v CTH Bank* (1995) 130 ALR 267 283; *Spies v The Queen* (2000) 173 ALR 529 par 95; *Sheahan v Verco* (2001) 79 SASR 109 132; *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242 249; *Lonrho v Shell Petroleum Co Ltd* [1980] 1 WLR 627 634; *In re Horsley & Weight Ltd* [1982] 3 All ER 1045 1055; *Peoples Department Stores Inc (trustee of) v Wise* [1998] QJ No 3571 (QSC (Bankruptcy and Insolvency Division) par 200.

¹¹⁹⁹ Trethowan "Directors' Personal Liability to Creditors for Company Debts" (1992) 20 *Australian Business Law Review* 41 53.

¹²⁰⁰ See cases listed *supra* n 4.

¹²⁰¹ Grantham "The Judicial Extension of Directors' Duties to Creditors" 1991 *Journal of Business Law* 1 13 justifies his preference for this method on the basis that it is favoured by the majority of cases and because, unlike the direct duty method, this method "may suggest solutions to its problems". Beveridge "Does a Corporation's Board of Directors Owe a Fiduciary Duty to Its Creditors?" (1994) 25 *St Mary's Law Journal* 589 619 are of the opinion that the purpose of the trust fund doctrine, applied to protect the interests of creditors, is not to allow "direct actions by contract creditors against directors or to create direct fiduciary duties running to creditors"; Riley "Directors' Duties and the Interests of Creditors" (1989) 10 *Company Lawyer* 87 92 admits that "attractive as the contrary may appear to the unsecured creditor, it appears that the duty to consider creditors is owed to the company alone, and desirable that it should be so"; also see Trethowan *supra* 54.

creditors.¹²⁰² The problem that flows from this fact is that the interests of various categories of creditors may be dissimilar, and even in conflict. Directors, in considering the interests of one category of creditors, may very well expose themselves to legal action by another group of creditors.¹²⁰³

It is imperative to determine a model for a directorial duty of creditors and to identify the various categories of creditors who may be entitled to the protection afforded by a directorial duty, as well as to establish the extent of the protection to which they are entitled. Without clarity in this regard it is impossible to provide a fully functional framework for directors' duties to creditors – directors will be left in the dark as to precisely whose interests should be considered, while creditors will have no indication as to who will be entitled to the benefits from a directorial duty to creditors, or who will be able to enforce such a duty.

In order to address the issue of the proper recipient of directors' duties, some background must firstly be provided on the orthodox viewpoint concerning the beneficiary of directors' fiduciary duties and duty of care and skill. Some commentators are also of the opinion that the duty to creditors should be modelled as closely as possible on traditional directorial duties.¹²⁰⁴ In order to succeed with this

¹²⁰² Riley *supra* 90; Sealy "Directors' 'Wider' Responsibilities – Problems Conceptual, Practical and Procedural" (1987) 13 *Monash University Law Review* 164 178 (hereinafter Sealy *Directors' "Wider" Responsibilities*); Van der Weide "Against Fiduciary Duties to Corporate Stakeholders" (1996) 21 *Delaware Journal of Corporate Law* 27 60; Wishart "Models and Theories of Directors' Duties to Creditors" (1991) 14 *New Zealand Universities Law Review* 323 329.

¹²⁰³ An analysis of the cases in which directors' duties to creditors were discussed indicated that the courts grappled with the question as to whether the interests of current, as well as prospective or future creditors, should be encompassed in a directorial duty to creditors. See discussion *supra* Ch 4 (Judicial Framework) par 4.5. This is only one of many possible variances on this particular theme, however. One may also set secured creditors *versus* unsecured creditors; voluntary creditors *versus* involuntary creditors; financial creditors *versus* trade creditors; and holders of debt equity *versus* other creditors. For more information on the various classes of corporate creditors, see Nicholls "Liability of Corporate Officers and Directors to Third Parties" (2001) 35 *The Canadian Business Law Journal* 1 23 – 30; Schwarz "Rethinking a Corporation's Obligations to Creditors" (1996) 17 *Cardozo Law Review* 647 659 – 665.

¹²⁰⁴ Shaffer "Corporate Fiduciary – Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About" (2000) 8 *American Bankruptcy Institute Law Review* 479 481.

replication one should obviously have a clear idea of what traditional directorial duties entail.

For these reasons a brief overview of traditional principles, focussing specifically on the beneficiary of directors' common law duties, is provided.¹²⁰⁵

This is followed by a discussion of the various methods used by the judiciary to facilitate the extension of directors' duties to creditors.¹²⁰⁶ An analysis of the perceived advantages and disadvantages of the methods used by the judiciary is subsequently provided,¹²⁰⁷ and finally a method for the extension of directors' duties to creditors is suggested.¹²⁰⁸

8.2 ORTHODOX VIEW

8.2.1 Interest of the Company

The orthodox view of directors' common law duties is that directors owe their common law fiduciary duties and the duty of care and skill to the company.¹²⁰⁹ This means that directors, when required to act in the best interest of "the company", are

¹²⁰⁵ *Infra* par 8.2.

¹²⁰⁶ *Infra* par 8.3. In this discussion an outline is provided of the basic elements of each of the methods as they appear from the cases. Questions that are left unanswered and problem areas will be discussed in the following paragraph.

¹²⁰⁷ *Infra* par 8.4.

¹²⁰⁸ *Infra* par 8.5.

¹²⁰⁹ In *In re Smith & Fawcett* [1942] Ch 304 306 the court clearly stated that directors should act "*bona fide* in what they consider...is in the interest of *the company* (own emphasis). See also Cilliers & Benade *Corporate Law* (2000) par 10.09; Farrar & Hannigan *Farrar's Company Law* (1998) (hereinafter Farrar) 378; 380; and Pennington *Pennington's Company Law* (2001) 709 who is also very clear on the point that directors' common law duties "are owed *exclusively to the company* of which the defendant is a director" and that this fact does not "impose parallel duties on a director toward the company's members or creditors" (own emphasis).

under no obligation to act in the best interests of individual shareholders¹²¹⁰ or creditors.¹²¹¹

This well-known principle was reaffirmed in *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd*,¹²¹² the court leaving no room for doubt that

directors indeed stand in a fiduciary relationship to the company, as they are appointed to manage the affairs of the company and they owe fiduciary duties to the company though not to the creditors, present or future, or to individual shareholders.¹²¹³

Treating a metaphysical entity as the beneficiary of directors' duties may naturally present certain problems.¹²¹⁴ The statement that directors should act in the best interests of the company immediately raises the question as to what should be considered as the best interests of the company.

For many years it was generally accepted that the “company as a whole” refers to the body of shareholders,¹²¹⁵ which meant that directors, when required to act in the best interests of the company, actually had to consider the best interests of the shareholders of the company. In terms of this viewpoint the company is equated with its collective

¹²¹⁰ *Percival v Wright* [1902] 2 Ch 421. The judgment in *Kalinko v Nisbet* 2002 5 SA 766 (W), however, signals a significant change in the way in which the courts regard the beneficiary of directors' fiduciary duties. In this case the court indicated that it would be willing to permit an individual shareholder to bring action against the directors for losses that he sustained in that there was a diminution in the value of his shareholding in the company, due to the fact that the directors did not comply with their fiduciary duties, as long as it would not result in “double recovery” by both the shareholder and the company from the wrongdoers (*id* 777 – 778).

¹²¹¹ In *In re Wincham Shipbuilding, Boiler, and Salt Company* (1878) 9 ChD 322 328 – 329 it was stated emphatically that “directors are trustees for the shareholders, that is, for the company”, but not “trustees for the creditors of the company”.

¹²¹² [1983] 2 All ER 563.

¹²¹³ *Id* 585; own emphasis.

¹²¹⁴ Davies *Gower and Davies' Principles of Modern Company Law* (2003) (hereinafter Gower) 371.

¹²¹⁵ *Dodge v Ford Motor Co* 170 NW 668 (Mich 1919); *Greenhalgh v Arderne Cinemas Ltd* [1951] 1 Ch 286.

membership, which is traditionally understood to comprise the general body of shareholders.¹²¹⁶

It may therefore be concluded that directors' duties to act in the best interests of the company are owed to the company as a separate entity. In terms of the orthodox position the content of the interest of the company is determined with reference to the interests of shareholders of the company.

8.2.2 Enforcement of Directors' Duties

A logical consequence of the above view is that should the directors act in breach of their common law duties to the company, the company as a juristic person is the proper person to sue them. This principle, which is usually referred to as the rule in *Foss v Harbottle*, was laid down by two well-known cases, namely *Foss v Harbottle*¹²¹⁷ and *Mozley v Alston*¹²¹⁸ and was succinctly summarised as follows:

The proper plaintiff is prima facie the company. Where the wrong or irregularity might be made binding on the company by a simple majority of its members, no individual shareholder is allowed to maintain an action in respect of that matter.¹²¹⁹

The company is able to institute action against the wrongdoers through one of its organs. This includes the board of directors, the general meeting of members by

¹²¹⁶ Sealy "The Directors as Trustees" 1967 *Cambridge Law Journal* 83 89 explains the rationale for defining the company as the members on the basis of the historical development of the company as a form of enterprise. In a deed-of-settlement company, the members were in fact the company. A more modern formulation of this principle may be found in the "enlightened shareholder value" approach, as discussed *supra* Ch 2 (Conceptual Justification) par 2.2.3, in terms of which directors are permitted to consider the interests of other stakeholders, but only insofar as it will promote the shareholders' interests. The interests of the shareholders are thus interpreted on a long-term basis with the emphasis on the company being managed in a sustainable manner. Shareholders' interests are therefore still regarded as central, which means that the interests of the company are still primarily defined with reference to the interests of its shareholders.

¹²¹⁷ (1843) 2 Hare 461.

¹²¹⁸ (1847) 1 Ph 790.

¹²¹⁹ Farrar *supra* 431. This is a basic summary of a rule with many complexities and uncertainties. A detailed analysis of all the complexities of this rule will be superfluous for present purposes, however. See the following sources for a more detailed analysis of the content and the complexities of the rule in *Foss v Harbottle*: Farrar *supra* 430 – 441; Gower *supra* 449 – 465; Pennington *supra* 791 – 812; Wedderburn "Shareholders' Rights and the Rule in *Foss v Harbottle* 1957 *Cambridge Law Journal* 194 (hereinafter Wedderburn Part I); Wedderburn "Shareholders' Rights and the Rule in *Foss v Harbottle* (cont) 1958 *Cambridge Law Journal* 93 (hereinafter Wedderburn Part II).

ordinary resolution, or the liquidator once winding-up proceedings have commenced.¹²²⁰

Individual shareholders are therefore generally precluded from acting against delinquent directors on behalf of the company. However, in some circumstances individual shareholders are permitted to act against wrongdoers on behalf of the company by way of a “derivative action”, described in this way because “the individual member sues to enforce a claim which belongs to the company, and his right to sue is derived from it”.¹²²¹ As a derivative action is instituted on behalf of the company, any benefit accruing from a successful action will belong to the company.¹²²²

8.2.3 Ratification of a Breach of Directors’ Duties

8.2.3.1 Distinction between Ratifiable and Unratifiable Wrongs

Taking action against directors is, however, not the only option available in the case of a breach of duties by the directors.

It is said that it is a “normal principle of the law relating to fiduciaries that those to whom the duties are owed may release those who owe the duties from their legal obligations”.¹²²³ This may be done prospectively or retrospectively, provided that full

¹²²⁰ Pennington *supra* 793 and authority there referred to.

¹²²¹ Pennington *supra* 795. These instances are construed as exceptions to the rule in *Foss v Harbottle*. For more detail on exceptions to the rule in *Foss v Harbottle* see Farrar *supra* 435 - 441; Gower *supra* 458 *et seq*; Naude *Die Regsposisie van die Maatskappydirekteur met Besondere Verwysing na die Interne Maatskappyverband LLD UNISA* (1969) 266 – 275; Pennington *supra* 799 *et seq*; Wedderburn Part I 203 – 215; and Wedderburn Part II. Today many jurisdictions have enacted statutory exceptions to the rule in *Foss v Harbottle*, in terms of which provision is made for the institution of actions by members of the company for wrongs done to the company, where the company itself failed to do so. See eg s 266 of the South African *Companies Act* 61 of 1973 (hereinafter *South African Companies Act*); ss 236 and 237 of the Australian *Corporations Act* 2001 (hereinafter *Australian Corporations Act*); s 459 of the English *Companies Act* 1985 (hereinafter *English Companies Act*), which in actual fact provides that a member may approach the court for relief if the company’s affairs have been conducted in a manner which is unfairly prejudicial to the interest of its *members*, but which is allowed to be used to secure the redress of wrongs done to the company; and s 239 of the *Canada Business Corporations Act* (RSC 1985, c C-44; hereinafter *CBCA*).

¹²²² Unless the viewpoint in *Kalinko v Nisbet supra* gains general acceptance, in which case an individual shareholder will be allowed to recover from the directors the losses that he personally suffered as a result of the diminution of the value of his shareholding, which reduction in value resulted from the directors not having complied with their fiduciary duties.

¹²²³ Gower *supra* 437.

disclosure of relevant facts was made in advance of the decision.¹²²⁴ Case law also indicated that it is not only a breach of fiduciary duties that may be ratified by the company, but also a breach of the duty of care and skill.¹²²⁵ The effect of a valid ratification is that the right of shareholders to sue in future is extinguished.¹²²⁶

In principle the company should therefore be able to ratify breaches of directors' duties.¹²²⁷ There are exceptions to this principle, however, and certain wrongs against the company are categorised as "unratifiable".¹²²⁸ These include conduct in breach of the company's rights as per the company constitution; illegal conduct; conduct in breach of the common law; and instances of what is commonly referred to as "fraud on the minority".¹²²⁹

The last category, namely "fraud on the minority", created much confusion, with the courts recognising the ability of the general meeting to ratify a breach of directors' duties in one instance,¹²³⁰ while denying it in the next.¹²³¹ The basis on which the

¹²²⁴ Gower *supra* 437. Cf Partridge "Ratification and Release of Directors" (1987) 46 *Cambridge Law Journal* 122 143 – 147.

¹²²⁵ In *Pavlides v Jensen* [1956] 2 All ER 518 523 the court recognised that "it was open to the company by a vote of the majority to decide that, if the directors by their *negligence or error of judgment* had sold the company's mine at an undervalue, proceedings should not be taken by the company against the directors" (own emphasis).

¹²²⁶ Payne "A Re-examination of Ratification" (1999) 58 *Cambridge Law Journal* 604 616 and authority there referred to. Ratification and a decision not to sue should therefore not be regarded as synonymous.

¹²²⁷ *Bamford v Bamford* [1970] Ch 212.

¹²²⁸ Ie incapable of being ratified by the majority of members in general meeting.

¹²²⁹ Cilliers and Benade *supra* par 19.14; see also Rider "Amiable Lunatics and the Rule in *Foss v Harbottle*" (1978) 37 *Cambridge Law Journal* 270 273, according to whom this is the main exception to the rule in *Foss v Harbottle*; and Sealy *Directors' "Wider" Responsibilities* 169. Naude *supra* 260 *et seq* indicates that the proper term in regard to the company having been wronged is "fraud on the company". See discussion *infra* par 8.2.3.3 for further information.

¹²³⁰ *Regal Hastings Ltd v Gulliver* [1942] 1 All ER 378.

¹²³¹ *Cook v Deeks* [1916] 1 AC 554.

courts distinguished between a breach of duties that may be ratified and breaches that are incapable of being ratified, is not at all clear.^{1232 1233}

A number of commentators are troubled by this conflict¹²³⁴ and a principled exposition of the reason for this distinction is often attempted. The conflict between reported decisions is sometimes explained on the basis of the fact that directors acted *bona fide* in the first case, while the latter case represented the opposite end of the spectrum, namely the actual misappropriation of company funds by directors.¹²³⁵ Some list specific examples of director conduct that is not be capable of being ratified by an ordinary majority of shareholders, for example the misappropriation of the company's property,¹²³⁶ the expropriation of minority members' shares,¹²³⁷ *mala fide* actions,¹²³⁸ or where the director benefited himself at the expense of the company.¹²³⁹ The general meeting is also regarded as powerless to relieve directors from their fiduciary obligation to act *bona fide* for the benefit of the company.¹²⁴⁰

It is rightly conceded, however, that there is no authority for the proposition that the conduct of directors acting *mala fide* towards the company is incapable of being

¹²³² According to Gower *supra* 439 a "satisfactory answer, consistent with common sense and with the decided cases, is difficult (and perhaps impossible) to provide".

¹²³³ This distinction is of course also important insofar as it has to be determined whether a minority member has the right to bring a derivative action. According to the rule in *Foss v Harbottle* a minority member of the company will generally be able to institute action on behalf of the company if the wrong done to the company is an unratifiable wrong and the wrongdoers are in control of the company. See Gower *supra* 458. Also see Naude *supra* 272.

¹²³⁴ Cilliers & Benade *supra* par 19.14; Farrar *supra* 424; Wedderburn Part I 194; Wedderburn Part II.

¹²³⁵ See Farrar *supra* 424; in n 16 reference is made to Sealy *Cases and Materials in Company Law* (1996) 297, where it is stated that this apparent conflict can only be explained on the basis that the finding of *bona fides* is crucial.

¹²³⁶ Glover *Commercial Equity – Fiduciary Relationships* (1995) 201, with reference to *Menier v Hooper's Telegraph Works* (1874) LR 9 Ch App 350; and *Cook v Deeks supra*.

¹²³⁷ Glover *supra* 201, with reference to *Brown v British Abrasive Wheel Co* [1919] 1 Ch 290; and *In re Bugle Press* [1961] Ch 270.

¹²³⁸ Naude *supra* 272 provides one such an example, namely the receiving of bribes.

¹²³⁹ Naude *supra* 272. This viewpoint is endorsed by Cilliers & Benade *supra* par 19.14.

¹²⁴⁰ Glover *supra* 201.

ratified.¹²⁴¹ The single certainty provided by the cases on this point therefore seems to be that the only breaches of fiduciary duties that are not capable of being ratified, are where the delinquent director benefited at the expense of the company or misappropriated company property.¹²⁴²

8.2.3.2 Ratification by Directors as Shareholders

A further question in this respect is whether it is possible for directors, acting in their capacity as shareholders, to ratify a breach of their duties as directors. Shareholders are traditionally viewed as not subject to fiduciary duties when voting on resolutions to ratify director conduct.¹²⁴³ In principle directors should therefore be able to absolve themselves from liability in their capacity as shareholders, insofar as the particular wrong is ratifiable,¹²⁴⁴ although some cases hold a contrary view.¹²⁴⁵ The resulting ratification may, however, be open to challenge.¹²⁴⁶

¹²⁴¹ Naude *supra* 266.

¹²⁴² As was the case in *Cook v Deeks supra*; *Menier v Hooper Telegraph Works supra*; *Daniels v Daniels* [1978] 2 All ER 89; and *Prudential Assurance Co Ltd v Newman Industries Ltd (2)* [1980] 2 All ER 841 862. One is therefore inclined to agree with Gower *supra* 440 that “[b]eyond the proposition that ratification is not effective where it would amount to misappropriation of corporate property, it is difficult to formulate any further limitations which command general consent”.

¹²⁴³ In *Menier v Hooper’s Telegraph Works supra* 354 the court, per Mellish LJ, held that “shareholders of a company may vote as they please, and for the purpose of their interests”. Also see *North-West Transportation Co Ltd and Beatty v Beatty* (1887) 12 App Cas 589 593, where the court specifically stated:

Every shareholder has a perfect right to vote upon any such question, although he may have a personal interest in the subject matter opposed to or different from the general or particular interest of the company.

A similar principle appears from *Pender v Lushington* (1877) 6 ChD 70 75 – 76; *Burland v Earle* [1902] AC 83; *Goodfellow v Nelson Line* [1912] 2 Ch 324; and *Northern Counties Securities Ltd v Jackson & Steeple Ltd* [1974] 1 WLR 1133. The South African judiciary confirmed this principle in a number of cases, eg *Gundelfinger v African Textile Manufacturers Ltd* 1939 AD 314 325; *Sammel v President Brand Gold Mining Co Ltd* 1969 3 SA 629 (A) 679; *Desai v Greyridge Investments (Pty) Ltd* 1974 1 SA 509 (A) 519; and *Ben Tovim v Ben-Tovim* 2001 3 SA 1074 (C) 1088, in which case the court made it clear that “[a] director, in his capacity as a shareholder of a company, may act entirely in his personal interests without taking any account of any conflicting interests of the company, provided he is not guilty of fraud or oppression of minority shareholders”. See Hannigan “Limitations on a Shareholder’s Right to Vote – Effective Ratification Revisited” 2000 *Journal of Business Law* 493 507 – 511 for further discussion.

¹²⁴⁴ Farrar *supra* 437 and Gower *supra* 438 n 99 are in support of this viewpoint, with Gower going so far as to describe the contrary views of Vinelott J in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) supra*, namely that interested shareholders may not vote on ratification resolutions, as “heretical”. Wedderburn “Derivative Actions and *Foss v Harbottle*” (1981) 44 *Modern Law Review* 202 204 (hereinafter *Derivative Actions and Foss v Harbottle*) is also of the opinion that Vinelott J’s contrary views are “wrong in law and policy”.

It is a very difficult task to identify the limits that the courts have placed on the power of directors *qua* shareholders to ratify breaches of directors' common-law duties.¹²⁴⁷ The most commonly formulated proposition in this regard is that a majority of the shareholders may not by resolution appropriate company property to themselves, because the property of the company is something in which all the shareholders of the company have an interest.¹²⁴⁸

Other commentators also recognise the limitation on the ability of directors to ratify a breach of fiduciary duties in their capacity as shareholders, but do not confine this limitation to the specific instances of a misappropriation of company property, however, and regard it as applicable in respect of any breach of duties by directors.¹²⁴⁹ Ratification by a majority of the independent minority will, however, exonerate directors insofar as the particular breach may be regarded as a ratifiable wrong.¹²⁵⁰

¹²⁴⁵ *Atwool v Merryweather* (1867) LR 5 Eq 464; *Cook v Deeks supra*; *Daniels v Daniels supra* 96; *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) supra*.

¹²⁴⁶ *Hannigan supra* 510.

¹²⁴⁷ As rightly noted by *Gower supra* 439 – 440.

¹²⁴⁸ *Gower supra* 440. Authority for this proposition may be found in *Burland v Earle supra* 93, where the court clearly stipulated that the majority cannot “appropriate to themselves money, property or advantages which belong to the company or in which the other shareholders are entitled to participate”.

¹²⁴⁹ *Pennington supra* 719 is of the opinion that “directors who are controlling shareholders cannot absolve themselves from liability for breaches of duties which they owe to the company...by using their votes as shareholders”. McLennan “The Condonation by Companies of Wrongs Committed Against Themselves” 1998 *SALJ* 129 140 seems to favour this approach and feels that it is time for the law to put an end to the ability of wrongdoers to ratify wrongs committed by themselves. Sealy *Directors' “Wider” Responsibilities* 182 also seems to be of the opinion that the law ought to be changed, so that “a perverse or self-serving misappropriation of corporate funds by directors in disregard of the claims of creditors should not be capable of condonation or release by the votes of shareholders...who may even be the same persons as the directors”.

¹²⁵⁰ *Pennington supra* 807. *Payne supra* 621 concedes that this solution may seem attractive at first glance, but that it may raise numerous practical problems. The first is how dependence should be defined and secondly, how it should be detected. A further problem is that none of the shareholders might pass the independency test.

A further suggestion is that all shareholders should be required to act *bona fide* in the interests of the company when ratifying director conduct in breach of their duties.¹²⁵¹

A deviation from the principle that shareholders are entitled to exercise their voting rights in any way they please is not supported by South African case law, however.¹²⁵²

The legal principle, in general,¹²⁵³ is therefore that members of a company do not stand in a fiduciary relationship to the company and are therefore not under a duty to exercise their votes *bona fide* in the interests of the company as a whole.

Directors are therefore in principle entitled to use their power as shareholders to absolve themselves from any liability flowing from a breach of fiduciary duties.¹²⁵⁴

The only instances where directors are precluded from using their votes as shareholders as they please, are in cases where the directors misappropriated company property,¹²⁵⁵ where directors benefited at the expense of the company,¹²⁵⁶ or in

¹²⁵¹ Cranston “Limiting Directors’ Liability; Ratification, Exemption and Indemnification” 1992 *Journal of Business Law* 197 204, according to whom there is Australian authority to this effect in the case of *Ngurli Ltd v McCann* (1953) 90 CLR 425 438.

¹²⁵² See cases referred to *supra* n 49.

¹²⁵³ It must be kept in mind, however, that an application for the winding-up of a company can be brought by a member in case of oppression by the majority, on the ground that it would be just and equitable (in terms of s 344(h) of the South African *Companies Act*, as interpreted by the court in *Rand Air (Pty) Ltd v Ray Bester Investments (Pty) Ltd* 1985 2 SA 345 (W) 349 – 351). Members are therefore free to exercise their voting rights in any way they want, but do expose themselves to the possibility that it would constitute a basis for the winding-up of the company should they exercise their voting rights in bad faith in oppression of the minority in the company. Pennington *supra* 819, with reference to the ability of a member to apply for the winding-up of a company on the basis that the affairs of the company are being conducted in a manner which is unfairly prejudicial to the interests of its members (in terms of s 459(1) of the English *Companies Act*), confirms that “the court’s reluctance to examine business decisions would disappear if it were shown that the...controlling shareholders concerned did not make the impugned decisions *in good faith in the interests of the members of the company as a whole*” (own emphasis).

¹²⁵⁴ Rider *supra* 285 agrees that “there would appear to be no objection to the persons implicated in the breach of duty using their own votes in general meeting”. In *Ben-Tovim v Ben-Tovim* *supra* 1088 the South African judiciary confirmed that a director, “in his capacity as a shareholder of a company, may act entirely in his personal interests without taking any account of any conflicting interests of the company...”.

¹²⁵⁵ In *Regal Hastings Ltd v Gulliver* *supra* the court indicated its willingness to allow directors who controlled the majority vote at the general meeting of shareholders to ratify a breach of their duties where they did not misappropriate company property. In *Cook v Deeks* *supra*, however, the court refused to allow directors to ratify their own conduct in their capacity as shareholders as their misconduct entailed the misappropriation of company property.

¹²⁵⁶ *Daniels v Daniels* *supra*.

instances of oppression of minority shareholders.¹²⁵⁷ In such cases the ratification is open to challenge.

This state of affairs seems to be the only satisfactory option. A prohibition on directors to cast their votes as shareholders in any way they please is impossible to police and easy to evade by transferring votes to family members and other nominees.¹²⁵⁸ One is therefore inclined to agree that it is much more satisfactory to “allow a director to vote as a shareholder in all circumstances and to invite the court then to consider the substance of the transaction which has been ratified”.¹²⁵⁹

8.2.3.3 Ratification by Unanimous Consent

The classification of certain wrongs as unratifiable took place in the context of providing protection to minority shareholders. A question that is left unanswered, however, is whether directors who are not only the *controlling* shareholders, but the *sole* shareholders of a company, are, in their capacity as shareholders able to ratify their wrongful conduct as directors.

Uncertainty in this regard seems to derive from the fact that the limitation of the power of directors to absolve themselves from liability in their capacity as shareholders where they misappropriated company property was justified on the basis that it would constitute a “fraud on the minority”. If there were no minority that could be defrauded, which would be the case where the directors are the sole shareholders of the company, it would indeed be problematic to justify the limitation that is placed on the right of directors to exercise their votes as shareholders in any way they wish.

¹²⁵⁷ In *Ben-Tovim v Ben-Tovim supra* 1088 the court listed two instances where directors will not be able to use their votes as shareholders in their own interests, namely fraud and oppression of minority shareholders.

¹²⁵⁸ *Ibid.*

¹²⁵⁹ Hannigan *supra* 510. Payne *supra* 625 – 626 draws the same conclusion. See also Worthington “Corporate Governance: Remediating and Ratifying Directors’ Breaches” (2000) 116 *Law Quarterly Review* 639 647 who regards any limitation on a shareholder’s voting power as an “inconsistent, and therefore unacceptable, infringement of the property rights inherent in share ownership”.

This is an unfortunate result of the fact that it is a misnomer to refer to this type of conduct as “fraud on the minority”.¹²⁶⁰ It is in reality “fraud on the company” and the question as to whether there is a minority that should be protected should not even be raised, since it is the company as a legal entity that is wronged.¹²⁶¹

Cases such as *In re Halt Garage (1964) Ltd*¹²⁶² and *Rolled Steel Products (Holdings) Ltd v British Steel Corp*¹²⁶³ are indicative of the qualification that ratification will only be effective insofar as the transaction have not been fraudulent.¹²⁶⁴

It can thus be concluded that directors who misappropriated company property or benefited at the expense of the company will not be able to use their votes as shareholders, whether they are controlling shareholders or the sole shareholders of the company, to ratify their conduct and in so doing to escape liability.¹²⁶⁵

By way of summary it can thus be said that a majority at the general meeting of shareholders is entitled to ratify a breach of directors’ duties. Directors are allowed to use their votes as shareholders to ratify their own wrongdoing. Where the breach constitutes a misappropriation of company property, or directors benefiting at the expense of the company, the wrong is regarded as unratifiable. In the case of an

¹²⁶⁰ Naude *supra* 260 *et seq.*

¹²⁶¹ The fact that directors, in their capacity as sole shareholders, are precluded from ratifying a breach of common-law directorial duties, seems to indicate support for the viewpoint that the interest of the company can no longer be defined simply with reference to the interests of the shareholders of the company.

¹²⁶² [1982] 3 All ER 1016 1037.

¹²⁶³ [1986] Ch 246.

¹²⁶⁴ According to Hannigan *supra* 496 “fraudulent” here essentially means the “misappropriation of assets of the company by the shareholders *to the fraud of the company’s creditors*” (own emphasis). She rightly notes that this will only become an issue in insolvent companies, as the matter may never come to light in solvent companies (*id* 498).

¹²⁶⁵ Support for this conclusion can be found in a number of cases. See eg *S v De Jager* 1965 2 SA 616 (A) 624; *S v Hepker* 1973 1 SA 472 (W) 484, where the court emphatically stated that “directors are not allowed knowingly to bind their companies to transactions which are unprofitable to the company and are intended to serve the directors’ own ends...*even when they hold all the shares*” (own emphasis). Authors such as McLennan *supra* 131 are also of the opinion that it “would obviously be absurd” to allow directors as sole shareholders to ratify their own wrongdoings.

unratifiable wrong, any proposed ratification is open to judicial scrutiny and minority shareholders, if there are any, will generally be entitled to proceed against the delinquent directors on behalf of the company by way of a derivative action, should the company fail to do so.¹²⁶⁶

8.3 JUDICIAL METHODS FOR EXTENDING DIRECTORS' DUTIES TO CREDITORS

8.3.1 Indirect Duty Method

8.3.1.1 *Beneficiary of Duty*

The indirect duty method is to a large extent based on the traditional viewpoint as referred to above,¹²⁶⁷ in terms of which directors are still considered to owe their common law duties to the company. The indirect duty method is supported in most jurisdictions.¹²⁶⁸ Creditor protection by way of a directorial duty is contemplated on the basis that creditors' interests should be the dominating factor in determining the interest of the company when it experiences economic or financial distress.¹²⁶⁹ It is usually phrased to indicate that directors are under an obligation to *consider* the interests of creditors in discharging their duties *to the company*. The company, as a separate legal entity, thus remains the beneficiary of directors' duties.¹²⁷⁰

¹²⁶⁶ Unless the majority of the independent shareholders decided against bringing the action. See *Smith v Croft (No 2)* [1987] 3 All ER 909 956.

¹²⁶⁷ *Supra* par 8.2.

¹²⁶⁸ According to Thomson "Directors, Creditors and Insolvency: A Fiduciary Duty Or a Duty Not to Oppress" (2000) 58 *University of Toronto Faculty of Law Review* 31 43 the general position under English, Australian and New Zealand law is that "directors do not owe a fiduciary duty directly to creditors – the fiduciary duty is owed to the corporation, which continues to be regarded implicitly as the body of shareholders."

¹²⁶⁹ The interests of creditors thus seem to replace the interests of shareholders as the most important factor in determining the interest of the company. Uncertainty exists as to whether shareholders' interests will be totally replaced by creditors' interests upon the company experiencing distress, or whether shareholders' interests will only become of secondary importance upon the company experiencing distress. This matter is dealt with in more detail *supra* Ch 7 (Point in Time When the Duty Arises) par 7.4, under the discussion as to whether the duty should be viewed as a dual or a fluctuating duty.

¹²⁷⁰ Gower *supra* 373 regards directors' duties to creditors as a duty that is owed to "the creditors as a group through the mechanism of their interests being identified as constituting the company's interests as insolvency approaches". Sarra & Davis *Director and Officer Liability in Corporate Insolvency: A Comprehensive Guide to Rights and Obligations* (2002) 15 interpret directors' duties to creditors in the same way and comment that

A directorial duty to creditors on this basis seems to be couched in similar terms to section 309 of the English *Companies Act*. This provision endows directors with the right to consider the interests of company employees in discharging their duties to the company. The resemblance between the statutory formulation of a directorial right to consider the interests of corporate employees and the judicial extension of directors' duties to creditors as corporate constituents creates the possibility that section 309 of the English *Companies Act* may provide helpful insights as to how the application of the indirect duty to creditors should be viewed.

Section 309 provides as follows:

- (1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.
- (2) Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.

8.3.1.2 Right of Action

It seems fairly obvious that, since directors are still deemed to owe their duties to the company in terms of the indirect duty method, the company is still the proper party to bring action against directors if they fail to comply with their duties.¹²⁷¹ The company, as a metaphysical entity, will be able to enforce directors' duties to consider the interests of creditors through the liquidator upon the commencement of formal

[a]t the point of insolvency, while directors and officers continue to be obliged to manage in the best interests of the corporation, the focus of those interests shifts from one in which shareholder interests are paramount, to one in which the interests of creditors become important.

¹²⁷¹ Riley *supra* 91; Trethowan *supra* 54. S 309(2) is very specific on the point that a duty to employees is "enforceable in the same way as any other fiduciary duty owed to a company by its directors", which indicates that this interpretation of directors' duties to creditors is in line with the general way in which the English legislature views the manner in which the interests of other corporate constituents should be considered.

winding-up procedures.¹²⁷² Creditors themselves have no right at common law to enforce the duties owed by directors.¹²⁷³

Any action brought for the benefit of creditors will furthermore be for the benefit of creditors as a whole and not for the benefit of individual creditors.¹²⁷⁴ The proceeds of a successful action will therefore be applied to the general pool of assets available for distribution among the creditors.

8.3.1.3 Power of Ratification

The orthodox viewpoint is that the beneficiary of directors' fiduciary duties and duty of care and skill, namely the company, is capable of ratifying a breach of directors' duties. The general meeting of shareholders is traditionally vested with this power.¹²⁷⁵

It was recognised in numerous decisions, however, that shareholders are unable to ratify a breach of directors' duties once the duty to creditors is triggered.¹²⁷⁶ A number of authors agree with this limitation on the power of shareholders to ratify a breach of directors' duties to consider the interests of creditors.¹²⁷⁷ This leads one to conclude that, once creditors become the beneficiaries of directors' duties, ratification

¹²⁷² See discussion *supra* par 8.2.2.

¹²⁷³ In *Yukong Line Ltd v Rendsburg Investments* [1998] 2 BCLC 485 503 the court stated that a director does not "owe a direct fiduciary duty towards an individual creditor, *nor is an individual creditor entitled to sue for breach of the fiduciary duty owed by the director of the company* (own emphasis); and in *In re New World Alliance Pty Ltd (rec and mgr apptd); Sycotex Pty Ltd v Baseler* (1994) 122 ALR 531 550 it was also made very clear that "the duty to take into account the interests of creditors...does not, in the absence of any conferral of such right by statute, confer upon creditors any general law right against former directors of the company to recover losses suffered by those creditors". Also see Hargovan "Directors' duties to creditors in Australia after *Spies v The Queen* – Is the Development of an Independent Fiduciary Duty Dead or Alive?" (2003) 21 *Company & Securities Law Journal* 390 409.

¹²⁷⁴ Dabner "Directors' Duties – The Schizoid Company" (1988) 6 *Company & Securities Law Journal* 105 114; Trethowan *supra* 54.

¹²⁷⁵ See discussion and authority referred to *supra* par 8.2.3.

¹²⁷⁶ See authority referred to *supra* Ch 4 (Judicial Framework) par 4.6. In none of the decisions did the courts provide an indication as to whether *creditors* will be able to ratify the particular breach of duties, however. See *infra* par 8.4.1.2 for further discussion on this aspect and other potential problem areas in respect of the direct duty method.

¹²⁷⁷ See eg Grantham *supra* 17 and Parkinson "Non-commercial Transactions and the Interests of Creditors" (1984) 5 *The Company Lawyer* 55 63, who puts it quite strongly that it would be "irrational that the directors should be excused from liability by ratification by the members" in the case of a transaction that constitutes a breach of duty because of its prejudicial effect on creditors, as it is not members' interests that are at stake.

of a breach by the company in general meeting will be invalid and that creditors may not be deprived of a remedy flowing from the breach in this way.¹²⁷⁸

8.3.2 Direct Duty Method

8.3.2.1 Beneficiary of Duty

In terms of the direct duty method, or independent duty as it is called by some,¹²⁷⁹ creditors are the direct beneficiaries of directorial duties. Any protection afforded to them in terms of such a duty therefore does not devolve upon them through their position as one of the constituents of the corporate enterprise, but in their own right.

8.3.2.2 Right of Action

The direct duty method is not based on existing company law principles, but supposes a new set of principles which are not clarified by the few court cases in which a duty to creditors on this basis was mooted. As a result, it is more difficult to define the basic principles upon which such a duty is founded, as would be the case with the indirect duty method.

The fact that it is viewed as diametrically opposite to the indirect duty method does, to a certain extent, aid an attempt to establish the elements of a separate duty. If the

¹²⁷⁸ Grantham *supra* 17 explains this departure from the orthodox position as follows:

The shareholders' right to waive a breach of duty derived from the traditionally exclusive association of the company with its shareholders. The new conception, however, reflecting a community of interests, will in some circumstances displace the shareholders as "owners" and thus render it inappropriate, in those circumstances, for shareholders to forgive the breach.

Parkinson *supra* 64 interprets this limitation on the power of shareholders with reference to the fact that creditors form part of the "company as a whole". A transaction that is a breach of duty because of its effect on creditors cannot be ratified by the shareholders alone, as the consent of the "company as a whole" was not obtained. Sealy *Directors' "Wider" Responsibilities* 181 stated his disagreement with this proposition in no uncertain terms and argued that "we cannot conclude that the shareholders are no longer competent to act, for they are the only residual organ that the company has".

¹²⁷⁹ See eg McConvill "Directors' Duties to Creditors in Australia after *Spies v The Queen*" (2002) 20 *Company & Securities Law Journal* 4 13, who distinguishes between a duty of imperfect obligation, in terms of which the duty to creditors is mediated through the company, and an "independent" fiduciary duty.

creditors are not allowed to enforce a directorial duty directly in terms of the indirect duty method, they should be able to do so in terms of the direct duty method.¹²⁸⁰

There is little clarity, however, on the point as to whether an individual creditor may bring action on his own behalf, or whether creditors should act collectively. If it is assumed that they should act collectively, another problem presents itself, namely the fact that company law does not provide creditors with a mechanism to enable them to act collectively against directors in breach of their duties to creditors.¹²⁸¹ Creditors are therefore in need of some type of class action to enable them collectively to enforce a duty owed to them directly.

It is also uncertain who will be entitled to the proceeds of a successful action. If any individual creditor is entitled to proceed against delinquent directors on his own behalf, the proceeds of a successful action should go to the creditor who instituted action. On the other hand, if creditors are regarded as a single body, the proceeds of a successful action should be applied towards the general pool of assets available for distribution. The latter option diminishes the incentive for an individual creditor to take action against directors.

8.3.2.3 Power of Ratification

Case law provided clear indication that shareholders are divested of the power to ratify a breach of directors' duties once it is established that directors' duty to creditors has come into operation. This should be the case whether the direct or indirect duty method is applied.

As was the case with the indirect duty method, the question remains whether creditors themselves are able to ratify a breach of directors' duties to them.

¹²⁸⁰ This surmise is reinforced by the fact that commentators such as Riley *supra* 91 also seems to view the direct duty in this way, as well as the fact that creditors are sometimes allowed to maintain a direct action against directors. See eg *Geyer v Ingersoll Publications Co* 621 A 2d 784 (Del Ch 1992). This case is criticised by authors such as Beveridge *supra* 619, however, for its flawed analysis in that the cases cited in *Geyer* do not support giving creditors a direct cause of action against directors of an insolvent company.

¹²⁸¹ In case of a duty owed directly to creditors, creditors will not be able to use the vehicle of the company to enforce this duty collectively, as was the case with the indirect duty method.

8.4 EVALUATION OF JUDICIAL METHODS

8.4.1 Indirect Duty Method

8.4.1.1 Perceived Advantages

The indirect duty method, as construed above,¹²⁸² at first glance seems simplistic and its attraction for being modelled on known principles may well be understood.¹²⁸³ The fact that existing principles pertaining to directors' duties provide some sort of basis for a directorial duty to creditors in terms of the indirect duty method is, however, not the only reason why numerous commentators prefer this method.

Further reasons are based on concerns that a duty that is directly enforceable by creditors will lead to a multiplicity of actions against directors; encourage litigation; result in too much time being spent on such matters; and a huge increase in costs, all of which may largely be allayed if the company were the only possible plaintiff.¹²⁸⁴

A further perceived advantage of the indirect duty method is that it circumvents the potential problem of a conflict of interest between various classes of creditors. The duty would still be owed to the company, which would entail that the proceeds of any action is to be paid into the corporate estate to be distributed without regard to any categorisation of creditors' interests that should have been considered. If the rules of distribution are fixed the need to distinguish between creditors in the definition of the duty is therefore removed.¹²⁸⁵

¹²⁸² *Supra* par 8.3.1.

¹²⁸³ See eg Trethowan *supra* 52 who acknowledges the value of traditional principles pertaining to directors' fiduciary duties and suggests that problems regarding directors' duties to creditors must be addressed with reference to the nature of a director's duty to the company.

¹²⁸⁴ Riley *supra* 92. Cohen *supra* 357 provides a similar list of reasons justifying the restraint on creditors' ability to institute action against directors directly and added that the grant of a right of action to individual creditors could expose directors to the risk of a double claim. In *Kalinko v Nisbet supra* 778, a case in which the court had to pronounce on the right of an individual shareholder to proceed against directors for not having complied with their fiduciary duties, the court indicated, however, that the "potential mischief of a 'double recovery'" should not preclude a plaintiff from attempting to pursue his remedy (own emphasis). The court thus seems to hold the opinion that the danger of double recovery should clearly be present, and not only be feared, before a plaintiff will be disallowed from individually proceeding against directors.

¹²⁸⁵ Wishart *supra* 330.

A final factor that seems to swing the balance in favour of the indirect duty method is the application of certain principles of insolvency law, specifically those pertaining to an equitable distribution of assets upon winding-up.¹²⁸⁶ It is assumed that the rationale of ordering delinquent directors to make payment to the company is to ensure that the proceeds are distributed in accordance with established rules relating to priorities of debts in a winding-up. Should each creditor be allowed to institute action on his own behalf, the rules aimed at achieving some measure of justice and certainty between creditors will in effect be by-passed.¹²⁸⁷

8.4.1.2 Perceived Problems

Despite the apparent persuasive power of the above arguments, the indirect duty method does not enjoy uncritical support and closer analysis reveals a number of possible deficiencies.

The first problem relates to the enforcement of the duty by the creditors.¹²⁸⁸ It is proposed that their interests should enjoy prime consideration upon the company

¹²⁸⁶ In a South African context the concept of *concursum creditorum* will play a key role in this regard. This concept was explained as follows in *Walker v Syfret* 1911 AD 141 166:

The sequestration order crystallises the insolvent's position; the hand of the law is laid upon the estate, and at once the rights of the general body of creditors have to be taken into consideration. No transaction can thereafter be entered into with regard to estate matters by a single creditor to the prejudice of the general body. The claim of each creditor must be dealt with as it existed at the issue of the order.

The same underlying philosophy is often expressed with reference to the concept of *pari passu*. See eg the Report of the Review Committee on Insolvency Law and Practice, HMSO, London, Cmnd 8558, 1982 par 26, in which it is stated as a fundamental objective of insolvency law to "achieve a rateable, that is to say *pari passu*, distribution of the uncharged assets of the insolvent among the unsecured creditors".

¹²⁸⁷ Riley *supra* 92. Sealy *Directors' "Wider" Responsibilities* 177 also recognises that affording some creditors a remedy in insolvency which is denied to others will undermine the fundamental principle that all creditors should participate *pari passu* in the bankrupt estate. Also see Trethowan *supra* 59 who is of the opinion that there is no justifiable reason why "individual creditors with sufficient resources to litigate should be in a better position than other creditors in insolvency".

¹²⁸⁸ Dean "Stakeholding and Company Law" (2001) 22 *The Company Lawyer* 66 72 rightly notes that "[i]n the absence of effective sanctions to back them up, new legal responsibilities are likely to prove ineffectual" and that "[a]ny law that is not enforced or enforceable in practice is in danger of becoming a dead letter".

being in distress. Creditors are powerless, however, to enforce this duty, except through the liquidator once the company is in formal liquidation.¹²⁸⁹

It is furthermore uncertain whether they would be entitled to proceed on their own behalf, should the liquidator refuse to take action against the delinquent directors. This construction of the duty led to it being termed a “duty of imperfect obligation”¹²⁹⁰ and seems to regard the duty to creditors as nothing more than a limitation of the power of shareholders to ratify a breach of directors’ duties.¹²⁹¹

An indirect duty to creditors may also serve as a defence for directors in actions instituted against them by dissatisfied shareholders on behalf of the company.¹²⁹² Directors may, for example, very well justify actions that caused complaints among shareholders as being in the best interest of creditors of the company.¹²⁹³ An indirect

¹²⁸⁹ A fact that contributed to many authors’ rejection of directors’ duties to creditors or criticism against this particular method. See eg Hill “Duties of Directors Towards Creditors – Whether There Are Such Duties When the Company Is Insolvent” (1986) 60 *Australian Law Journal* 525 527 who considers it as “odd” that “creditors have not to date been considered to have an independent cause of action in respect of breach of directors’ duties...where the directors have a duty to consider their interests”; and Renard, in a commentary on a paper by Heydon “Directors Duties and the Company’s Interests” in Finn (ed) *Equity and Commercial Relationships* (1987) 120 140 who asks the question why creditors are not entitled to sue in equity if directors owe a duty to them; Sealy *Directors’ “Wider” Responsibilities* 177 who rejects the notion of a duty to creditors on the basis that a “supposed legal duty which is not matched by a remedy is a nonsense”.

¹²⁹⁰ This term was first used by Heydon *supra* 131 and was subsequently applied in *In re New World Alliance Pty Ltd; Sycotex Pty Ltd v Baseler* *supra* 550.

¹²⁹¹ McConvill *supra* 6.

¹²⁹² This perception seems to be reinforced by explanatory comments on the purpose of section 309 of the English *Companies Act*, which provides statutory protection to company employees along similar lines as the indirect common law duty to creditors. The purpose of this provision is apparently to leave room for directors to look after the well-being of company employees without exposing themselves to liability that may flow from actions by dissatisfied shareholders.

¹²⁹³ The fact that directors may use their allegiance to various corporate constituents as a defence in actions against them is one of the main points of criticism against a duty to creditors, and the point that a duty to everyone is in fact a duty to no one was made by various commentators. See eg Sealy *Directors’ “Wider” Responsibilities* 175; as well as the introduction to the *King Report on Corporate Governance for South Africa 2002* (hereinafter *King II*) where it is expressly stated in par 5.1 that

[t]he stakeholder concept of being accountable to all legitimate stakeholders must be rejected for the simple reason that to ask boards to be accountable to everyone would result in their being accountable to no one.

duty to creditors is therefore in danger of being perceived as a shield providing protection to directors, rather than a sword in the hands of creditors.

A further problem relates to the ratification of a breach of directors' duty to consider creditors' interests. Reference was already made to the fact that the beneficiary of fiduciary duties is in principle entitled to ratify a breach of such duties.¹²⁹⁴ This principle was adapted for company law to provide that the company, acting through its organ, the general meeting, is entitled to ratify a breach of directors' fiduciary duties.¹²⁹⁵ On the whole this adaptation of the principle seems to be acceptable, as the interest of the company is traditionally determined with reference to the interest of the shareholders.¹²⁹⁶

This clear picture becomes blurred at the edges, however, once the interests of creditors intrude.¹²⁹⁷ The fallacy of allowing shareholders to ratify directors' failure to consider the interests of creditors was recognised by the courts.¹²⁹⁸ Questions that were not addressed by the courts, however, are whether creditors are able to ratify a breach of duties to consider their interests, and how they will be able to do so.¹²⁹⁹

8.4.2 Direct Duty Method

8.4.2.1 Perceived Advantages

¹²⁹⁴ *Supra* 8.2.3.

¹²⁹⁵ This principle was extended to directors' duty of care and skill. See discussion *supra* par 8.2.3.

¹²⁹⁶ See discussion *supra* par 8.2.1.

¹²⁹⁷ *Sealy Directors' "Wider" Responsibilities* 173 notes that "the traditional method...is inadequate when 'wider' interests have to be reckoned in. If directors are to be required to have a concern for (say) employees and creditors, it is no longer appropriate to regard the membership alone as the constituent body so as (for example) to entrust it with an unfettered power to ratify and condone directors' irregular acts".

¹²⁹⁸ This fact was stated in numerous decisions on directors' duties to creditors. See discussion *supra* Ch 4 (Judicial Framework) par 4.6.

¹²⁹⁹ Statements by Dabner *supra* 114 that "[i]n the insolvency context it is to creditors that the directors must look for exoneration" and Hill *supra* 527 that a "breach of that duty cannot be waived without the creditors' consent" seem to indicate support for the idea that creditors should be able to ratify a breach of directors' duties to consider their interests. *Sealy Directors' "Wider" Responsibilities* 181, on the other hand, is vehemently opposed to any such possibility, as indicated by his statement that "there is no room in company law to allow for any possibility of ratification by the creditors".

The most obvious advantage of the direct duty method lies in the fact that any uncertainty regarding creditors' *locus standi* is removed, as a duty owed directly to creditors "will permit them to bring actions in their own right, and for their own benefit".¹³⁰⁰ This will render the duty more effective, since it will place enforcement in the hands of those with the keenest interest in taking action for its breach.¹³⁰¹

The possibility that the proceeds of a successful action by a creditor for breach of duty would go to the particular creditor, rather than merely to the company for division amongst some or all creditors, may also be regarded as an advantage.¹³⁰²

8.4.2.2 Perceived Problems

The direct duty method is criticised for its potential to allow inappropriate interference in corporate management by creditors and to create unwarranted threats of director liability by raising conflicting duties to shareholders and to creditors.¹³⁰³

A direct duty may also infringe on directorial freedom when making corporate decisions and may inhibit qualified people from taking on the responsibilities and duties of directors.¹³⁰⁴

It is furthermore rejected for its apparent disregard of fundamental principles of insolvency law¹³⁰⁵ and for cutting across the prime economic function of a company, namely the "pursuit of maximum profits and the directors as the agents of this maximisation".¹³⁰⁶

¹³⁰⁰ Butcher *Directors' Duties: A New Millennium, A New Approach?* (2000) 184.

¹³⁰¹ Riley *supra* 91.

¹³⁰² *Ibid.*

¹³⁰³ Beveridge *supra* 621.

¹³⁰⁴ *Id* 622.

¹³⁰⁵ With reference to the *pari passu* principle. See Butcher *supra* 184; and Keay "Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors" (2003) 66 *Modern Law Review* 665 (hereinafter Keay *Contractarian Concerns*) 670.

¹³⁰⁶ Grantham *supra* 12.

Application of the direct duty method may furthermore lead to double recovery, in that the creditors will be able to sue individually and the liquidator may sue on behalf of the company if it ends up in insolvent liquidation.¹³⁰⁷

Further criticism against the direct duty method is that it does not sit easily alongside the board's existing fiduciary duties. Although a direct duty to creditors is apparently an extension of traditional rules, it is largely inconsistent with them.¹³⁰⁸

It may also prove difficult to enforce a direct duty in that a creditor who wishes to take action against delinquent directors on this basis will first have to establish that a duty was indeed owed to him.¹³⁰⁹

Creditors' ability to sue in case of a breach of the duty is also not as clear-cut as it appears to be at first glance. In case of the indirect duty to creditors, creditors are in a position where they may use the separate entity of the company as a vehicle to enable them to act collectively.¹³¹⁰ If the duty is construed as being owed to creditors directly, this option is not available to them. Company law furthermore does not provide creditors with a mechanism such as a class action through which to act collectively against directors in breach of their duties to creditors, making it very difficult for creditors to act collectively in enforcing a direct duty owed to them.¹³¹¹

The direct duty method furthermore provides for a "separate duty" to creditors under circumstances where the company is in financial or economic distress.¹³¹² Nothing in the composition of a direct duty indicates that it replaces directors' traditional duties

¹³⁰⁷ *Keay Contractarian Concerns* 670. The South African judiciary would, however, not seem to be concerned about the *potential* danger of double recovery. See *Kalinko v Nisbet supra*.

¹³⁰⁸ *Grantham supra* 13.

¹³⁰⁹ *Trethowan supra* 53.

¹³¹⁰ See discussion *supra* par 8.3.1.2.

¹³¹¹ The *Constitution of the Republic of South Africa* 1996 does provide for a class action in terms of s 38(c). Such a class action is, however, limited to instances where it is alleged that a right in the Bill of Rights has been infringed or threatened. Whether the provision of a class action for an infringement of a fundamental right will provide impetus for the development of a class action in other areas of the law remains to be seen.

¹³¹² *Trethowan supra* 53.

to the company. It thus appears that directors of fully solvent companies owe traditional common-law duties to the company. Directors of companies that are in economic or financial distress, will, however, in addition to the common law duties that they owe to the company, owe certain duties, the content of which is not clear, to the creditors of the company.

Establishing how an independent duty to creditors should operate is thus complicated by the fact that it is not modelled as closely on existing principles as the indirect duty method. This causes a number of problems and uncertainties, for example whether creditors are allowed to act independently in bringing action, or whether they are required to act collectively; the apparent necessity of a class action which is not currently provided for; the lack of rules regarding the distribution of the proceeds of a successful action; the basis on which various classes of creditors should be differentiated; the content of the duty; and its relationship with directors' traditional common-law duties when they exist in the same company and at the same time.

8.4.3 Summary

The biggest advantage that the indirect duty method seems to have over the direct duty method, being based on existing principles, is the fact that some basis for the operation of a duty to creditors is provided for. This may facilitate the extension of directors' duties to creditors.

The fact that the company remains the beneficiary of directors' duties in application of the indirect duty method will furthermore dispel concerns that principles of insolvency pertaining to the distribution of assets will be undermined. It will also make a complicated differentiation between various classes of creditors, each with its own rights in respect of directors' duties, unnecessary.

Criticism that a duty to creditors will allow them to interfere with the management of the company while it is still a going concern is also addressed by the fact that creditors are powerless to enforce the duty prior to liquidation. This so-called

advantage is, however, also the biggest shortcoming of the indirect duty method. The question has been asked whether a duty without a remedy is of any use.¹³¹³

Creditors are not left completely without a remedy, as the liquidator is still entitled to proceed on their behalf once the company is in liquidation. The fact that a liquidator is entitled to proceed against delinquent directors when the company is in liquidation is nothing new, however, and this fact raises another question, namely why such a right should be formulated in connection with a duty to creditors.

The only apparent reason seems to be that the liquidator may sometimes be faced with a wrong to the company that was ratified by the directors in their capacity as shareholders. Under such circumstances the liquidator is, in principle, not allowed to proceed against the directors, as they have been absolved from all possible liability. This may lead some to regard the duty to creditors as nothing more but an attempt by the court to address this apparent injustice by declaring the shareholders to be incapable of ratifying a breach of directors' duties, as the duty was in fact owed to the *creditors* under specific circumstances.¹³¹⁴

An indirect duty to creditors thus seems to provide directors with a defence in actions by dissatisfied shareholders and only to aid creditors insofar as a limitation is placed on the right of shareholders to ratify a breach of directors' duties under particular circumstances.

It is submitted that this formulation of the duty is too narrow and that criticism against it on the basis that a duty without a remedy is nonsense,¹³¹⁵ is absolutely justified. This may lead to the whole concept of a directorial duty to creditors being discarded.

¹³¹³ Sealy *Directors' "Wider" Responsibilities* 177 put it quite strongly that a "supposed legal duty without a remedy is a nonsense"; Wishart *supra* 326 also emphasised the importance of a *nexus* between those to whom the duty is owed and those protected by the duty.

¹³¹⁴ See *supra* Ch 7 (Point in Time When the Duty Arises) for a discussion on the circumstances that would trigger a duty to creditors.

¹³¹⁵ Sealy *Directors' "Wider" Responsibilities* 177. It must be noted, however, that Sealy made this statement to indicate absolute opposition to a duty to creditors, and not by way of advocating a remedy

It is therefore crucial that creditors be provided with some sort of mechanism to maintain an action to enforce the duty owed to them, albeit in an indirect way.

8.5 SUGGESTED METHOD

8.5.1 Beneficiary of Duty

It is submitted that, since a duty to creditors is generally triggered by the company in question being in financial difficulty,¹³¹⁶ the operation of the duty should not be contrary to principles of insolvency law, specifically those regarding the equitable distribution of assets upon insolvent winding-up. The duty to creditors should therefore be formulated in such a way that the proceeds of a successful action are applied to the general pool of assets.¹³¹⁷ Such a formulation will allay concerns that a directorial duty to creditors will be contrary to the fundamental principles of insolvency law regarding distribution.

It is furthermore submitted that a duty in terms of which individual creditors are the direct beneficiaries of the duty is too foreign to existing company law principles for it to be capable of successful judicial development.¹³¹⁸ The orthodox viewpoint regarding the beneficiary of directors' duties should, in other words, be replicated as

to be linked to the duty to creditors. Heydon *supra* 131 and Renard *supra* 140, in a commentary on Heydon's paper, voiced similar concerns.

¹³¹⁶ See discussion *supra* Ch 7 (Point in Time When the Duty Arises) for more detail.

¹³¹⁷ This submission naturally raises the question as to whether a duty to creditors is then necessary, since it is proposed that the result should be similar to what may be achieved by way of insolvency law principles. In a previous discussion it was indicated, however, that traditional insolvency law remedies will not always be able to address prejudice suffered by company creditors, which fact indicates scope and need for a directorial duty to creditors. See *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.3.

¹³¹⁸ The judgment in *Kalinko v Nisbet supra*, in terms of which the court seemed to be open to the idea that individual *shareholders* may be allowed to enforce directors' fiduciary duties, may perhaps be interpreted to contradict this submission. It must be noted, however, that a duty to creditors is proposed in respect of insolvent companies or companies whose solvency is in doubt. For that reason it was suggested that the duty be formulated in such a way that it does not undermine insolvency law principles regarding an equitable distribution of assets. A direct duty enforceable by individual creditors holds the danger that these principles will indeed be undermined. The more liberal approach of the court in *Kalinko v Nisbet supra* should thus not be extended to directors' duties to *creditors*.

far as possible, since courts would then at least be provided with a basis from which they could develop existing principles to provide for creditors' interests.

The logical conclusion flowing from these submissions is therefore that the company should remain the primary beneficiary of directors' duties when extending directors' duties to include creditors, as suggested by the majority of judicial opinion and commentators on this topic.¹³¹⁹

The interest of the company should, however, not automatically be equated with the interests of the shareholders. In this regard the suggestion that the interest of the company should be defined according to the interests of its *members*, with a flexible definition of "membership", is supported.¹³²⁰ In terms of this flexible definition the residual risk bearers should be regarded as the members of the company. When the company is financially and economically sound the shareholders will in other words constitute the members of the company, while the creditors will do so when that is not the case.¹³²¹

The indirect method of extending directors' duties to include creditors is thus supported insofar as it provides for a duty that is mediated through the juristic person of the company. This will in turn mean that the company remains the recipient of the fruits of a successful action, which can then be distributed among creditors according to the normal rules of distribution upon winding-up.

8.5.2 Classes of Creditors

The suggestion that the company is to remain the beneficiary of directors' duties would, to a large extent, address the problem of creditors not being a homogenous group. If the proceeds of a successful action were to be distributed according to the

¹³¹⁹ See eg Worthington "Directors' Duties, Creditors' Rights and Shareholder Intervention" (1991) 18 *Melbourne University Law Review* 121 131 who agrees that "some of the confusion and controversy might be removed if it were held that the fiduciary duty is owed to the company as a separate legal entity". Such an approach will be advantageous for according with the existing conceptual framework of company theory and the underlying principles of fiduciary powers; and will furthermore be simple (*id* 131).

¹³²⁰ Wishart *supra* 349 *et seq.*

¹³²¹ Wishart *supra* 350. Also see Sarra & Davis *supra* 15.

normal rules of distribution upon winding-up, it would be irrelevant whether a creditor is a trade creditor; holder of debt equity; a voluntary creditor; or an involuntary creditor.

A question that will still remain is whether future creditors should be regarded as a group who are entitled to the protection afforded by directors' duties. This issue will come to the fore in a scenario similar to the one that the court was confronted with in *Jeffree v National Companies and Securities Commission*.¹³²² In this case directors of a company, in anticipation of a judgment being delivered against the company, the effect of which would be to render the company insolvent, decided to pay existing creditors in full and to transfer the assets of the company to a new company, specifically formed for that purpose. The new company comprised the same shareholders, same directors and conducted the same business. The judgment creditor was eventually left with a successful claim against a dormant shell.

In such a case the other creditors of the company will clearly be satisfied since their claims were settled in full and they will obviously have no interest in proceeding with any actions against the directors. The initial company was furthermore not put into formal liquidation, thereby leaving the judgment creditor without the option of recourse through a liquidator. Action was instituted against the directors personally on the basis that they failed to comply with their duties to the company, as the interests of "future" creditors were disregarded.

The inclusion of future creditors in the group of creditors whose interests should, as a general rule, be considered by directors may prove problematic specifically with reference to aspects such as the bringing of actions or ratification in case of a breach of the duty. It will also complicate the already complex issue of determining the solvency of the company in question even further. It is therefore submitted that directors' duties to creditors should be limited to existing creditors.¹³²³

¹³²² (1989) 15 ACLR 217.

¹³²³ The interests of the company have been defined in some cases such as *Gaiman v National Association for Mental Health* [1971] Ch 317 338, as the interests not of specific shareholders, but as the "interests of both present and future members" (own emphasis). This may lead one to conclude that

Future creditors, such as the judgment creditor in *Jeffree v NCSC*,¹³²⁴ will not be left without remedies and may rely on an individual delictual action against the directors,¹³²⁵ or they may request the piercing of the corporate veil in order to institute action against the newly formed company.¹³²⁶ A remedy such as the *Mareva* injunction may also prove valuable in safeguarding the interests of future creditors, such as the judgment creditor in *Jeffree v NCSC*.¹³²⁷

8.5.3 Right of Action

The principle that creditors will have to rely on traditional company organs¹³²⁸ to enforce a duty to consider creditors' interests is not supported, however. For the duty to creditors to be more than just a shield behind which directors may hide, or a limitation on the right of shareholders to ratify a breach of directors' duties under

when the interests of the company are defined with reference to the interests of its creditors, the interests of future creditors should be included. In this respect it is submitted, however, that the reference to the interests of the future members does not relate to the enforceability of directors' duties by future members, just as future creditors will not be able to enforce directors' duties, but that it simply provides an indication that "a long-term view should be balanced against the short-term interests of present members", as noted by Heydon *supra* 123, with reference to Gower "Corporate Control: The Bottle for the Berkeley" (1954) 68 *Harvard Law Review* 1176 1185. Any reference to future members thus seems to come down, in effect, to nothing more but the fact that the directors must manage the company in a sustainable manner.

¹³²⁴ *Supra*.

¹³²⁵ It must be conceded, however, that the legal principles regarding liability of directors for delicts committed by the company are far from clear. See in general De Koker *Die Roekelose en Bedrieglike Dryf van Besigheid in die Suid-Afrikaanse Maatskappyereg* LLD UOVS (1996) 107 *et seq*; De Koker "Die Aanspreeklikheid van Direkteure vir Delikte Gepleeg in Ampsverband" 2002 *TSAR* 18; Du Plessis *Maatskappyregtelike Grondslae van Die Regsposisie van Direkteure en Besturende Direkteure* LLD UOVS (1990) 251; Du Plessis & Henning "Die Deliktuele Aanspreeklikheid van Persone wat as Maatskapyorgane Optree" 1989 *THRHR* 540.

¹³²⁶ See discussion *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.4 for more information on the application of this doctrine.

¹³²⁷ *Supra*. The *Mareva* injunction seems to be ideally suited to protect the interests of future creditors, as it is an order whereby a defendant can be compelled to leave his assets within the court's jurisdiction until the court has reached a decision about the claim made against the defendant. Faul & Malan "The *Mareva* Injunction" 1990 *SA Merc LJ* 305 explain that it enables "the seizure of assets so as to preserve them for the benefit of the creditor, but not to give a charge in favour of any particular creditor". Also see Cane "Prejudgment *Mareva*-type Interdicts in South African Law" 1997 *SALJ* 77 for more information on the application of this type of remedy in South African law.

¹³²⁸ In the general meeting of shareholders when the company is a going concern, and the liquidator when the company is being wound-up.

limited circumstances, creditors should be provided with a mechanism to enforce a duty in terms of which their interests should be considered.

There are two options available in this regard. The first is a derivative action for creditors and the second is through acceptance of the flexible definition of “membership” of the company – not only for the purpose of determining the company’s interest, but also for the purpose of determining who has the right to institute action on behalf of the company.¹³²⁹

8.5.3.1 Creditors’ Derivative Action

One is inclined to agree that any benefit by way of a directorial duty should benefit the creditors as a whole, just as traditional directors’ duties should benefit the company as a whole and not individual shareholders.¹³³⁰ An important distinction is, however, that creditors, unlike shareholders, have no concept of a derivative action on which to rely.¹³³¹

In some of the other jurisdictions discussed so far, specifically Canada, it is possible for creditors, however, to maintain a derivative action against directors on behalf of the company. The derivative action is provided for in terms of section 239 of the *CBCA*, which reads as follows:

- (1) Subject to subsection (2), a complainant may apply to a court for leave to bring an action in the name and on behalf of a corporation or any of its subsidiaries, or intervene in an action to which any such body corporate is party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate.
- (2) No action may be brought and no intervention in an action may be made under subsection (1) unless the court is satisfied that

¹³²⁹ Wishart *supra* 348 – 353 proposes a flexible definition of membership in order to determine the interest of the company.

¹³³⁰ Dabner *supra* 114. See *Kalinko v Nisbet supra* for a possible deviation from this principle.

¹³³¹ As noted by Dabner *supra* 114. This certainly rings very true for company creditors in South Africa. Both the common law derivative action and statutory derivative action in terms of s 266 of the South African *Companies Act* provide for an action to be instituted on behalf of the company by a shareholder of the company. Creditors are thus precluded from proceeding against directors on behalf of the company by way of a derivative action

- (a) the complainant has given notice to the directors of the corporation or its subsidiary of the complainant's intention to apply to the court under subsection (1) not less than fourteen days before bringing the application, or as otherwise ordered by the court, if the directors of the corporation or its subsidiary do not bring, diligently prosecute or defend or discontinue the action;
- (b) the complainant is acting in good faith; and
- (c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.

The court held that a creditor qualifies as “a complainant” in terms of subsection (1) in cases where the interest of the creditor is a direct financial interest or a particular legitimate interest in the manner in which the affairs of the corporation are being managed.¹³³² The creditor who brings the derivative action must furthermore be in a position that is analogous to that of a minority shareholder, who has no right to influence what would seem to be abuses of management or conduct contrary to the company's interests.¹³³³

A derivative action by creditors may operate as follows: In cases where the company is a going concern, a creditor or creditors may maintain a derivative suit on behalf of the company if the directors fail to consider their interests. It should be emphasised, however, that creditors will only be entitled to use this mechanism once the duty to them is triggered.¹³³⁴ In all other circumstances the general meeting of shareholders, or individual shareholders by way of derivative action, will still be the only possible parties to enforce directors' duties on behalf of the company.

¹³³² *In re Daon Development Corporation* (1984) 54 BCLR 235 243 (BCSC); *Kosmopoulos v Constitution Insurance Co of Canada* [1987] 1 SCR 2 par 12; and *Jacobs Farms Ltd v Jacobs* [1992] OJ No 813 (Ont Crt (Gen Div)) 12 14, as referred to by Sarra “Taking the Corporation Past the ‘Plimsoll Line’ – Director and Officer Liability when the Corporation Founders” (2001) 10 *International Insolvency Review* 229 244.

¹³³³ *In re Doan Development Corporation* (1984) 54 BCLR 235; *Jacobs Farms Ltd v Jacobs supra*, as referred to by Sarra *supra* 245.

¹³³⁴ In other words, when creditors replace shareholders as the corporate constituent whose interests should enjoy prime consideration. See *supra* Ch 7 (Point in Time When the Duty Arises) for more detail.

All benefits from a successful action, it being a derivative action, will go to the company to be distributed according to the normal principles of distribution. Moreover, since the action is derivative the company will fund the costs of litigation and the creditor will not have to risk his own resources to this end.¹³³⁵

Care should be taken, however, that the funds of a struggling company are not wasted on vexatious litigation. Rigorous statutory tests, such as those contained in section 239 of the *CBCA*, namely that the complainant explored other avenues; is acting in good faith; and that the action appears to be in the interests of the company or its subsidiary, along with high thresholds set by the courts for the institution of the action, may prevent this from happening.¹³³⁶

Once the company is in the process of being wound-up, a standard requirement for the institution of a derivative action will apply, namely that a creditor or creditors will only be entitled to proceed against delinquent directors by way of derivative action if the company, through the liquidator, failed to do so itself.¹³³⁷

Extending traditional directors' duties to include creditors' interests occurred through the development of common-law principles by the judiciary. The question to be asked is whether a derivative action by creditors will develop in the same way.

Whether the courts would be willing to go so far as recognising a common law duty to creditors as well as a common law derivative action by creditors, is doubtful. In light of this fact it is submitted that it may be easier to enjoin the legislature to amend present provisions governing the statutory derivative action so as to make it possible

¹³³⁵ Sarra *supra* 245.

¹³³⁶ *Ibid.*

¹³³⁷ This standard is similar to the current statutory derivative action provided for by s 266(1) of the South African *Companies Act*. This provision expressly states that a member is entitled to proceed on behalf of the company, provided that "the company has not instituted proceedings for the recovery of such damages, loss or benefit".

for creditors to proceed derivatively on behalf of the company under specific circumstances, as is the case in Canada.¹³³⁸

8.5.3.2 Flexible Definition of “Membership”

Another way in which the problem of a “duty without a remedy” may be addressed, is by acceptance of a flexible definition of “membership”, not only for the purpose of determining the company’s interest, but also for the purpose to determine who has the right to institute action on behalf of the company.¹³³⁹ If creditors were regarded as the members of the company when it is in distress and directors fail to consider their interests in those circumstances, nothing will hinder the body of creditors to take action against the directors, as they are in fact “the company” at that stage.

This flexible definition seems to indicate the substitution of the general meeting of shareholders as company organ by the body of creditors. One assumes that the judiciary’s instinctive reaction to such a suggestion will be one of discomfort, a sentiment that will probably be shared by many company law scholars.

Another point of criticism that may be levelled against this approach is that shareholders are statutorily provided with a mechanism to act collectively, namely the general meeting. The manner in which the general meeting should operate is regulated extensively in the *Companies Act*.¹³⁴⁰ The same cannot be said of a body of creditors.

This problem is not insurmountable. The South African *Companies Act* does regulate collective action by creditors under particular circumstances, for example with regard to a compromise in terms of section 311(1); section 311(2) and section 312. Collective action by creditors to enforce directors’ duties may be developed along similar lines.

¹³³⁸ Davis “Hoff and Harff: Does the Convertible Debenture Holder Have Standing to Maintain a Shareholder Derivative Action?” (1975) 26 *Syracuse Law Review* 730 753 is of the opinion that if the derivative action is to be “a truly effective check on the actions of corporate management, it should be available to all”.

¹³³⁹ See Wishart *supra* 348 – 353 for a comprehensive discussion on “membership” of the company.

¹³⁴⁰ See Cilliers & Benade *supra* par 8.05 – 8.46 for a comprehensive discussion on these provisions.

It is furthermore submitted that classes of creditors should be distinguished according to the same principles applied with regard to section 311(1) of the South African *Companies Act*, namely on the basis of a similarity of rights.¹³⁴¹ Secured creditors, for example, will not be interested to proceed against directors where their claims are covered in full by the security that they hold over the company's assets, and they should therefore be excluded from meetings that are convened for the purpose of protecting the position of unsecured creditors.

The total displacement of the general meeting as company organ by creditors may, however, affect the whole fabric of company law, which is based on the idea that the company as a going concern has two organs only, namely the board of directors and the general meeting of shareholders.¹³⁴²

8.5.3.3 Summary

For the sake of clarity the proposal advanced here may be summarised as follows. In a solvent company the interests of the company are equated with those of its shareholders, who will be the only organ vested with authority to proceed against directors in breach of their duties.

Should the company experience financial or economic distress, however, prior to formal winding-up procedures having been instituted, the interests of the company comprise those of the creditors. Creditors should then be able to proceed against directors who acted in breach of their duties to the company by failing to consider the interests of creditors.

This may be done by way of a statutory derivative action for creditors, or by acceptance of the notion of "flexible membership" of the company, in terms of which creditors displace shareholders as "members" in a struggling company. This will provide creditors with the right to proceed collectively against delinquent directors.

¹³⁴¹ See Cilliers & Benade *supra* par 25.13 – 25.14; 25.16 and authority there referred to.

¹³⁴² Consequences of such displacement could eg cause a question mark to be placed on the right of shareholders to appoint and remove directors from office.

The way in which creditors will be able to act collectively may develop by way of analogy to mechanisms provided by section 311 of the South African *Companies Act*.

In respect of companies that are in the process of being wound up, the right to proceed against delinquent directors should rest with the liquidator. Should he refuse to take such action, creditors should be able to take action against the directors on behalf of the company in liquidation, provided that a certain majority of creditors are in support of this.¹³⁴³

Providing creditors with a mechanism with which to enforce directors' duties will only partially protect their interests. Other deficiencies in the legal system will also have to be addressed in order to ensure that creditors are in a position fully to use the protective measure that is afforded to them by an extension of directors' duties.¹³⁴⁴

8.5.4 Power of Ratification

The usefulness of section 309 of the British *Companies Act* as a source of guidelines on how the indirect duty to creditors should operate runs out at this point. Section 309(2) specifically provides that the "duty" to employees is to be enforced in exactly

¹³⁴³ The insolvent company will probably have to foot the bill of such an action. An unsuccessful action will mean that there is even less money available for creditors. The body of creditors will therefore have to consider very carefully whether they are willing to proceed with such an action. In this respect it is once again submitted that a distinction should be drawn between the various classes of creditors. Secured creditors, eg, will not be interested in proceeding against directors, as their claims are covered by the security that they hold. They should therefore be excluded from voting at such a meeting to the extent that their claims are covered in full by the security that they hold, or, to put it differently, should be able to vote only to the extent that their claims are unsecured.

¹³⁴⁴ The truth of this statement is recognised in the Department of Trade and Industry's *South African Company Law for the 21st Century: Guidelines for Corporate Law Reform* (2004) 18, as indicated by the following statement:

Perhaps the most significant deficiency in the current law is that it does not provide effective mechanisms for the enforcement of even those duties prescribed under the present law. The result is that the directors and senior management of large companies are effectively immune from legal control, except perhaps in regard to the more outrageous criminal offences. The lack of enforcement and recourse is in part attributable to the disincentives to litigation created by the court system, such as the under developed nature of class actions and contingency fees and the costs of protracted litigation, which collectively diminish the practical effectiveness of the civil and criminal sanctions and remedies contained in law.

the same way as traditional directorial duties. This entails that a breach of the “duty” may be enforced or ratified by the company through the general meeting of shareholders. The judiciary indicated, however, that a breach of the indirect duty to creditors is not ratifiable by the company in general meeting.¹³⁴⁵ A clear divergence is thus created from section 309 and any uncertainties regarding ratification of a breach of directors’ duties to consider the interests of creditors will therefore not be resolved by relying on this statutory provision.

If one assumes for the moment that creditors are not entitled to ratify a breach of directors’ duties, it will mean that there is no mechanism to ratify the failure of directors to consider the interests of creditors in discharging their duties to the company, as shareholders as well as creditors will be precluded from doing so. This will be contrary to the general principles pertaining to fiduciary obligations.

One proposed solution, contrary to the thrust of the majority of cases on this point, is that the power to ratify a breach of directors’ duties should remain with the shareholders, but that their decisions must be more readily open to review by the courts.¹³⁴⁶ This solution relies on the fact that “self-serving” or “phoney” votes by shareholders have been struck down on more than occasion by the courts, usually on the basis of particular decisions constituting a “fraud on the minority”.¹³⁴⁷ It is furthermore suggested that the company should be regarded as a corporate enterprise rather than a corporate membership.¹³⁴⁸ This will facilitate a shift in interpretation of “fraud on the company” to embrace the “enlarged constituency”.¹³⁴⁹

¹³⁴⁵ It seems that the English legislature also subscribes to this view. The Company Law Review Steering Group *Modern Company Law for a Competitive Economy* (Final Report Vol I) par 6.6 is clear on the point that a “ratification of a breach of duty in relation to creditors...should not be lawful”.

¹³⁴⁶ Hannigan *supra* 510; Payne *supra* 625 – 626; and Sealy *Directors’ “Wider” Responsibilities* 181.

¹³⁴⁷ Sealy *Directors’ “Wider” Responsibilities* 174.

¹³⁴⁸ *Ibid.*

¹³⁴⁹ Sealy *Directors’ “Wider” Responsibilities* 182.

This proposal shows progress in the direction of requiring shareholders to act in good faith towards the company, minority shareholders, or even creditors of the company when exercising their voting rights. However, the proposal that “phoney” votes by shareholders may be struck down by the court may create numerous problems.¹³⁵⁰

A second solution lies in allowing creditors to ratify a breach of a duty to consider their interests. One may use the construction that was suggested with regard to the right of action¹³⁵¹ as a guideline as to how and when creditors should be able to do so.

In terms of the suggested method for enhancing creditor protection by way of directors’ duties, these duties are still owed to the company as a juristic person. The company, as beneficiary of directors’ duties, should therefore in principle remain entitled to excuse a breach of directors’ duties. The company will have to do so through the body of its creditors, however, once the duty to them is triggered. The mechanisms that are provided for creditors to act collectively in terms of section 311 of the South African *Companies Act* may furthermore provide an example of how creditors should act collectively in ratifying of a breach of directors’ duties.

This solution seems preferable, but leaves one with the situation that creditors are in effect becoming an organ of the company once it begins to experience financial or economic distress. This construction will probably be met with fierce resistance by proponents of traditional company law dogma.

However, it seems to be the only logical conclusion. This construction is also analogous to the voluntary winding-up of a company by creditors – shareholders initiate the winding-up of an insolvent company, upon which the primacy of their interests is displaced by those of the creditors. An indication of development in this

¹³⁵⁰ See Wedderburn *Derivative Actions and Foss v Harbottle* 208 for a discussion on the difficulties inherent to such a solution. Wishart *supra* 340 also questions the practicality of this suggestion.

¹³⁵¹ See *supra* par 8.5.3.

direction is evidenced by the fact that some jurisdictions already provide a statutory derivative action to creditors.¹³⁵²

8.6 CONCLUSION

Court cases in which the issue of directors' duties to creditors was raised, indicated that the judiciary followed one of two approaches in extending the benefits of directors' duties to creditors. The first was by way of recognition of a direct duty to creditors, while the second is modelled on existing legal principles, namely that the company remains the beneficiary of directors' duties, but that directors, in compliance with their duties to the financially distressed company, have to consider the interests of creditors.

Both of these methods revealed a number of shortcomings. The major flaw of the direct duty method is that it does not provide guidelines in respect of enforcement and ratification of directors' duties, as it is not based on existing legal principles. Another critical drawback is that application of the direct duty method may result in the principles of insolvency law regarding equitable distribution of assets being negated. This is a serious concern in light of the fact that directors' duties to creditors are mooted for companies that are insolvent, or on the brink of insolvency.

The indirect duty method has an advantage over the direct duty method, in that the existing legal principles on which it is based provide some structure for the operation of the duty to creditors. Unfortunately the extent of an indirect duty to creditors seems to be restricted to a limitation on the power of the general meeting to ratify a breach of directors' duties, where these duties are perceived to be aimed at the protection of creditors' interests. This has led to the duty being termed a "duty of imperfect obligation",¹³⁵³ as creditors are not provided with the means to enforce the duty prior to the winding-up of the company. It also raises questions regarding the body that would be able to ratify a breach of directors' duties, seeing that the general meeting is precluded from doing so.

¹³⁵² With reference to s 239(1) of the *CBCA*.

¹³⁵³ Heydon *supra* 131.

It is therefore submitted that neither of the methods used by the courts provide a complete structure for the extension of directors' duties to creditors. The indirect duty method is preferable to the direct duty method, however, in light of the fact that it does provide some guidelines for the operation of a duty to creditors.

In light of this fact the following method is envisaged for the operation of directors' duties to creditors. The primary beneficiary of directors' duties remains the company as a juristic person. Once the duty to creditors is triggered, however, creditors displace shareholders as the corporate constituent whose interests will give content to the phrase "interests of the company". This substitution of creditors' interests for shareholders' interests will have important consequences with regard to the enforcement and ratification of a breach of directors' duties.

As proposed by the judiciary, shareholders will no longer be in a position to enforce directors' duties or ratify a breach thereof. It is submitted, however, that the effect of a duty to creditors should not be limited to this result, but that creditors should now be able to enforce these duties, or ratify a breach thereof on behalf of the company.

Enforcement of the duty by creditors may be facilitated by a derivative action for creditors, as is provided for in terms of section 239 of the *CBCA*, or through acceptance of a flexible definition of "membership".¹³⁵⁴

A mechanism to enable creditors to act collectively in enforcing directors' duties, or in ratifying a breach thereof, may be developed by analogy with the mechanism that is statutorily provided to enable creditors to collectively assess the merits of a proposed arrangement.¹³⁵⁵

¹³⁵⁴ As proposed by Wishart *supra* 348 – 353.

¹³⁵⁵ In terms of s 311 and s 312 of the South African *Companies Act*.

This method will retain the structure provided by existing legal principles, but it will go one step further in ensuring that the duty to creditors provides meaningful protection for their interests and that it is more than merely a “duty of imperfect obligation”.¹³⁵⁶

¹³⁵⁶ Heydon *supra* 131.

CHAPTER 9

RELIEF FROM LIABILITY

SUMMARY

- 9.1 INTRODUCTION
 - 9.2 RELIEF BY THE COURT
 - 9.3 INDEMNIFICATION
 - 9.4 DIRECTOR LIABILITY INSURANCE
 - 9.5 CONCLUSION
-

9.1 INTRODUCTION

It has been said that the “major corporate governance problem is the intricate balance between maximizing the efficiencies necessary to create wealth and ensuring that the controlling parties are accountable to those with a stake in the enterprise”.¹³⁵⁷ The balance between creating an environment conducive to wealth maximizing, while providing adequately for accountability, may be adversely affected by a duty to creditors. Such a duty may be perceived to expose directors to personal liability to such an extent that they become excessively risk averse. This in turn may lead to wealth creation being sacrificed in favour of accountability.¹³⁵⁸

¹³⁵⁷ Swanson “Corporate Governance: Sliding Seamlessly into the Twenty-first Century” (1996) 21 *Journal of Corporation Law* 417 418. In the same vein Finch “Personal Accountability and Corporate Control” (1994) 57 *Modern Law Review* 880 881 regards it as one of the purposes of the rules of corporate law to “encourage wealth creation yet discourage corporate wrongdoing”. Johnston “Corporate Indemnification and Liability Insurance for Directors and Officers” (1978) 33 *The Business Lawyer* 1993 defines the problem as balancing “the need for punishing faithless fiduciaries against the need to protect aggressive managers who are willing to take good-faith risks in the search for profits”. According to Ramsay “Liability of Directors for Breach of Duty and the Scope of Indemnification and Insurance” (1987) 5 *Company & Securities Law Journal* 129 “[a]ny regulation of the activities of companies and their directors must have as its twin objectives both the need to protect shareholders against mismanagement and self-dealing by directors through the threat of personal liability, and the need to encourage directors to take good faith risks when exercising their business judgment on behalf of the shareholders”.

¹³⁵⁸ The pertinence of this concern is recognised by numerous authors. See eg Caraccio “Void Ab Initio: Application Fraud as Grounds for Avoiding Directors’ and Officers’ Liability Insurance Coverage” (1986) 74 *California Law Review* 929 943; Daniels & Hutton “The Capricious Cushion: The Implications of the Directors’ and Officers’ Insurance Liability Crisis on Canadian Corporate Governance” (1993) 22 *Canadian Business Law Journal* 182 229; Johnston *supra* 2035 who warns that eventually the “enterprise system itself will be the loser”; Spisto “D and O Insurance for Directors and Officers – What Is This and Is It a Viable Option in South African Law?” 1996 *CILSA* 61 (hereinafter

It is furthermore feared that increased exposure to personal liability will deter many competent persons from being willing to serve on the boards of companies,¹³⁵⁹ which is contrary to one of the goals of company law of “fostering entrepreneurial talent, rewarding it, and then protecting it from untoward liability”.¹³⁶⁰

In defence of a duty to creditors it must be emphasised that the purpose of such a duty is not to hold directors liable for every corporate failure. Liability should ensue only in cases of a *breach of duties* by directors. It is furthermore submitted that the goal of reaching and maintaining the balance between wealth maximization and accountability will not be attained through a reduction in director liability. Such a step will be undesirable, as it will increase the vulnerability of corporate creditors to the conduct of delinquent directors, who will in fact be provided with an opportunity to do as they please in the absence of a possible sanction of personal liability.¹³⁶¹

As an alternative it is proposed that one should look to corporate law measures providing relief from liability under specified circumstances.¹³⁶² Measures such as

Spisto *D and O Insurance*); and Weiss “The Effect of Director Liability Statutes on Corporate Law and Policy” (1989) *Journal of Corporation Law* 637 642.

¹³⁵⁹ Bradley & Schipani “The Relevance of the Duty of Care Standard in Corporate Governance” (1989) 75 *Iowa Law Review* 1 7, 34; Caraccio *supra* 942; Ramsay *supra* 132; Spisto *supra* 69; Weiss *supra* 638. Cohn “Demise of the Director’s Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule” (1983) 62 *Texas Law Review* 591 600 indicates that, though inappropriate, even the judiciary may base decisions on “the extent to which imposition of statutory standards would affect the selection process of directors”. In a comment on a paper by Menzies “Directors’ Duties” (1959) 33 *Australian Law Journal* 156 169, it was noted as early as in 1959 that:

The stage has been reached where, if a man is to become a director of a company, more particularly of a public company, he must either have as well as integrity, also great courage, or else be abysmally ignorant of the law surrounding the office he is to accept.

¹³⁶⁰ Cranston “Limiting Directors’ Liability: Ratification, Exemption and Indemnification” 1992 *Journal of Business Law* 197 209.

¹³⁶¹ In this respect one is bound to agree with Cranston *supra* 209 that “the law of directors’ duties is not only about whether particular breaches of duty are to result in monetary payments, *but also about ensuring that directors adhere to certain fiduciary and management standards*” (own emphasis).

¹³⁶² Apart from corporate law measures providing relief from liability, directors are of course also free to take steps to provide some cover against personal liability (Spisto *supra* 62). The most obvious example of such a step is professional liability insurance. Although this topic does not fall within the

these may play an important role in striking a balance between imposing liability on delinquent directors, thus ensuring accountability, while providing freedom to take calculated business risks without the threat of personal liability, should the corporation fail.¹³⁶³ They may also serve to attract persons of the right calibre to serve on the boards of companies.¹³⁶⁴

Company law provides for a number of these measures,¹³⁶⁵ for example relief granted by the court;¹³⁶⁶ indemnification;¹³⁶⁷ director liability insurance;¹³⁶⁸ and ratification.¹³⁶⁹ For these measures to achieve their aim with any degree of success it is important, however, that the right balance be struck between providing adequate defences for directors whose conduct can be shown to be beyond reproach, while ensuring that

ambit of this study, it not forming part of the general legal framework, a potential increase in personal liability could impact significantly on the cost of such insurance, making it unaffordable. Effective legal measures providing relief from personal liability could go some way towards ensuring that such personal measures do not become unavailable by reason of being unaffordable.

¹³⁶³ Carhart & Thomson “Limiting Compromises of Director and Senior Officer Liability in CCAA Proceedings: *NBD Bank, Canada v Dofasco Inc*” (2000) 17 *National Insolvency Review* 38 observe that there are “few assignments in modern life more challenging than being a director...of a large company in financial distress”. The availability of relieving measures thus seems to be especially important in relation to directors of struggling companies.

¹³⁶⁴ Cohn *supra* 600 agrees that the resolution of conflict between enforcing acceptable standards of director conduct and ensuring competent people being willing to be appointed to the boards of companies lies “not in judicial negation of standards but in the legislative realm, where public policy conflicts are best resolved”.

¹³⁶⁵ It must be noted that this section only deals with relief from personal liability in general. In some jurisdictions provisions imposing personal liability for insolvent or fraudulent trading contain their own measures specifically to provide directors with relief from the liability imposed in terms of those provisions. Measures providing relief from liability under those specific circumstances are discussed in the chapter pertaining to the statutory provisions imposing personal liability for fraudulent or insolvent trading. See *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.2.

¹³⁶⁶ See discussion *infra* par 9.2.

¹³⁶⁷ See discussion *infra* par 9.3.

¹³⁶⁸ See discussion *infra* par 9.4.

¹³⁶⁹ The general meeting of shareholders is generally entitled to absolve directors from liability for a breach of their duties through ratification (*Pavlidis v Jensen* [1956] 2 All ER 518; *Daniels v Daniels* [1978] 2 All ER 89). The way in which it is possible for shareholders to ratify a breach of directors’ duty to consider the interests of creditors, was discussed in a previous chapter (see discussion *supra* Ch 8 (Beneficiary of the Duty)) and is not discussed again here.

these measures are not formulated so broadly as to allow delinquent directors to avail themselves thereof, thus escaping liability.¹³⁷⁰

In this chapter an attempt is made at answering the question whether the existing measures are successful in attaining the balance mentioned above by analysing each of the above-mentioned measures in various jurisdictions, upon which their efficiency and the possible impact on a duty to creditors are evaluated.

9.2 RELIEF BY THE COURT

9.2.1 Introduction

In the majority of jurisdictions referred to in this study, courts have the power to grant directors relief from possible personal liability. A court has this power either in terms of a business judgment rule,¹³⁷¹ or in terms of a specific statutory provision.¹³⁷²

For the purposes of the discussion of relief by the courts, the usual order in which jurisdictions are discussed in the comparative study is deviated from, grouping together those jurisdictions that use specific statutory provisions in terms of which courts have the discretion to grant relief¹³⁷³ and those jurisdictions in which a business judgment rule applies.¹³⁷⁴ There are no specific legal doctrines or statutory provisions exclusively dealing with the courts' discretion to relieve directors from liability in Canada¹³⁷⁵ and New Zealand.¹³⁷⁶ This discussion therefore does not contain further reference to these jurisdictions.

¹³⁷⁰ Or in the words of Spisto *D and O Insurance* 60, one needs to balance “the need for punishing faithless fiduciaries against the need to protect aggressive directors willing to take good faith risks in the search for profits”.

¹³⁷¹ The business judgment rule is formally recognised and applied in the USA and Australia.

¹³⁷² Eg s 248 of the South African *Companies Act* 61 of 1973 (hereinafter South African *Companies Act*); s 1318 of the Australian *Corporations Act* 2001 (hereinafter Australian *Corporations Act*); and s 727 of the English *Companies Act* 1985 (hereinafter English *Companies Act*). South African company law does not formally provide for the application of a business judgment rule.

¹³⁷³ Ie South Africa, Australia and England.

¹³⁷⁴ Ie the USA and Australia. The USA, being the jurisdiction in which the business judgment rule originated, will be discussed before Australia.

¹³⁷⁵ Rousseau “The Duties of Directors of Financially Distressed Corporations: A Quebec Perspective on the *Peoples Case*” (2004) 39 *Canadian Business Law Journal* 368 374 makes the point, however,

9.2.2 Statutory Provisions Empowering Courts to Grant Relief

9.2.2.1 South Africa

Section 248 of the South African *Companies Act* provides that the court may exercise its discretion to relieve directors¹³⁷⁷ from liability under particular circumstances.¹³⁷⁸

This provision reads as follows:

- (1) If in any proceedings for negligence, default, breach of duty or breach of trust against any director, officer or auditor of a company it appears to the Court that

that the Canadian courts could generally be seen to be reluctant to pass judgment on business decisions made in good faith and recognised an “implied rule of deference toward management decisions”, without formalising the rule as a doctrinal rule, as was done in the USA. Rousseau 374 – 375, quoting from Ziegel *et al Cases and Materials on Partnerships and Canadian Business Corporations* (1994) 478, furthermore indicates that numerous commentators argued that the end result is the same, leading to the conclusion that “the considerations underlying the [business judgment] rule have simply been imported into the formulation of the final standard of care that governs directorial conduct”. The Canadian courts have been leaning more and more towards articulating a standard of review that resembles the US type business judgment rule (see eg *CW Shareholdings Inc v WIC Western International Communications Ltd* (1998) 38 BLR (2d) 196 (Ont Ct (Gen Div)) 213 – 214, as referred to by Rousseau *supra* 375) to the point where the Canadian supreme court seems to have enshrined the business judgment rule. See *Peoples Department Stores Inc v Wise* 2004 SCC 68 par 64, where the court stated:

It might be tempting for some to see unsuccessful business decisions as unreasonable or imprudent in light of information that becomes available *ex post facto*. Because of this risk of hindsight bias, *Canadian courts have developed a rule of deference to business decisions called the “business judgment rule”, adopting the American name for the rule (own emphasis).*

Sarra “Canada’s Supreme Court Rules No Fiduciary Obligation towards Creditors on Insolvency – *Peoples Department Stores v Wise*” (2006) 15 *International Insolvency Review* 1 10 is of the opinion that this statement has the effect of “moving Canada firmly towards the US standard in that respect”.

¹³⁷⁶ According to Farrar “The Duty of Care of Company Directors in Australia and New Zealand” in Ramsay (ed) *Corporate Governance and the Duties of Company Directors* (1997) 81 90 (hereinafter Farrar *Duty of Care*), the only reference to the business judgment rule in New Zealand is in the long title of the 1993 *Companies Act*. In terms of par (d) of the long title, it is an object of the Act to “encourage efficient and responsible management of companies by allowing directors a wide discretion *in matters of business judgment* while at the same time providing protection for shareholders and creditors against the abuse of management power” (own emphasis).

¹³⁷⁷ This provision applies to directors, officers and auditors of the company. The position regarding directors of the company is the only aspect that is relevant for the purposes of this study and the way in which other parties are affected in terms of thereof is not discussed in any detail.

¹³⁷⁸ The aim of this study is to assess whether provisions such as s 248(1) and the equivalent thereof in other jurisdictions are adequate in providing directors with some form of relief from civil liability. The question as to whether they provide relief from possible criminal liability falls outside the scope of this discussion and this matter is not dealt with in any detail. See Edmunds & Lowry “The Continuing Value of Relief for Directors’ Breach of Duty” (2003) 66 *Modern Law Review* 195 218 *et seq* and authority there referred to for more information pertaining to relief from criminal liability.

the person concerned is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, the Court may relieve him, either wholly or partly, from his liability on such terms as the Court may think fit.

(2) Any such director, officer or auditor who has reason to apprehend that any claim will be made against him in respect of any negligence, default, breach of duty or breach of trust, may apply to the Court for relief, and the Court shall on any such application have the same powers to grant relief as are by subsection (1) conferred upon it with reference to proceedings referred to in that subsection.

Subsection (1) operates as a defence that may be advanced by directors in proceedings against them, whereas the proceedings under subsection (2) should be by way of motion.¹³⁷⁹

9.2.2.2 Australia

The Australian courts are endowed with the power to grant relief in terms of section 1318 of the *Corporations Act*. Section 1318(1) is very similar to its South African counterpart¹³⁸⁰ and reads as follows:

If, in any civil proceeding against a person to whom this section applies for negligence, default, breach of trust or breach of duty in a capacity as such a person, it appears to the court before which the proceedings are taken that the person is or may be liable in respect of the negligence, default or breach but that the person has acted honestly and that, having regard to all the circumstances of the case, including those connected with the person's appointment, the person ought fairly to be excused for the negligence, default or breach, the court may relieve the person either wholly or partly from liability on such terms as the court thinks fit

Subsection (2), nearly identical to section 248(2) of the South African *Companies Act*, provides for the possibility that a person to whom the provision applies may apply to

¹³⁷⁹ Meskin, Kunst, Galgut, Delpont & Vorster *Henochsberg on the Companies Act* (1994 –) (hereinafter Henochsberg) 461.

¹³⁸⁰ S 248(1) of the South African *Companies Act*.

the court for relief should he have reason to believe that a claim will be made against him in respect of negligence, default, breach of trust or breach of duty.¹³⁸¹

9.2.2.3 England

Section 727(1) of the English *Companies Act*¹³⁸² is the equivalent of section 248(1) of the South African *Companies Act*. This provision is identical to section 248(1) of the South African *Companies Act* in all material aspects and reads as follows:

If in any proceedings for negligence, default, breach of duty or breach of trust against an officer of a company...it appears to the court hearing the case that the officer...is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that having regard to all the circumstances of the case (including those connected with his appointment) he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, that court may relieve him, either wholly or partly, from his liability on such terms as it thinks fit.¹³⁸³

9.2.2.4 Evaluation

9.2.2.4.1 Applicability of Relieving Provisions in Case of Statutory Liability

There seems to be some uncertainties regarding particular aspects of the relieving provisions. The first relates to whether directors who are involved in proceedings in terms of provisions such as section 424(1)¹³⁸⁴ may avail themselves of the potential relief offered by section 248.

¹³⁸¹ Subsection (3) deals with instances where the case against the respondent is tried by a judge with a jury. This scenario is irrelevant in a South African context and is not discussed further. Subsection (4) contains information on the persons entitled to relief in terms of this provision. This study is particularly concerned with possible relief for *directors* and further detail on parties other than directors entitled to this type of protection is not provided.

¹³⁸² This provision has been described by some as the “principal protection for directors under English company law”. See Pasban, Campbell & Birds “Section 727 and the Business Judgment Rule: A Comparative Analysis of Company Directors’ Duties and Liabilities in English and United States Law” (1992) 6 *Journal of Transnational Law and Policy* 202.

¹³⁸³ Relief was granted under this provision in cases such as *In re D’Jan of London Ltd* [1994] BCLC 561 and *In re Welfab Engineers Ltd* [1990] BCLC 833. Relief was refused in *Guinness plc v Saunders* [1990] 1 All ER 652 HL; *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498; *In re Produce Marketing Consortium Ltd* [1989] 3 All ER 1. See Edmund & Lowry *supra* 203 – 215 for a detailed discussion on the meaning of the phrases “honesty”; “reasonableness”; and “fairness”.

¹³⁸⁴ Providing for the personal liability for company debts of directors and others responsible for being knowingly involved in managing the business of the company in a fraudulent or reckless manner. See *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.2.1 for more detail.

Section 248 provides that proceedings against directors must concern *negligence, default, breach of duty or breach of trust*.¹³⁸⁵ Some commentators are of the opinion that directors' liability on the basis of a declaration in terms of section 424(1) is not liability in respect of negligence, default, breach of duty or breach of trust within the meaning of section 248(1).¹³⁸⁶ This entails that directors who are involved in section 424(1) proceedings are unable to make use of section 248. Others feel that relief in terms of section 248 will be available in the context of section 424.¹³⁸⁷

A similar question arose in England. The first opportunity that the judiciary had to provide clarity on the relationship between section 727 and section 214 of the *Insolvency Act*¹³⁸⁸ presented itself in *In re Produce Marketing Consortium Ltd*.¹³⁸⁹ According to Justice Knox the wording of these provisions indicated that it was not the intention of the legislature that they should be used in conjunction.¹³⁹⁰ In a subsequent decision, *In re DKG Contractors Ltd*,¹³⁹¹ relief was denied to the directors accused of wrongful trading in terms of section 214, not because relief under section 727 is not available in conjunction with section 214, but because the court found that the directors did not act reasonably. The decision in this case thus seems to have cleared the path for section 214 and section 727 to be used in conjunction.

¹³⁸⁵ Own emphasis.

¹³⁸⁶ Eg Henochsberg 461.

¹³⁸⁷ De Koker *Die Roekelose en Bedrieglike Dryf van Besigheid in die Suid-Afrikaanse Maatskappyereg* LLD UOVS (1996) 251. He concedes, however, that the viewpoint on the ambit of section 248 relief is of theoretical importance, only, since it would be impossible for a defendant director to show that he acted *honestly*, where he participated in the management of the company's affairs *fraudulently*. See *Ex parte Lebowa Development Corporation Ltd* 1989 3 SA 71 (T) 107. It would furthermore be very difficult for a defendant director to show that he acted *reasonably* where he took part in managing the business of the company *recklessly*.

¹³⁸⁸ *Insolvency Act* 1986 (hereinafter English *Insolvency Act*). Section 214 could partially be regarded as the equivalent of section 424(1) of the South African *Companies Act*. See *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.2.2.3 for more detail.

¹³⁸⁹ *Supra*. See Case Comment "No Excuse for Wrongful Trading" 1990 *Journal of Business Law* 249 for an extensive analysis of this case.

¹³⁹⁰ *Id* 751.

¹³⁹¹ [1990] BCC 903 912 (Ch).

This issue will probably not present a serious problem in Australia, as the Australian statutory provision on directors' personal liability for insolvent trading¹³⁹² has its own particular defences upon which directors may rely.¹³⁹³ Some commentators are of the opinion, however, that the defence in section 1318(1) will be available as an additional defence to those provided by section 588H of the Australian *Corporations Act*.¹³⁹⁴

Lack of clarity as to whether these provisions may be used in conjunction with statutory liability provisions¹³⁹⁵ is not of much concern for the purposes of this study, as its focus is primarily on the extension of directors' common law duties to creditors. Directors accused of breaching their duties to consider the interests of creditors should therefore be entitled to the relief in terms of these provisions, provided that they are able to convince the court that they acted honestly, reasonably, and ought fairly to be excused with regard to all the circumstances of the case.¹³⁹⁶ A codification or partial codification of directors' duties¹³⁹⁷ may, however, result in this protection of directors becoming unavailable.¹³⁹⁸

¹³⁹² S 588G of the Australian *Corporations Act*. See discussion *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.2.2.1 for more detail.

¹³⁹³ In terms of s 588H of the Australian *Corporations Act*. See discussion *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.2.2.1 for more detail.

¹³⁹⁴ See eg Hyland "Insolvent Trading: Does S 1318 Apply?" (1996) 34 *Law Society Journal* 44 45.

¹³⁹⁵ Eg s 424(1) of the South African *Companies Act* and section 214 of the English *Insolvency Act*.

¹³⁹⁶ In terms of the wording of s 248(1) of the South African *Companies Act*; s 727 of the English *Companies Act*.

¹³⁹⁷ As proposed in Ch 6 (Protection Afforded by the Duty of Care and Skill).

¹³⁹⁸ Pasban, Campbell & Birds *supra* 207 argue that the fact that the introduction of a law against wrongful trading in terms of s 214 of the English *Insolvency Act* took place long after the enactment of s 727 of the English *Companies Act*, indicates that it was not intended that these provisions work in conjunction, as Parliament could not have intended to provide relief against a future statutory liability. Directors could thus be deprived of significant protection should the same argument be extended to the application of this type of relief in respect of non-compliance with statutory duties. A counter-argument is that subsequent legislation is enacted against the background of existing law and that the legislature, when promulgating new law, would assume that later provisions should slot in with existing provisions, thus creating the possibility that the type of relief offered in terms of s 248(1) of the South African *Companies Act* and equivalent provisions in other jurisdictions, will become available in cases of a breach of statutory duties.

In order to ensure that a codification of directors' duties does not result in what would be an undesirable state of affairs, with directors potentially being exposed to increased liability while being deprived of an important protective mechanism,¹³⁹⁹ the safest route may be to amend the relieving provisions to bring them in line with a codification of directors' duties. This may be done along similar lines as the proposed amendments to section 727 in England.¹⁴⁰⁰

9.2.2.4.2 *Uncertainty Regarding Proceedings to which Relieving Provisions Will Apply*

It is uncertain whether relieving provisions are applicable in respect of all proceedings by anyone against directors,¹⁴⁰¹ or whether their application is limited to proceedings against directors specifically instituted by the company.¹⁴⁰²

The English judiciary seems to be of the opinion that section 727 relief is only available in respect of proceedings instituted against the director by the company and not in respect of third-party claims against the director.¹⁴⁰³

Should the model for extending directors' duties to creditors that was suggested in a previous chapter be accepted,¹⁴⁰⁴ this particular issue will not present a serious problem insofar as directors' liability to creditors is concerned. If the model be accepted that creditors become the primary corporate constituents once the duty to

¹³⁹⁹ According to Pasban, Campbell & Birds *supra* 202 a provision "permitting the exercise of judicial discretion, is the principal protection for directors".

¹⁴⁰⁰ As part of the major overhaul of English company law, a codification of directors' duties is proposed. See *supra* Ch 5 (Protection Afforded by Fiduciary Duties) and Ch 6 (Protection Afforded by the Duty of Care and Skill) for more detail on this matter. The Company Law Review *Modern Company Law for a Competitive Economy* Final Report Vol I par 6.3 – 6.4 proposed that the detailed statutory formulation of breaches to which the relief applies be deleted and that relief be confined to those provided for in the statutory statement of directors' duties.

¹⁴⁰¹ This is the viewpoint advocated by Henochsberg 460.

¹⁴⁰² The viewpoint adopted by Stegmann J in *Ex parte Lebowa Development Corporation Ltd* 1989 (3) SA 71 T 107.

¹⁴⁰³ *Customs & Excise Commissioners v Hedon Alpha Ltd* [1981] 2 All ER 697 (CA).

¹⁴⁰⁴ See discussion *supra* Ch 8 (Beneficiary of the Duty) par 8.5.

them is triggered,¹⁴⁰⁵ any action against directors for failing to consider the interests of creditors will still be an action by “the company”. The relief provided for by section 248(1) of the South African *Companies Act* and the counterparts thereof in other jurisdictions,¹⁴⁰⁶ should thus still be available in respect of actions against directors on the basis that they breached their duties to the company for having neglected the interests of creditors at a certain stage.

9.2.2.4.3 Anomaly in that Person who Acted Negligently Is Entitled to Relief if He Acted Reasonably

A third problem regarding the application of section 248 of the South African *Companies Act* is the apparent anomaly created by the fact that a person who acted *negligently* may be relieved from liability if it can be shown that he acted *reasonably*.¹⁴⁰⁷ Usually a person is considered to have been negligent because he did not act reasonably.¹⁴⁰⁸ A suggestion in this regard is that when a decision has to be made on whether relief should be granted in respect of negligence, “reasonably” should be interpreted to mean “understandably”.¹⁴⁰⁹ Another view is that the degree

¹⁴⁰⁵ See discussion *supra* Ch 7 (Point in Time When the Duty Arises) for more detail on when the duty to creditors should be triggered.

¹⁴⁰⁶ S 727(1) in England; s 1318 in Australia.

¹⁴⁰⁷ Amongst other things. According to Henochsberg 461, with reference to *Niagara Ltd v Langerman* 1913 WLD 188 202; *Selangor United Rubber Estates Ltd v Cradock (3)* [1968] 2 All ER 1073 1155, a director wishing to avail himself of the relief offered in terms of s 248 will have to prove on a balance of probabilities that he acted honestly, reasonably and that he ought fairly to be excused.

¹⁴⁰⁸ According to Neethling, Potgieter & Visser *Law of Delict* (2001) 128 – 129 negligence is generally determined with reference to the objective standard of the reasonable person. It is indicated that the following statement by Holmes JA in *Kruger v Coetzee* 1966 2 SA 428 (A) 430 is regarded as the most authoritative test for negligence:

For the purposes of liability *culpa* arises if –

- (a) a *diligens paterfamilias* in the position of the defendant –
 - (i) would foresee the reasonable possibility of his conduct injuring another in his person or property and causing him patrimonial loss; and
 - (ii) would take reasonable steps to guard against such occurrence; and
- (b) the defendant failed to take steps.

¹⁴⁰⁹ Henochsberg 462.

of negligence involved should determine whether a person may be held to have acted “reasonably”.¹⁴¹⁰

The English court used the opportunity to comment on the strange wording of section 727, which allows it to excuse a director who is guilty of *negligence*, provided that he acted *reasonably*, in *In re D’Jan of London Ltd*.¹⁴¹¹ The implication of this apparent anomaly is that while the test for reasonableness is primarily an objective one for the purposes of negligence liability, it contains a subjective element in the context of an application for relief under section 727.¹⁴¹²

A possible solution to this problem is simply to remove the requirement of “reasonableness” from the relieving provision, as was done in section 1318 of the Australian *Corporations Act*. This also seems to be the route advocated by the Company Law Review Steering Group with regard to section 727(1).¹⁴¹³

Retaining the requirement of “honesty” may also be problematic, however, in that courts may be forced to pronounce upon the extent “to which honesty is or is not determined subjectively and/or objectively”.¹⁴¹⁴ In this respect it is proposed that “fairness” should be the only requirement that has to be satisfied for a director to be relieved from liability.¹⁴¹⁵ The notion of fairness is wide enough to encompass the

¹⁴¹⁰ According to Stegmann J in *Ex parte Lebowa Development Corporation Ltd supra* 108 – 109.

¹⁴¹¹ *Supra* 564. In the words of Lord Hoffman:

[It] may be odd that a person found to have been guilty of negligence, which involves failing to take reasonable care, can ever satisfy the court that he acted reasonably. Nevertheless the section clearly contemplates that he may do so and it follows that conduct may be reasonable for the purposes of section 727 despite amounting to lack of reasonable care at common law.

¹⁴¹² Pasban, Campbell & Birds *supra* 209.

¹⁴¹³ *Developing the Framework* DTI/Pub 4754/4k/3/00/NP, as referred to by Edmund & Lowry *supra* 212 n 91.

¹⁴¹⁴ Edmunds & Lowry *supra* 222.

¹⁴¹⁵ *Id* 223.

other two elements of the relieving provision and may also “balance the protection of the director with the needs of other constituencies, such as members and creditors”.¹⁴¹⁶ Acceptance of this suggestion will also lead to the provision being more transparent, as the courts did not succeed in keeping a precise division between the three requirements.¹⁴¹⁷

9.2.2.4.4 *Extent of the Court’s Discretion*

A further problem is that the power of the court to grant relief is discretionary and not mandatory.¹⁴¹⁸ This is indicated by phrases granting a wide and flexible discretion to the court hearing the matter, for example that a director ought “fairly to be excused”; “having regard to all the circumstances...of the case”; and the absolute discretion contained in these provisions that a court “*may* relieve” a director under these circumstances.¹⁴¹⁹ Consequently, even if a director acted honestly and reasonably there is no guarantee that he will escape personal liability.¹⁴²⁰

In light of the fact that courts are reluctant to pronounce on the wisdom of managerial decisions, it is possible that directors may be in a more favourable position to obtain relief from liability where the relief depends on the discretion of the courts. A strict statutory framework pertaining to circumstances under which a court is under obligation to grant relief, which curtails the court’s discretion, may work against

¹⁴¹⁶ *Ibid.*

¹⁴¹⁷ *Ibid.*

¹⁴¹⁸ Pasban, Campbell & Birds *supra* 211.

¹⁴¹⁹ The wording of s 248 of the South African *Companies Act* and of s 727 of the English *Companies Act* is identical in these respects.

¹⁴²⁰ This has led Pasban, Campbell & Birds *supra* 212 to conclude that

a great deal will depend on the attitude of the trial judge towards the exercise of the discretion vested to him. If a case is brought before a judge who applies a wide and general interpretation of the concepts, the respondent will likely be given the relief, whereas if a case is proceeded by a judge who interprets legal expressions in a strict way, an application for the relief may likely be rejected.

Greenhow “The Statutory Business Judgment Rule: Putting the Wind into Directors’ Sails” (1999) 11 *Bond Law Review* 33 56 raises similar concerns.

directors. The courts may have been willing to go further in granting relief than a statutory framework would allow.

It is thus submitted that the fact that the relief granted by the courts is discretionary does not justify the conclusion that the protection afforded in terms of these provisions is inadequate. It is probable that this would rather lead to the exact opposite result, with the discretion in the hands of the courts potentially affording directors wider protection than would have been available had the court been obliged to grant relief within a strict regulatory framework.

9.2.3 The Business Judgment Rule

9.2.3.1 *United States of America*

The business judgment rule has its origin in the United States of America.¹⁴²¹ In one of the classic cases on the business judgment rule, *Aronson v Lewis*,¹⁴²² the business judgment rule was defined as a

presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.¹⁴²³

At first glance, one may assume the business judgment rule to be a defence that directors may raise in cases where they are accused of having breached their duties to the company. The application of the business judgment rule clearly indicates, however, that the assessment of directors' possible liability does not involve a two-step approach with directors first trying to show compliance with their duties and failing that, raising the business judgment rule as a defence.¹⁴²⁴

¹⁴²¹ According to Johnson "The Modest Business Judgment Rule" (2000) 55 *The Business Lawyer* 625 639 the phrase "business judgment rule" was first used by the Delaware Chancery Court in 1959, in the case of *Nadler v Bethlehem Steel Corporation* 154 A 2d 146 149 (Del Ch 1959). The author indicates that the phrase "business judgment" and the concept of the rule had been in use for several decades, however, with reference to *Gottlieb v Heyden Chemical Corporation* 90 A 2d 660 663 (Del 1952); *Davis v Louisville Gas & Electrical Company* 142 A 654 660 (Del Ch 1928).

¹⁴²² 473 A 2d 805 (Del 1984).

¹⁴²³ *Supra* 812. According to Hansen "The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project" (1993) 48 *The Business Lawyer* 1355 1360, this is one of the best formulations of the rule.

¹⁴²⁴ Hansen *supra* 1373 – 1374.

The business judgment rule is rather seen as a presumption that the directors have met various criteria in the decision-making context. These criteria constitute the essential elements of the business judgment rule, namely that the directors obtained the necessary information before making any business decisions; that they acted with the required degree of care in making the decision;¹⁴²⁵ that directors acted in genuine good faith; and that they ensured the absence of personal interest.¹⁴²⁶

In other words, plaintiffs have to overcome the presumption that the directors complied with these criteria to be successful with an action against directors. If they fail to do so the action will fail,¹⁴²⁷ and the directors will escape liability.¹⁴²⁸ Directors will thus be considered to have complied with their duty of care in a decision-making context, if they took adequate steps to become informed before making certain decisions.¹⁴²⁹

Should a plaintiff be successful in rebutting the presumption, the court's inquiry is not whether the director acted with the necessary care, but whether the transaction was

¹⁴²⁵ The standard for determining whether a business judgment is an informed one, is gross negligence. See Radin "The Director's Duty of Care Three Years After *Smith v Van Gorkom*" (1988) 39 *Hastings Law Journal* 707 711 and authority referred to in n 33.

¹⁴²⁶ See Hinsey "Business Judgment and the American Law Institute's Corporate Governance Project: the Rule, the Doctrine, and the Reality" (1984) 52 *George Washington Law Review* 609 610; and Pasban, Campbell & Birds *supra* 215 – 216 for more detail on these requirements. Balotti & Hanks "Rejudging the Business Judgment Rule" (1993) 48 *The Business Lawyer* 1337 1339 refer to these elements as a "statement of circumstances...under which a court will not substitute its judgment for that of directors".

¹⁴²⁷ In this respect one is inclined to agree with Balotti and Hanks *supra* 1345 - 1347 that the so-called "procedural presumption" is in fact not a presumption at all, but a mere restatement of traditional rules of evidence that the plaintiff alleging director misconduct is saddled with the burden of proving "a lack of good faith, absence of due care, or action not in the best interests of the corporation". At the end of the day it is thus only the substantive aspect of the rule which is of any importance, namely that the court will not second-guess the business merits of a business decision. S 8.31(a)(1) of the revised *MBCA* does seem to recognise the concept as unnecessary and avoids it when referring to procedural issues. The section reverts to traditional procedural principles and provides that the plaintiff carries the burden of proving that liability is not precluded by a provision of the *MBCA* and that challenged conduct is actionable. See Balotti & Hinsey *supra* for more detail.

¹⁴²⁸ The business judgment rule does not only serve to protect directors from liability in this way, but also has a secondary function of protecting the decision itself from challenge. On this basis Hinsey *supra* 611 – 613 distinguishes the business judgment *rule* which protects directors, from the business judgment *doctrine* which protects the decision.

¹⁴²⁹ Hansen *supra* 1361.

“intrinsicly fair”.¹⁴³⁰ The burden of proving that the transaction was indeed fair to shareholders rests on the directors.¹⁴³¹

It should furthermore be noted that the business judgment rule only applies in respect of actions taken or decisions made by directors. Refraining from doing anything will therefore not entitle directors to the protection afforded by the business judgment rule, unless it was a positive decision, meeting all the standards for decision-making under the business judgment rule, to do nothing. The business judgment rule, therefore, on the face of it does not seem to be available in respect of directors’ oversight functions,¹⁴³² although the possibility of extending the rule to directors’ oversight responsibilities is not excluded.¹⁴³³

Application of the business judgment rule entails that the judiciary does not have to involve itself in an evaluation of the *merits* of the decision by directors.¹⁴³⁴ The role of the court will be limited to examining the *process or procedure* by which the decision was reached.¹⁴³⁵ As such the rule is a legal recognition of judicial reluctance to interfere with the internal affairs of corporations.¹⁴³⁶

¹⁴³⁰ See Hansen *supra* 1373 n 111 for authority for this proposition. Also see McMurray “An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule” (1987) 40 *Vanderbilt Law Review* 605 618.

¹⁴³¹ Cieri, Sullivan & Lennox “The Fiduciary Duties of Directors of Financially Troubled Companies” (1994) 3 *Journal of Bankruptcy Law and Practice* 405 408 and authority referred to in n 19.

¹⁴³² Hinsey *supra* 615.

¹⁴³³ Hinsey *supra* 615, with reference to *Aronson v Lewis supra* 813 n 7, where reference is made to judgments in which questions of a director’s liability were decided upon concepts of business judgments, although the elements of business judgment were not actually present.

¹⁴³⁴ Bradley & Schipani *supra* 24 view the business judgment rule as recognition of the fact that “it is in the best interest of the shareholders, that managers, rather than shareholders and courts, make business decisions”.

¹⁴³⁵ Pinto “Monitoring the Board of Directors in American Corporations” (1998) 46 *American Journal of Comparative Law* 317 332.

¹⁴³⁶ Ubelaker “Director Liability under the Business Judgment Rule: Fact or Fiction?” (1981) 35 *Southwestern Law Journal* 775 791. The role may even be seen as a “judicial abdication of the court’s role” to determine whether a director acted in breach of his duties to the corporation (*id* 799).

The question arises whether the business judgment rule will offer protection to directors of companies operating in the “vicinity of insolvency”,¹⁴³⁷ or of companies that are already technically insolvent.¹⁴³⁸

According to some commentators there are sound policy reasons for arguing that the rule should not be rendered inapplicable by a shift in directors’ duties upon the corporation experiencing financial difficulties, without being technically insolvent.¹⁴³⁹ This argument is based on the fact that the application of the rule is even more critical where the board has to make difficult decisions when the corporation is struggling financially.¹⁴⁴⁰ An adapted formulation of the business judgment rule is offered in this regard, namely that the expansion of directors’ duties should not “preclude risk-taking or entrepreneurship, provided the decision to pursue such activities is made in the informed, good faith belief that it is reasonably likely to enhance the long-term wealth-generating abilities of the firm”.¹⁴⁴¹

Whether the business judgment rule will protect board decisions made in insolvency, is uncertain. Some hold the view that the business judgment rule will be available under such circumstances,¹⁴⁴² while others are of the opinion that such a conclusion is not supported by decisions that directors become trustees in a literal sense upon

¹⁴³⁷ The phrase was used in *Credit Lyonnais Bank Netherland, NV v Pathe Communications Corporation* No 12150, 1991 WL 277613 (Del Ch Dec 30, 1991), reprinted in (1992) 17 *Delaware Journal of Corporate Law* 1099 1155, to indicate the point in time when a shift in directors’ duties will occur. See discussion *supra* Ch 7 (Point in Time When the Duty Arises) for more detail.

¹⁴³⁸ See discussion *supra* Ch 7 (Point in Time When the Duty Arises) for more detail on these and other “triggers” for the duty to creditors.

¹⁴³⁹ Varallo & Finkelstein “Fiduciary Obligations of Directors of the Financially Troubled Company” (1992) 48 *The Business Lawyer* 239 243.

¹⁴⁴⁰ *Ibid.*

¹⁴⁴¹ Varallo & Finkelstein *supra* 243. Tompkins “Directors’ Duties to Corporate Creditors: Delaware and the Insolvency Exception” (1993) 47 *Southern Methodist University Law Review* 165 187 – 190, however, is of the opinion that directors who are seen to owe duties to creditors could be deprived of the protection afforded in terms of the business judgment rule, should the interpretation of the elements thereof as provided by the court in *Credit Lyonnais Bank Netherland, NV v Pathe Communications Corporation supra* be followed.

¹⁴⁴² Coogan, Bermont & Glatt “The Problems of the Sinking Ship” (1976) 31 *The Business Lawyer* 1371 1375.

insolvency,¹⁴⁴³ and are liable for damages based on simple negligence, and not gross negligence as per the business judgment rule.¹⁴⁴⁴

An argument is presented in favour of the application of the business judgment rule in the insolvency context, however, as the “traditional policies which are invoked to support the business judgment rule outside the insolvency context are equally applicable in the insolvency context”,¹⁴⁴⁵ with specific reference to the court’s inability to make business decisions for directors.¹⁴⁴⁶ A modified business judgment rule under such circumstances would, however, require some “threshold proof” by directors that they did indeed consider the interests of creditors.¹⁴⁴⁷

9.2.3.2 Australia

In 1995 already the Australian judiciary afforded some recognition to the legitimacy of a certain degree of risk taking in business judgment. The majority judgment in *Daniels v Anderson*¹⁴⁴⁸ stated:

¹⁴⁴³ In terms of the so-called trust fund doctrine.

¹⁴⁴⁴ Varallo & Finkelstein *supra* 245.

¹⁴⁴⁵ Varallo & Finkelstein *supra* 254. Also see Cieri, Sullivan & Lennox *supra* 422 who agree with this view in no uncertain terms, stating that

[w]hile a focus on and consideration of creditor interests is undoubtedly required, given the glaring and fundamental difficulty in determining when insolvency occurs and the corporate law mandate that the affairs of a corporation are to be managed under the direction of the board, courts or the state legislatures should provide directors with some form of business judgment rule protection...for decisions made in the ‘fourth quarter’ of a corporation’s life.

¹⁴⁴⁶ Varallo & Finkelstein *supra* 253 indicate that a variant of the business judgment rule was applied by the court in *In re Xonics Inc* 99 BR 870 (Bankr NDI II 1989), in which case action was brought against directors of the insolvent corporation by creditors, even though the court stated that its decision was based on the trust fund doctrine. This conclusion is derived from a statement by the court that

this court must be able to rely on officers’ and directors’ actions, even for an insolvent corporation unless those seeking damages show that such actions are venal (*id* 875).

Also see Cieri, Sullivan & Lennox *supra* 421 for a similar interpretation of the specific case.

¹⁴⁴⁷ Cieri, Sullivan & Lennox *supra* 421.

¹⁴⁴⁸ (1995) 37 NSWLR 438.

The courts have recognised that directors must be allowed to make business judgments and business decisions in the spirit of enterprise untrammelled by the concerns of a conservative investment trustee. Any entrepreneur will rely upon a variety of talents in deciding whether to invest in a business venture. These may include legitimate but ephemeral, political insights, a feel for future economic trends, trust in the capacity of other human beings. Great risks may be taken in the hope of commensurate rewards. If such ventures fail, how is the undertaking of it to be judged against an allegation of negligence by the entrepreneur?¹⁴⁴⁹

Statutory recognition of the above stance followed in 2001.¹⁴⁵⁰ This was done through the adoption of section 180(2) of the Australian *Corporations Act*,¹⁴⁵¹ which provides for a statutory business judgment rule as a corollary to the statutory duty of care in terms of section 180(1). Section 180(2) reads as follows:

A director or other officer¹⁴⁵² of a corporation who makes a business judgment is taken to meet the requirements of subsection (1), and their equivalent duties at common law and in equity, in respect of the judgment if they:

- (a) make the judgment in good faith for a proper purpose; and
- (b) do not have a material personal interest in the subject matter of the judgment; and
- (c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
- (d) rationally believe that the judgment is in the best interests of the corporation.¹⁴⁵³

¹⁴⁴⁹ *Id* 501.

¹⁴⁵⁰ See Carrigan “The Role of Capital in Regulating the Duty of Care and Business Judgment Rule” (2002) 14 *Australian Journal of Corporate Law* for an insightful synopsis of the role played by the “business elite” in ensuring the enactment of the business judgment rule.

¹⁴⁵¹ *Corporations Act* 2001 (hereinafter *Australian Corporations Act*).

¹⁴⁵² Parties who are thus afforded the protection of the business judgment rule would, apart from directors, include other people who manage the corporation; receivers; and liquidators, etc, as indicated by the extended definition of the term “officer” in s 9 of the *Australian Corporations Act*. This study is, however, only concerned with the protection that this rule offers to directors of the company.

¹⁴⁵³ See Greenhow *supra* 46 – 48; and Kyrou “Directors’ Duties, Defences, Indemnities, Access to Board Papers and D&O Insurance Post CLERPA” (2000) 18 *Company & Securities Law Journal* 555 561 – 562 for more detail on the contents of the four elements of the business judgment rule.

The director's or officer's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.

Section 180(3) continues to define business judgment as “any decision to take or not take action in respect of a matter relevant to the business operations of the corporation”. In terms of this subsection it is clear that the Australian business judgment rule, like the American business judgment rule, is only applicable in respect of decisions to do, or not to do something, after judgment has been exercised in reaching the conclusion.¹⁴⁵⁴ It does therefore not extend to a failure to make a decision, or to the mere “rubber-stamping” of decisions.¹⁴⁵⁵ The subject matter of the decision must furthermore be relevant to the operations of the company.¹⁴⁵⁶

Compliance with the statutory business judgment rule only satisfies the duties under section 180(1) and the equivalent thereof at common law.¹⁴⁵⁷ Not all decisions are therefore protected by the business judgment rule.¹⁴⁵⁸ Decisions that are not so protected are, for example, decisions made in the context of insolvent trading, or decisions with regard to misstatements in a prospectus or takeover document.¹⁴⁵⁹

¹⁴⁵⁴ Greenhow *supra* 39.

¹⁴⁵⁵ *Ibid.*

¹⁴⁵⁶ Greenhow *supra* 39; Langford “The New Statutory Business Judgment Rule: Should it Apply to the Duty to Prevent Insolvent Trading?” (1998) 16 *Company & Securities Law Journal* 533 534.

¹⁴⁵⁷ S 180(2).

¹⁴⁵⁸ A note to the provision makes it clear that it does not operate in relation to duties under any other provision of law.

¹⁴⁵⁹ Greenhow *supra* 40; Kyrou *supra* 561; Langford *supra* 540.

9.2.3.3 Evaluation

9.2.3.3.1 Arguments in Favour of a Statutory Business Judgment Rule

9.2.3.3.1.1 Judiciary's Stance on Pronouncing on Business Decisions

The judiciary is well-known for its apparent reluctance to interfere with the management of the affairs of a company,¹⁴⁶⁰ perhaps because it feels ill-equipped to deal with such matters,¹⁴⁶¹ or is desirous to adhere to the legal doctrine that the *directors* and not the courts are burdened with managing the affairs of the company.

Whatever the reason for the reluctance, the application of the business judgment rule seems to fit perfectly with the way in which the judiciary feels itself equipped to or permitted to judge business decisions of directors, in that it only has to examine *process* due care and not the actual *merits* of the decision itself.¹⁴⁶²

The legal recognition that the business judgment rule affords to this role adopted by the courts may provide plaintiffs beforehand with an indication of whether or not a particular action should be brought against directors. Directors, on the other hand, will not be subjected to a review of their decisions by persons who may not be equipped to do so and who may furthermore enjoy the unfair advantage of hindsight.

9.2.3.3.1.2 Encouragement of Risk-Taking

The importance of allowing directors to be bold and take business risks is emphasised on many levels.¹⁴⁶³ The business judgment rule is seen as instrumental in encouraging

¹⁴⁶⁰ See eg *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 832 where the court made clear its sentiments that it would be wrong for the court to substitute its opinion for that of the management, or to question the correctness of the management's decision, as long as it was arrived at *bona fide*.

¹⁴⁶¹ A view shared by commentators. See eg Bradley & Schipani *supra* 24 who are of the opinion that courts "do not possess the requisite experience and expertise to make complex business decisions".

¹⁴⁶² See discussion *supra* par 9.2.3.1.

¹⁴⁶³ According to the American Law Institute's *Principles of Corporate Governance: Analysis and Recommendations* (1994) 176, as referred to by Redmond "Safe Harbour or Sleepy Hollows: Does Australia Need a Statutory Business Judgment Rule?" in Ramsay (ed) *Corporate Governance and the Duties of Company Directors* (1997) 185 199, the business judgment rule would provide a stimulus for "risk taking, innovation, and other creative entrepreneurial activities". In terms of the Australian Companies and Securities Law Review Committee *Company Directors and Officers: Indemnification, Relief and Insurance* Report No 10 (1990) par 76; as referred to by Redmond 199, a business judgment rule would "encourage business endeavour by assuring people who embark on business enterprises by specific legislation that if, acting honestly, they take risks there is some safeguard against personal liability flowing from tribunals reviewing with hindsight the merits of bona fide business decisions".

directors to take business risks, without the fear of personal liability continuously hanging over their heads.¹⁴⁶⁴ This, in turn, may attract directors of a high calibre to the office.¹⁴⁶⁵

9.2.3.3.1.3 Need for Protection at the Moment When Directors Take Business Judgments

According to the Australian Institute of Company Directors, there is a need to give directors certainty “at the time when they take their decisions, that if specified prerequisites are met that their decisions will be beyond challenge”.¹⁴⁶⁶ The business judgment rule may fulfil this function.¹⁴⁶⁷

9.2.3.3.1.4 Arguments from Fairness and Expediency

The recognition of a business judgment rule is also propagated on the basis of fairness and expediency.¹⁴⁶⁸ According to the “expediency argument”, shareholder welfare stands to benefit from encouraging risk taking,¹⁴⁶⁹ and is closely related to a previous

Numerous commentators hold the same view. See eg Herzel & Katz “*Smith v Van Gorkom*: The Business of Judging Business Judgment” (1986) 41 *The Business Lawyer* 1187 1189 who emphasise the importance of allowing directors to be bold and warn that caution on the part of directors should not be regarded as a virtue, but rather a “costly vice”.

¹⁴⁶⁴ Herzel & Katz *supra* 1189, in a critique of the decision in *Smith v Van Gorkom* 488 A 2d 858 (Del 1985), warn that an interpretation of the business judgment rule as in this case might not serve this purpose. Also see Greenhow *supra* 54 who emphasises the perceived importance of the business judgment rule in encouraging “responsible risk taking”.

¹⁴⁶⁵ Greenhow *supra* 54.

¹⁴⁶⁶ Australian Institute of Company Directors *Submission to the Attorney-General of the Commonwealth of Australia on the Exposure Draft (February 1992) of the Corporate Law Reform Bill 1992* (May 1992) 24 – 25, as referred to by Redmond *supra* 199.

¹⁴⁶⁷ Greenhow *supra* 54 agrees that the business judgment rule will provide “enhancement and clarification” as well as “an awareness of the duties owed”. Also see Arsalidou “Objectivity vs Flexibility in Civil Law Jurisdictions and the Possible Introduction of the Business Judgment Rule in English Law” (2003) 24 *The Company Lawyer* 228 231 for similar arguments.

¹⁴⁶⁸ Farrar “Corporate Governance, Business Judgment and the Professionalism of Directors” (1993) 6 *Corporate and Business Law Journal* 1 23 – 24 (hereinafter Farrar *Corporate Governance, Business Judgment and Professionalism*).

¹⁴⁶⁹ In the words of Farrar *Corporate Governance, Business Judgment and Professionalism* 23 – 24:

The expediency reason recognises that shareholders’ welfare may be better advanced by encouraging rather than restricting risk taking. Making directors liable for mere errors of judgment will promote risk adverse behaviour which will stifle economic growth.

Greenhow *supra* 54 and Arsalidou *supra* 231 make the same point.

argument in favour of the importation of the business judgment rule.¹⁴⁷⁰ The “fairness argument” is based thereon that directors are treated unfairly in the absence of a body of practice against which they are able to assess the acceptability of a business judgment.¹⁴⁷¹

9.2.3.3.2 Arguments against a Statutory Business Judgment Rule

9.2.3.3.2.1 Superfluity of a Statutory Business Judgment Rule

It is rightly noted that much of the uncertainty surrounding the exact content of the business judgment rule is caused by the unfortunate misnomer thereof as a “presumption”.¹⁴⁷²

In this respect, one is inclined to agree that the so-called “procedural presumption” is in fact not a presumption at all, but a mere restatement of traditional rules of evidence that the party alleging director misconduct is saddled with the burden of proving this.¹⁴⁷³ Should the plaintiff be unsuccessful with discharging the burden of proof, the defendant director will escape liability as a logical consequence of the application of these rules, and not because of some “presumption” that the director complied with his or her duties.

At the moment this is how the duty of care operates in South Africa and its current formulation allows ample scope for the judiciary to refrain from having to pass judgment on directors’ “business decisions”. In this regard there seems to be no

¹⁴⁷⁰ *Supra* par 9.2.3.3.1.2.

¹⁴⁷¹ Farrar *Corporate Governance, Business Judgment and Professionalism* 23 – 24 states:

The fairness justification focuses on the difference between good decisions which turn out badly and bad decisions. All professionals are liable for the latter. However, in the case of most professionals there is a body of practice against which one can judge what is acceptable conduct. This is not the case with company directors. Many of the decisions taken are complex decisions made on the basis of incomplete information and necessarily involve risk.

¹⁴⁷² Balotti & Hanks *supra* 1339.

¹⁴⁷³ Balotti & Hanks *supra* 1345 – 1347. Also see Johnson *supra* 627, who seems to agree that the “procedural burden-assigning function of the rule is rather trivial, and creating a doctrine simply to assign plaintiff a burden it already had is...unwarranted”.

reason to implement a statutory business judgment rule in South Africa. One has to agree, therefore, that there is a well-developed body of legal principle which “in function, if not in fact, embodies a business judgment rule”.¹⁴⁷⁴

A final argument that may be raised in this regard is that sufficient protection exists in terms of other provisions that provide the court with a discretion to grant directors relief from liability.¹⁴⁷⁵

9.2.3.3.2.2 Limited Application of and Protection Afforded by the Rule

The business judgment rule is also seen as not successfully providing directors with adequate protection. This is firstly because of the fact that it offers very limited coverage – it only protects directors against compensation liability which did not result from the exercise of corporate powers for an improper purpose, and does not protect them against possible injunctive relief, an account of profits or the declaration of a constructive trust.¹⁴⁷⁶

A director is furthermore required to be informed to an extent that he or she *reasonably* believes to be appropriate in the circumstances. This may open the door to directors’ decisions being challenged.¹⁴⁷⁷

In the third place, directors are only protected by the business judgment rule insofar as they actively exercised a business judgment. A major part of directors’ responsibilities, namely the supervisory process, is thus not covered by the protection offered by the business judgment rule.¹⁴⁷⁸

¹⁴⁷⁴ Redmond *supra* 202. Also see Redmond *supra* 185, where it is eloquently put that “there is no reason to believe that a statutory business judgment rule would offer superior protection to that provided by long established general law doctrines of directors’ duties which protect business judgments from inappropriate hindsight review, including review of the merits of the business judgment”. Arsalidou *supra* 231 refers to this as the “implied” or “unwritten” business judgment rule. Also see Havenga “The Business Judgment Rule – Should We Follow the Australian Example?” 2000 *SA Merc LJ* 25 37.

¹⁴⁷⁵ Eg s 248(1) of the South African *Companies Act*; s 1318(1) of the Australian *Corporations Act*; and s 727(1) of the English *Companies Act*.

¹⁴⁷⁶ Kyrou *supra* 561; Redmond *supra* 202.

¹⁴⁷⁷ Redmond *supra* 203.

¹⁴⁷⁸ Arsalidou *supra* 232.

9.2.3.3.2.3 Creation of Formalism

The business judgment rule, as applied in the United States of America, seems to protect directors against decisions that turn out badly, provided that the *procedure* involved in making the decision was acceptable. A decision that results from careful deliberation will thus be beyond reproach, even if the consequences of the decision were to the detriment of the company.

This may result in greater formalism on the part of the board of directors, when going about the business of “cultivating an aura of care, diligence, thoroughness, and circumspection”.¹⁴⁷⁹ Such formalism will obviously involve an increase in costs for the company, as directors may deem it as necessary to involve experts of every kind in all decisions of the board, should the process by which the decision was reached be questioned at a later stage.¹⁴⁸⁰

9.2.3.3.2.4 Realism About Shareholder Litigation Risk

There is a relatively small number of cases where proceedings were brought against directors for a breach of their duty of care. One of the reasons for this may be that shareholder remedies for enforcement of directors’ duties are inadequate and that this presents a “serious obstacle to their function of setting standards of conduct”.¹⁴⁸¹ In light of this fact one is inclined to agree that any further barriers to shareholder action, for example a statutory business judgment rule, will require “formidable justification”.¹⁴⁸²

9.2.3.3.2.5 Effect of a Statutory Rule On the Content of a Duty of Care

The exact relationship between the business judgment rule and the duty of care is a source of great confusion,¹⁴⁸³ with some seeing the business judgment rule as defining

¹⁴⁷⁹ Herzel & Katz *supra* 1191.

¹⁴⁸⁰ *Ibid.*

¹⁴⁸¹ Redmond *supra* 203.

¹⁴⁸² *Ibid.*

¹⁴⁸³ Hinsey *supra* 614; Johnson *supra* 636 describes the relationship between the duty of care and the business judgment rule as “one of the most important, but least understood relationships in corporate law.”

the contents of directors' duty of care.¹⁴⁸⁴ Others, however, regard it as a “tool of judicial review rather than a standard of conduct”.¹⁴⁸⁵

In some enquiries pertaining to director misconduct, however, the enquiry as to whether due care has been exercised was apparently subsumed by the presumption embodied in the business judgment rule.¹⁴⁸⁶

One therefore has to disagree with those who see the business judgment rule as a “tool of judicial review rather than a standard of conduct”,¹⁴⁸⁷ as the business judgment rule, or the interpretation thereof, most certainly seems to lay down some standard of conduct. This standard of conduct, namely gross negligence, seems to justify concerns that a statutory business judgment rule will lower the risk of director liability, if not formally, at least substantially, thus compromising the standard of care required from directors.¹⁴⁸⁸

¹⁴⁸⁴ Cohn *supra* 594. According to Johnson *supra* 642 “the Delaware business judgment rule both preceded articulation of the due care duty and later enveloped care..., thereby ‘triumphing,’ if you will, over the duty of care as the more pre-eminent and central corporate law precept in Delaware”.

¹⁴⁸⁵ Cieri, Sullivan & Lennox *supra* 405.

¹⁴⁸⁶ According to Cohn *supra* 594 the business judgment rule which “began as an adjunct to duty of care standards” has now “enveloped the primary inquiry”. He notes that the courts “frequently invoke the due care standard and then proceed to the business judgment rule with only a cursory due care analysis” (*id* 594 n 9). This leads him to question whether the reasonable care standard is still a viable means for corporate governance, seeing that it is “doubtful whether there still exists a sanction for lack of care, unadulterated by self-enrichment or other opprobrious behavior” (*id* 594 – 595). Johnson *supra* 625 ascribes this “conceptual misuse” of the business judgment rule to the “late emergence of, and still unformed contours of, the duty of care”, in contrast to the well-developed business judgment rule, which led to the business judgment rule becoming and remaining the pre-eminent legal precept in Delaware corporate law.

¹⁴⁸⁷ Cieri, Sullivan & Lennox *supra* 405.

¹⁴⁸⁸ Redmond *supra* 204. Also see Carrigan *supra* 219, who describes the business judgment rule as a “safe harbour device...directed at diluting the standard of care”; Johnson *supra* 644, who bemoans the “functional downgrading of due care” by the business judgment rule; and Ubelaker *supra* 791 – 792 who concludes that “the true function of the business judgment rule has been to shield directors from application of an ordinary care standard of conduct” and that the use of the business judgment rule “has weakened the negligence standard that is relevant to mismanagement issues” and even “excised the requirement that directors exercise ordinary care in the conduct of their offices”. See Johnson *supra* 639 – 644 for an explanation, with reference to the development of the business judgment rule and duty of care, of how the duty of care came to be subsumed by the business judgment rule.

Apart from the *standard* of the duty that is being compromised through the application of the business judgment rule, the *content* of the duty also seems to be under threat by the business judgment rule. Application of the rule results in the duty to be “thinned” to nothing more than a requirement that directors be “informed” before exercising judgment.¹⁴⁸⁹ Eventually the only remnant of the duty of care might be the requirement to be diligent.¹⁴⁹⁰

9.2.3.3.2.6 Doctrinal Conflicts

With regard to the enactment of a business judgment rule in Australia, it was noted that one should be careful of “engrafting united States norms upon Anglo-Australian corporate jurisprudence, disregarding the potential pitfalls of such unreflective importation”.¹⁴⁹¹ These fears are equally valid with regard to South African company law which is largely based on English law. Importation of the business judgment rule will not sit easily alongside many common-law principles and doctrinal conflicts between principles pertaining to the common-law duty of care and the duty of care in terms of the business judgment rule seem probable.¹⁴⁹²

9.2.3.3.2.7 Uncertainty Regarding Parameters of the Business Judgment Rule

The exact parameters and application of the business judgment rule present problems even in its jurisdiction of origin.¹⁴⁹³ The failure to define the parameters of the

¹⁴⁸⁹ Johnson *supra* 643 states that it is unfortunate that the business judgment rule is able to “stunt the growth of a vigorous, all-encompassing duty of due care by delimiting that core duty to a duty to ‘be informed’”.

¹⁴⁹⁰ See discussion *supra* Ch 6 (Protection Afforded by the Duty of Care and Skill) par 6.3.1 for more detail on the elements of the duty of care, namely care, skill and diligence.

¹⁴⁹¹ Santow “Codification of Directors’ Duties” (1999) 73 *Australian Law Journal* 336 349. Also see Havenga *supra* 36 who cautions that “[t]ransposing only one aspect of directors’ duties can have unforeseen consequences”. Santow 348 furthermore warns that the unreflective importation of the rule resulted in the “so-called safe harbour” to have been “mined by statutory depth charges awaiting the unwary director”.

¹⁴⁹² These fears do not seem unfounded in light of the statement of Johnson *supra* 636 that the relationship between “on the one hand, the far-reaching, always-applicable director duty of due care and, on the other hand, the more finely drawn policy of non-review housed in the business judgment rule, is one of the most important, but least understood, relationships in corporate law”.

¹⁴⁹³ Hansen *supra* 1360 refers to various cases in which formulations for the rule were advanced and concludes that these formulations “by and large, lack clarity and consistency”.

business judgment rule results in attempts to quantify the degree of care that a director owes to his corporation being stifled substantially.¹⁴⁹⁴

In an attempt to clarify the parameters of the business judgment rule, some commentators suggest that a distinction is to be made between the business judgment *rule*, which shields directors from liability, and the business judgment *doctrine*, which protects the decision itself.¹⁴⁹⁵ It is conceded, however, that the elements of the rule and the doctrine are exactly the same, a fact which “undoubtedly contributed to the widespread tendency to overlook the distinction”.¹⁴⁹⁶

9.2.4 Application to a Duty to Creditors

The point was made that directors should have access to adequate measures that provide relief from liability, in order to address the concerns that a duty to creditors may impact detrimentally on directors’ risk-taking ability and that it may deter people from serving on company boards.

In light of the preceding discussion it is very doubtful, however, whether the business judgment rule could contribute in this regard and it is submitted that the statutory importation thereof should be considered with great circumspection.

This view is held because of two reasons, namely that the business judgment rule is doctrinally unsuitable in a South African company law context and, secondly, that the perceived value of the business judgment rule as a “safe harbour” is over-estimated and that there is actually no need for such a rule.

The first argument is supported by various factors.

¹⁴⁹⁴ Ubelaker *supra* 775.

¹⁴⁹⁵ See eg Hinsey *supra* 611 – 612 who ascribes the “misunderstanding and confusion” surrounding the business judgment rule to the fact that courts and commentators generally fail to make this distinction.

¹⁴⁹⁶ *Id* 612.

It was indicated that the relationship between the business judgment rule and the duty of care is far from clear in its jurisdiction of origin, mainly due to historical reasons – specifically the development of the duty of care after the business judgment rule was already in full force. The duty of care has a very definite place in South African company law and the ill-considered grafting of a foreign concept onto a legal system based on a very dissimilar conceptual foundation may cause many unforeseen problems and uncertainties.¹⁴⁹⁷

The business judgment rule also seems to intermingle what is in South Africa regarded as two separate duties, namely directors' fiduciary duties and their duty of care, further strengthening the argument that it is doctrinally unsuitable in the South African company law context.¹⁴⁹⁸

A last argument in this respect is that it is uncertain how the business judgment rule will function alongside a provision such as section 248(1) of the South African *Companies Act*, in terms of which the court may exercise its discretion to grant directors relief from liability for a breach of their duties under certain circumstances.¹⁴⁹⁹

¹⁴⁹⁷ Santow *supra* 350 refers to these problems as “statutory depth charges” with which the so-called “safe harbour” is mined.

¹⁴⁹⁸ The elements of the business judgment rule are that directors are presumed to have made informed decisions and to have acted with the necessary care when doing so. This relates to what is known in South Africa as the duty of care and skill. The other elements, however, namely actions in good faith and the absence of personal interest fit more comfortably with directors' fiduciary duties. In South Africa the basis of liability for a breach of each of these categories is totally different and a combination of the elements thereof in a business judgment rule may present serious problems. A codification of the common law duties will have the effect that the basis of liability will become statutory and will be similar for both categories of duties. It is doubtful, however, whether it will be possible to divorce such codified duties completely from their common law predecessors and the conceptual differences are likely to remain.

¹⁴⁹⁹ The Australian legislature retained the equivalent of the South African s 248(1), namely s 1318 of the Australian *Corporations Act*, as well as providing for a statutory business judgment rule. Australian commentators do not seem to be overly concerned with the way in which these two provisions will operate alongside each other. It is submitted, however, that two such conceptually different powers of the court may create more confusion than it does provide protection.

The second reason, pertaining to the superfluity of the business judgment rule, derives from the fact that the protection afforded by the business judgment rule is limited¹⁵⁰⁰ and that the substance thereof is in fact applied in an informal manner.¹⁵⁰¹ It may also have the unforeseen result of increasing the burden that already rests on directors in terms of their duties to the company.¹⁵⁰²

In relation to a duty to creditors specifically, there is doubt as to whether the business judgment is applicable, with authors holding conflicting views on its application in insolvency.¹⁵⁰³ Commentators also indicated that directors will be required to show that they considered the interests of creditors, even if it is accepted that a modified business judgment rule applies in insolvency.¹⁵⁰⁴

Directors are furthermore afforded possible relief from liability in terms of specific statutory provisions to this effect.¹⁵⁰⁵

It is true that these statutory provisions are not without problems and for them to fulfil the crucial role of ensuring a balance between allowing directors freedom to take

¹⁵⁰⁰ See discussion *supra* par 9.2.3.3.2.2.

¹⁵⁰¹ In the discussion *supra* par 9.2.3.3.2.1 it was indicated that the business judgment is merely a formal embodiment of the way in which the duty of care is approached by the courts, who are reluctant to pronounce on business decisions of directors, anyway. The current approach adopted by the courts may even offer better protection than a formal business judgment rule. In this regard one is inclined to agree with Davies “Self-Incrimination, Fair Trials, and the Pursuit of Corporate and Financial Wrongdoing” in Markesinis (ed) *The Impact of the Human Rights Bill on English Law* (1998) 50 – 58, as referred to by Santow *supra* 351, that

ex post customising of the standard of care is likely to be of greater benefit to directors than ex ante fixing of identifiable safe harbours – because the former is feasible whilst the latter is not without producing an unacceptable rigidity in judicial decision-making.

¹⁵⁰² Farrar *Duty of Care* 90 – 91, with reference to the United States experience, warns that the introduction of a business judgment rule, without a concomitant “tightening up” on disclosure requirements and the effective regulation of self-interested transactions, may bode very ill for investors.

¹⁵⁰³ See eg Coogan, Bermont & Glatt *supra* 1375; and Varallo & Finkelstein *supra* 245.

¹⁵⁰⁴ Cieri, Sullivan and Lennox *supra* 421.

¹⁵⁰⁵ S 248(1) of the South African *Companies Act*; s 727 of the English *Companies Act*; and s 1318 of the Australian *Corporations Act*.

calculated business risks without the fear of personal liability should these decisions turn out badly, and being held accountable for their actions, certain issues need to be addressed.¹⁵⁰⁶ As indicated in the above discussion¹⁵⁰⁷ these problems may be addressed without too much difficulty.

One can therefore not help but agree with various authors that the enactment of a business judgment rule is not only unnecessary, but also undesirable.¹⁵⁰⁸

9.3 INDEMNIFICATION

9.3.1 Introduction

One way in which directors may escape liability in case of a breach of their duties, is through exemption from or indemnification against liability.¹⁵⁰⁹ Such indemnification or exemption may, for example, be provided for by a company's articles of association, or in a contract between the director and the company.

Legislation in most jurisdictions draws a distinction between general indemnification and indemnification against liability for legal expenses. The extent to which exemption or indemnification may be granted is regulated to various degrees of strictness in the various jurisdictions. This section commences with a comparative

¹⁵⁰⁶ Pasban, Campbell and Birds *supra* 213 raised the issue that

the relief under section 727 has been an effective tool of protecting corporate directors. However, the courts have perhaps failed to resolve some of the problems and ambiguities inherent in this section. The section is in need of amendment.

¹⁵⁰⁷ *Supra* par 9.2.2.4.

¹⁵⁰⁸ See eg Arsalidou *supra* 233 who, after having weighed up various factors in favour of and against the introduction of a statutory business judgment rule, comes to the conclusion that "there is no pressing urgency to adopt a business judgment rule in the United Kingdom". Also see Botha & Jooste "A Critique of the Recommendations in the *King Report* Regarding a Director's Duty of Care and Skill" 1997 *SALJ* 65 67; and Havenga *supra* 37.

¹⁵⁰⁹ The terms "indemnification" and "exemption" are used in different ways in the various jurisdictions. In South Africa and England no clear distinction is made between the two concepts, whereas the Australian legislature decided to treat them in two separate subsections. New Zealand, on the other hand, has no provision regarding "exemption", but "indemnification" is formulated widely enough to cover both concepts. See discussion *infra* for more detail on the relevant statutory provisions in these jurisdictions. Where these terms are to be distinguished from one another regarding meaning and application, it will be clearly indicated.

study of how indemnity and exemption are regulated in various jurisdictions, after which the way in which it may be applied in respect of a duty to creditors is evaluated.

9.3.2 Statutory Regulation

9.3.2.1 South Africa

Section 247(1) of the South African *Companies Act* makes it clear that directors and others¹⁵¹⁰ may not be exempted from or indemnified against liability through private arrangements between themselves and the company, which would otherwise attach to them in respect of negligence, default, breach of duty or breach of trust.¹⁵¹¹ The relevant part of this provision reads as follows:

[A]ny provision, whether contained in the articles of a company or in any contract with a company, and whether expressed or implied, which purports to exempt any director or officer or the auditor of the company from any liability which by law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company or to indemnify him against any such liability, shall be void.

Section 247(1), however, does not prohibit the ratification of such conduct by the company in general meeting.¹⁵¹²

¹⁵¹⁰ This study is particularly concerned with directors, their duties and how they may be provided with relief from liability in case of a breach of these duties. The position in respect of other parties mentioned in terms of ss 247 and 248 and equivalent provisions in other jurisdictions, namely auditors and officers of the company, falls outside the scope of this contribution and is not discussed in any detail.

¹⁵¹¹ A similar provision was first adopted in England on recommendation of the Greene Committee on Company Law, Cmd 2657, which was appointed partly as a response to the public scandal arising from the affairs of the City Equitable Fire Insurance Co, which resulted in *In re City Equitable Fire Insurance Co* [1925] 1 Ch 407. See Baker “Disclosure of Directors’ Interests in Contracts” 1975 *Journal of Business Law* 181 186 for an overview of the historical development of this provision. This provision was introduced in SA on recommendation of the Lansdown Commission *Report of the Company Law Commission 1935 – 1936* UG No 45 1936 par 135 to put a stop to the practice of providing for the indemnity of directors in the articles of association for all liability other than that based on dishonesty (see Blackman “Exemption of Directors from Liability and Section 247(1) of the *Companies Act, 1973*” 1993 *THRHR* 537; and Cilliers & Benade *Corporate Law* (2000) par 10.55).

¹⁵¹² Du Plessis *Maatskappyregtelike Grondslae van die Regsposisie van Direkteure en Besturende Direkteure* LLD UOVS (1990) 78 – 79.

Subsection (2) furthermore provides for the indemnification of a director by the company under very limited circumstances. These are where the director incurred liability in defending civil or criminal proceedings and judgment was given in his favour; or where he was acquitted; or in respect of proceedings that were abandoned; or in connection with an application under section 248¹⁵¹³ in which relief is granted to him by the court.

9.3.2.2 Australia

In Australia indemnities and exemption are provided for by sections 199A¹⁵¹⁴ and 199C of the Australian *Corporations Act*.¹⁵¹⁵

Exemption and indemnification are dealt with in separate provisions. In terms of the provision pertaining to *exemption* a company or related body corporate is not allowed to exempt a person, directly or indirectly,¹⁵¹⁶ from a liability to the company incurred as an officer of the company.¹⁵¹⁷

The provision dealing with *indemnification* provides that a company or related body corporate is not allowed to indemnify a person by agreement, or by making a payment, whether directly or indirectly,¹⁵¹⁸ against particular liability incurred as an officer.¹⁵¹⁹ Liability includes “a liability owed to the company or a related body corporate”;¹⁵²⁰ “a liability for a pecuniary penalty order under section 1317G¹⁵²¹ or a

¹⁵¹³ See *supra* par 9.2.2.1 for more detail on s 248.

¹⁵¹⁴ Titled “Indemnification and exemption of officer or auditor”.

¹⁵¹⁵ Titled “Certain indemnities, exemptions, payments and agreements not authorised and certain documents void”.

¹⁵¹⁶ Ie “[t]hrough an interposed entity” (s 199A(1)).

¹⁵¹⁷ S 199A(1).

¹⁵¹⁸ Ie “[t]hrough an interposed entity” (s 199A(2)).

¹⁵¹⁹ S 199A(2).

¹⁵²⁰ S 199A(2)(a).

¹⁵²¹ In terms of s 1317G a court is authorised to order a person to pay a pecuniary penalty of up to A\$ 200 000, if the court makes a declaration that the person has contravened a civil penalty provision and certain other conditions are met. Civil penalty provisions include eg s 180(1), dealing with directors’ duty of care and diligence; as well as ss 181(1) and (2); 182(1) and (2); and 183(1) and (2), dealing

compensation order under section 1317H”;¹⁵²² ¹⁵²³ or “a liability that is owed to someone other than the company or a related body corporate and did not arise out of conduct in good faith”.¹⁵²⁴

The regulation of indemnity for legal costs is dealt with in a separate subsection.¹⁵²⁵ Section 199A(3) prohibits a company or related body corporate from indemnifying a person by agreement or by making a payment, directly or indirectly,¹⁵²⁶ against specific legal costs incurred as an officer of the company. The legal costs that such a person may not be indemnified against are those incurred “in defending or resisting proceedings in which the person is found to have a liability for which they could not be indemnified under subsection (2)”;¹⁵²⁷ “in defending or resisting criminal proceedings in which the person is found guilty”;¹⁵²⁸ “in defending or resisting proceedings brought by ASIC or a liquidator for a court order if the grounds for making the order are found by the court to have been established”;¹⁵²⁹ or “in connection with proceedings for relief to the person under this Law in which the Court denies the relief”.¹⁵³⁰

with fiduciary type obligations. See *supra* Ch 5 (Protection Afforded by Fiduciary Duties) par 5.4.4 and *supra* Ch 6 (Protection Afforded by the Duty of Care and Skill) par 6.4.2 for more detail on the operation of the civil penalty provisions.

¹⁵²² S 1317H provides that a court may order a person to compensate a corporation for damage suffered by it as a result of a contravention of a civil penalty provision by that person.

¹⁵²³ S 199A(2)(b).

¹⁵²⁴ S 199A(2)(c).

¹⁵²⁵ S 199A(3). The fact that indemnity against particular liabilities and indemnity against legal costs are to be treated strictly separately, does not only follow from the treatment thereof in separate subsections, but also from the heading of subsection (2), which reads: “When indemnity for liability (*other than for legal costs*) are not allowed” (own emphasis) and from the fact that subsection (2) itself expressly provides that it is not applicable to a liability for legal costs.

¹⁵²⁶ Ie “[t]hrough an interposed entity” (s 199A(3)).

¹⁵²⁷ S 199A(3)(a).

¹⁵²⁸ S 199A(3)(b).

¹⁵²⁹ S 199A(3)(c).

¹⁵³⁰ S 199A(3)(d). The proceedings for relief that are referred to here, are probably in relation to s 1318. See *supra* par 9.2.2.2 for more detail on this provision.

Anything that purports to indemnify a person against, or exempt him from a liability, is void insofar as it contravenes section 199A.¹⁵³¹

A related provision, section 212, furthermore provides that any benefit to directors by way of an indemnity, exemption or insurance premium pertaining to a liability incurred as an officer of that company, or an agreement to that effect, is not subject to the approval of the members of the company,¹⁵³² provided that to give the benefit will be reasonable in the circumstances.¹⁵³³ Member approval is also not necessary in respect of the making of, or agreement to make, a payment in respect of legal costs incurred by a director in defending an action for a liability incurred as an officer of the company,¹⁵³⁴ provided that it will be reasonable to give the benefit in the circumstances.¹⁵³⁵ The director will have to repay the amount if section 199A applies to the costs and the costs become costs for which the company should not have indemnified the director.¹⁵³⁶

9.3.2.3 New Zealand

The New Zealand *Companies Act* does not permit a company to indemnify a director of the company or a related company in respect of “[l]iability for any act or omission in his or her capacity as a director”,¹⁵³⁷ or in respect of “[c]osts incurred by that director...in defending or settling any claim or proceeding relating to any such liability”,¹⁵³⁸ unless the Act expressly states otherwise. Any indemnity provided in breach of this provision, is void.¹⁵³⁹

¹⁵³¹ S 199C(2).

¹⁵³² S 212(1).

¹⁵³³ S 212(1)(c).

¹⁵³⁴ S 212(2). In terms of this provision, payment can be “by way of advance, loan or otherwise”.

¹⁵³⁵ S 212(2)(d). S 212(3) lists factors that could be considered in order to determine whether the benefit was “reasonable in the circumstances”, for the purposes of ss 212(1)(c) and 212(2)(d).

¹⁵³⁶ S 212(2)(c)(ii).

¹⁵³⁷ S 162(1)(a).

¹⁵³⁸ S 162(1)(b).

¹⁵³⁹ S 162(2).

Section 162 lists the circumstances under which indemnity may be provided. Both of these “exceptions” to the general prohibition is subject to express authorisation granted in the company’s constitution.¹⁵⁴⁰ In terms of the first exception a company may indemnify a director of a company or a related company for any costs incurred by him in any proceeding that relates to “liability for any act or omission in his or her capacity as a director”¹⁵⁴¹ and in which “judgment is given in his or her favour, or in which he or she is acquitted, or which is discontinued”.¹⁵⁴²

In terms of the second exception a director of the company, or a related company, may be indemnified in respect of “[l]iability to any person other than the company or a related company for any act or omission in his or her capacity as a director”,¹⁵⁴³ as well as “[c]osts incurred by that director...in defending or settling any claim or proceeding relating to any such liability”,¹⁵⁴⁴ provided that the liability is not criminal liability, or liability in respect of a breach of the director’s duty in terms of section 131¹⁵⁴⁵ of the Act.¹⁵⁴⁶

Should indemnity be granted to a director of the company or a director of a related company, the board of the company is required to ensure that the particulars of the indemnity are entered into the interests register.¹⁵⁴⁷

The New Zealand *Companies Act* does not expressly prohibit *exempting* a director from liability. The statutory definition of “indemnify”, namely that it “includes relief

¹⁵⁴⁰ Ss 162(3) and 162(4) commence with the phrase “A company may, *if expressly authorised by its constitution*” (own emphasis).

¹⁵⁴¹ S 162(3)(a).

¹⁵⁴² S 162(3)(b).

¹⁵⁴³ S 162(4)(a).

¹⁵⁴⁴ S 162(4)(b).

¹⁵⁴⁵ S 131 relates to directors’ duties to act in good faith and in the best interests of the company. See *supra* Ch 5 (Protection Afforded by Fiduciary Duties) par 5.2.3 for more detail.

¹⁵⁴⁶ S 162(4).

¹⁵⁴⁷ S 162(7).

or excuse from liability, whether before or after the liability arises” is wide enough, however, to cover the concept of exemption as well.¹⁵⁴⁸ One issue that arises because of this wide definition is that it becomes questionable whether shareholder ratification itself will be effective to relieve a director from liability.¹⁵⁴⁹

9.3.2.4 England

Section 310 of the English *Companies Act*¹⁵⁵⁰ is the equivalent of section 247 of the South African *Companies Act*. In terms of section 310(1) and (2) “any provision, whether contained in a company’s articles or in any contract with the company or otherwise” which purports to exempt a director, officer¹⁵⁵¹ or auditor of a company from, or to indemnify him against “any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company” shall be void.

Subsection (3), however, provides that this prohibition does not prevent a company from indemnifying a director against liability incurred by him in successfully defending any civil or criminal proceedings¹⁵⁵² or in connection with any application under section 144¹⁵⁵³ or section 727.^{1554 1555}

¹⁵⁴⁸ S 162(9). It is furthermore stated that “indemnity” has a corresponding meaning.

¹⁵⁴⁹ Jones *Company Law in New Zealand: A Guide to the Companies Act 1993* (1993) 164. Cranston *supra* 198 raises a similar concern in respect of s 310 of the English *Companies Act*, the equivalent provision in England, should this provision be broadly interpreted. See *infra* par 9.3.2.4 for more detail on s 310.

¹⁵⁵⁰ *Companies Act*, 1985 (hereinafter English *Companies Act*).

¹⁵⁵¹ It is possible that the prohibition against indemnifying officers of the company, as opposed to directors, may be lifted. The Company Law Review *Modern Company Law for a Competitive Economy: Final Report Vol I* (London, DTI, 2001) par 6.3 indicates that it is not believed that s 310 should apply to liability of officers, other than directors. The reason for this is that it is “ultimately a matter for the board to determine the conditions of employment of senior employees” (*ibid*).

¹⁵⁵² S 310(3)(b)(i).

¹⁵⁵³ Dealing with the acquisition of shares by an innocent nominee.

¹⁵⁵⁴ With reference to the general power that the court has to grant relief in case of honest and reasonable conduct. See *supra* par 9.2.2.3 for more detail.

¹⁵⁵⁵ S 310(3)(b)(ii).

9.3.2.5 Canada

Section 124(1) of the *Canada Business Corporations Act*¹⁵⁵⁶ allows a corporation to indemnify a director against “all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment, reasonably incurred by the individual in respect of any civil, criminal, administrative, investigative or other proceeding in which the individual is involved because of that association with the corporation”.

This is subject, however, to the director having acted “honestly and in good faith with a view to the best interests of the corporation”¹⁵⁵⁷ and to having had reasonable grounds for believing that his conduct was lawful.¹⁵⁵⁸ The director should furthermore not have been judged by a court to have “committed any fault or omitted to do anything that the individual ought to have done”.¹⁵⁵⁹

9.3.2.6 United States of America

Concerns were raised that the decision in *Smith v Van Gorkom*¹⁵⁶⁰ and the consequent insurance crisis, manifesting itself in high premiums and deductibles, reduced capacity, and the broadening of existing exclusions from coverage and drafting of new ones,¹⁵⁶¹ may deter directors from serving on corporate boards.¹⁵⁶² This prompted the Delaware General Assembly to amend its corporate code.¹⁵⁶³

¹⁵⁵⁶ RSC 1985, cC-44 (hereinafter *CBCA*).

¹⁵⁵⁷ S 124(3)(a).

¹⁵⁵⁸ S 124(3)(b). S 124(3) is titled “Limitation”, but is referred to in other subsections, eg ss 124(2); 124(4); and 124(5)(b) as “conditions”.

¹⁵⁵⁹ S 124(5)(a). S 124(5) is titled “Right to indemnity”.

¹⁵⁶⁰ *Supra*.

¹⁵⁶¹ Caraccio *supra* 940.

¹⁵⁶² Weiss *supra* 638.

¹⁵⁶³ The *Delaware General Corporation Law* Del Code Ann tit 8 (1991) (hereinafter *DGCL*). According to Veasey, Finkelstein & Bigler “Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance” (1987) 42 *The Business Lawyer* 399 401, the legislature extended indemnification rights principally in response to the insurance crisis that arose as a result of the decision in *Smith v Van Gorkom supra*. Also see Caraccio *supra* 930 who convincingly shows that there were numerous other factors also contributing to the insurance crisis and who is of the opinion that the D & O crisis itself is but a component of the larger liability insurance crisis affecting American society (*id* 998).

In terms of one such an amendment, section 102(b)(7), a Delaware corporation may include in its articles of incorporation a clause eliminating or limiting directors' personal liability to the corporation for a breach of their duty of care.¹⁵⁶⁴ This provision reads as follows:

(b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section the certificate of incorporation may also contain any or all of the following matters –

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under section 174 of this Title, or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this subsection to a director shall also be deemed to refer to a member of the governing body of a corporation which is not authorized to issue capital stock.

It is clear that liability for a breach of the director's duty of loyalty; acts or omissions not in good faith, involving intentional misconduct, or a knowing violation of the law; wilful or negligent conduct in stock transactions; or any transaction from which the director derived an improper personal benefit may not be limited or done away with.¹⁵⁶⁵ It is uncertain, however, whether this amendment exempts directors from liability from recklessness.¹⁵⁶⁶

¹⁵⁶⁴ Veasy, Finkelstein & Bigler *supra* 403 indicate that this provision does not have the effect of eliminating the duty of care, but only liability in respect thereof. The duty of care still has a role to play in remedial contexts, eg in injunction and rescission cases and may also be relevant in the context of elections, proxy contests, resignations and removals, but no longer in actions against directors for personal monetary damages.

¹⁵⁶⁵ Weiss *supra* 644.

¹⁵⁶⁶ Weiss *supra* 644 n 54.

This is an enabling provision, which means that a corporation will have to amend its certificate of incorporation to be able to grant directors the protection against personal liability envisaged in terms of this provision.¹⁵⁶⁷ The power to amend the articles of incorporation in this way rests with the shareholders.¹⁵⁶⁸ Weiss is in favour of this approach for three reasons. The first reason is based on the principle that it is “shareholders who own the corporation; the directors merely run it”.¹⁵⁶⁹ It is furthermore shareholders’ money which is at stake and it will finally not interfere with the power of the shareholders to “approve or disapprove major changes in their corporation’s structure”.¹⁵⁷⁰

The end result of section 102(b)(7) is a “reduction in the overall sphere of liability to which a director is otherwise exposed”.¹⁵⁷¹

Directors’ rights to indemnification were also expanded insofar as their involvement in actual or threatened litigation or an investigation by reason of the status of that person as director is concerned. In terms of section 145(a) a corporation may firstly indemnify a director “against expenses (including attorneys’ fees), judgments, fines and amounts paid in settlement...if he acted in good faith and in a manner he reasonably believed to be in...the best interests of the corporation”.¹⁵⁷² This subsection is not applicable to actions brought by the corporation and is therefore only relevant in respect of third-party actions.¹⁵⁷³

¹⁵⁶⁷ Veasey, Finkelstein & Bigler *supra* 402. This is called an “opt in” election. All states do not follow this option. See Weiss *supra* 647 *et seq* for a discussion of the way in which the various states amended their corporate statutes to limit directors’ liability for a breach of the duty of care, distinguishing specifically between enabling statutes, such as the *DGCL*, and self-executing statutes, eg as in Indiana.

¹⁵⁶⁸ Weiss *supra* 647.

¹⁵⁶⁹ *Ibid.*

¹⁵⁷⁰ *Ibid.*

¹⁵⁷¹ Veasey, Finkelstein & Bigler *supra* 403 – 404.

¹⁵⁷² S 145(a).

¹⁵⁷³ Veasey, Finkelstein & Bigler *supra* 404.

Section 145(b) applies to actions brought against directors by the corporation itself and provides for indemnification for attorneys' fees and other expenses, but not for judgments or amounts paid in settlement.¹⁵⁷⁴

Mandatory indemnification against expenses and attorneys' fees in respect of an action that was successfully defended by the director is provided for by section 145(c).¹⁵⁷⁵ This provision reads as follows:

To the extent that a director...of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) and (b) of this section, or in defense of any claim, issue or matter therein, he shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by him in connection therewith.

In light of the phrase "successful on the merits or otherwise", it is clear that section 145(c) provides for mandatory indemnification as a matter of right, irrespective of whether the director won judgment in his favour on the merits, or whether he successfully relied upon a technical defence.¹⁵⁷⁶ What is not so clear, however, is whether this provision also applies in respect of a victory that is "less than total".¹⁵⁷⁷

The indemnification referred to in subsections (a) and (b) does not occur automatically and must be duly authorized by the appropriate decision maker.¹⁵⁷⁸ The "appropriate decision maker" may be the board of directors by a majority vote of a

¹⁵⁷⁴ Weiss *supra* 656 warns against the anomaly that would occur if a corporation was permitted to indemnify directors for amounts paid in settlement where an action was brought against the director by the corporation. This would entail that the corporation, as plaintiff, would receive money in damages, which it would then pay back to the delinquent director. On this point also see Bradley & Schipani *supra* 32; and Veasy, Finkelstein & Bigler *supra* 405 – 406.

¹⁵⁷⁵ S 145(c).

¹⁵⁷⁶ Veasey, Finkelstein & Bigley *supra* 406.

¹⁵⁷⁷ Veasey, Finkelstein & Bigley *supra* 406. Johnston *supra* 1998 is of the opinion that the phrase "to the extent that" indicates that a director who is partially successful will be entitled to be partially indemnified.

¹⁵⁷⁸ S 145(d).

disinterested quorum;¹⁵⁷⁹ independent legal counsel,¹⁵⁸⁰ should a quorum not be obtainable, or should a quorum of disinterested directors so direct; or the stockholders.¹⁵⁸¹ Section 145(d) furthermore stipulates that indemnification shall be made “*only as authorized in the specific case*”, indicating that it will not be possible to authorise indemnification in advance on the basis of a purported blanket authority.

Attorneys’ fees and other legal expenses incurred by a director may be paid in advance by the corporation, provided that the director furnishes the corporation with a receipt and an undertaking to repay the amount advance if it is ultimately determined that the director is not entitled to indemnification.¹⁵⁸²

It is also expressly provided that legislation is not the exclusive source of indemnity.¹⁵⁸³ It is thus possible to provide for more extensive protection through a by-law or an agreement specifically drafted for that purpose.¹⁵⁸⁴

¹⁵⁷⁹ Veasy, Finkelstein & Bigley *supra* 409 note that these directors are required to exercise this authority in good faith and in the exercise of due care.

¹⁵⁸⁰ Johnston *supra* 1999 suggests that independent legal counsel will be “special counsel appointed for this purpose only”.

¹⁵⁸¹ S 145(d).

¹⁵⁸² S 145(e).

¹⁵⁸³ In terms of s 145(f), which provides:

The indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any by-law, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office.

¹⁵⁸⁴ Johnston *supra* 1996. He warns, however, that there will undoubtedly be public policy limitations on how far such measures could go beyond the statutory formulation.

9.3.3 Application to a Duty to Creditors

9.3.3.1 *General Indemnity and Exemption*

9.3.3.1.1 *General*

It is clear that exemption from or indemnification against liability is regulated according to varying degrees of strictness in different jurisdictions. At the one end of the spectrum is Delaware, where it is permissible for a company to indemnify a director against any liability to the company resulting from a breach of the duty of care.¹⁵⁸⁵ At the opposite end of the spectrum are those jurisdictions, for example Australia and New Zealand, where exemption and indemnification are regulated very strictly and even to such an extent that the prohibition against it applies in a group context. South Africa and England lie somewhere in between, not being as liberal as Delaware, but allowing more room for exemption or indemnification than Australia and New Zealand, as indemnification by a subsidiary to a director of its holding company, for example, does not seem to be prohibited expressly.

At the outset of this chapter the importance of allowing directors room to take calculated business risks was emphasised. It was also indicated that it is not desirable to create this freedom by limiting directors' exposure to personal liability for a breach of their duties. As an alternative it was suggested that mechanisms providing relief from liability, provided the circumstances warrant it, may play a crucial role in achieving the desired balance.

The question may rightly be asked which of the above systems will best serve to achieve the balance between providing directors with the much-needed freedom to take calculated business risks without the continuous fear of personal liability, while not allowing unscrupulous directors the opportunity to escape liability for a breach of their duties.

¹⁵⁸⁵ It is only liability to the corporation itself that may be limited or eliminated in this way. Liability to parties other than the corporation, as well as liability to a related corporation, should therefore not be influenced by this provision.

It is submitted that strict regulation in respect of companies' ability to indemnify or exempt directors from their duties is advisable. This submission is based thereon that a liberal approach in terms of which directors' liability for a breach of their duties may be excluded through a resolution by the members of the company may provide too much of an escape route for delinquent directors.¹⁵⁸⁶ This will be especially relevant in the case of closely-controlled companies, where the directors are also the majority shareholders.

Furthermore, a very liberal system will operate unfairly towards creditors. The model that is proposed to facilitate the extension of directors' duties to creditors is that the company remains the beneficiary of directors' duties. The interests of the company are to be defined with reference to the interests of either its shareholders or its creditors,¹⁵⁸⁷ depending on the financial situation of the company.¹⁵⁸⁸ If it is assumed that creditors become the indirect recipients of directors' duties at a particular point in time, they will not be able to enforce any rights they gained in this regard, as the shareholders, who are no longer considered to be the primary corporate constituents at this stage,¹⁵⁸⁹ previously decided that *they* would be willing to excuse directors from any liability that might result from a breach of their duties, thus depriving creditors of any remedies against directors that they may have in future.¹⁵⁹⁰

¹⁵⁸⁶ On the basis of empirical research undertaken by them, Bradley & Schipani *supra* 74 note that legislative provisions to reduce the liability of corporate officials, with specific reference to s 102(7)(b) of the *DGCL* which provides for greater scope to indemnify directors, caused a decrease in the value of Delaware corporations. It also appears that firms who made use of the wider ability to grant directors indemnity, suffered statistically significant abnormal losses at that time as well. This leads them to conclude that "liability rules are a binding constraint on the behavior of corporate officials" and that "liability rules do matter".

¹⁵⁸⁷ See *supra* Ch 8 (Beneficiary of the Duty) par 8.5 for a more detailed explanation of the operation of this model.

¹⁵⁸⁸ See *supra* Ch 7 (Point in Time When the Duty Arises) for more detail on the circumstances that may give rise to the duty to creditors being triggered.

¹⁵⁸⁹ According to the model advocated in this study.

¹⁵⁹⁰ This point was also made *supra* Ch 8 (Beneficiary of the Duty), par 8.5.4.

9.3.3.1.2 Section 247(1) and Modifying or Releasing Provisions in Articles of Association

There seems to be some uncertainty as to the precise scope of provisions such as section 247(1). A strict interpretation of section 247(1) leads to the conclusion that provisions such as these are aimed solely at prohibiting exemptions from *liability*.¹⁵⁹¹

A large number of commentators are of the opinion, however, that it is also aimed at prohibiting provisions in the articles reducing or abrogating *duties* of directors.¹⁵⁹²

This interpretation is based on the viewpoint that a director

is exempted from liability just as effectively by a provision which says that the rules do not apply to him, as by one which says that the consequences of a breach of the rules do not apply to him.¹⁵⁹³

Should the second viewpoint, namely that the prohibition extends to agreements purporting to relieve directors from their *duties* and not only from *liability* that may result from a breach of those duties, be accepted as correct, one encounters the problem of reconciling this prohibition with legal principles permitting what appears to be a relief from duties.¹⁵⁹⁴

¹⁵⁹¹ Henochsberg 459 holds the view that only those provisions in the articles purporting to exempt a director from, or indemnify him against, *liability* that would exist in the absence of such a provision are prohibited in terms of s 247(1). It is indicated, however, that even should it be accepted as correct that provisions abrogating directors' duties are not prohibited in terms of section 247(1), such provisions would still be invalid for being *contra bonos mores*.

¹⁵⁹² According to Baker *supra* 186 interpreting the provision to allow the abrogation or exclusion of directors' duties will completely go against the intention of the Greene Committee *supra* in proposing the section. It will furthermore not be in line with a literal interpretation of the phrase that a director may not be relieved from liability "which would otherwise attach to him", as an exclusion of duties will have the precise effect of relieving a director from liability which would have attached him, were it not for the provision excluding or abrogating his duties (*id* 187). Blackman *supra* 540; Birds "The Permissible Scope of Articles Excluding the Duties of Company Directors" (1976) 39 *Modern Law Review* 394 396; and Gregory "The Scope of the Companies Act 1948, Section 205" (1982) 98 *Law Quarterly Review* 413 414 – 415 are also of the opinion that provisions to reduce or abrogate directors' duties are prohibited in terms of these statutory measures. Also see Spisto "Exemption from Liability under Section 247 of the Companies Act: To What Extent Does 'The Prohibition' in this Section Apply in the South African Context?" 1997 *CILSA* 60 for a discussion of the scope and effect of s 247(1).

¹⁵⁹³ Gregory *supra* 414.

¹⁵⁹⁴ Baker *supra* 190 justifies these clauses by arguing that breaches that are capable of being ratified after the event can be authorised in advance through clauses in the company's constitution. He concedes, however, that certain breaches that are ratifiable after they have occurred are not capable of being authorised beforehand, for example a breach of the duty to act with care and skill or the duty to act in good faith.

This conflict seems to be more glaring in England in light of certain clauses contained in the model Articles. Especially relevant in this regard is article 85 of Table A, which reads as follows:

Subject to the provisions of the Act, and provided that he has disclosed to the directors the nature and extent of any material interest of his, a director notwithstanding his office-

- (a) may be a party to, or otherwise interested in, any transaction or arrangement with the company or in which the company is otherwise interested;
- (b) may be a director or other officer of, or employed by, or a party to any transaction or arrangement with, or otherwise interested in, any body corporate promoted by the company or in which the company is otherwise interested; and
- (c) *shall not, by reason of his office, be accountable to the company for any benefit*¹⁵⁹⁵ which he derives from any such office or employment or from any such transaction or arrangement or from any interest in any such body corporate and no such transaction or arrangement shall be liable to be avoided on the ground of any such interest or benefit.¹⁵⁹⁶

Numerous commentators grapple with this issue¹⁵⁹⁷ and various solutions have been proposed to resolve the apparent conflict.¹⁵⁹⁸ Although there are differences in

¹⁵⁹⁵ Own emphasis.

¹⁵⁹⁶ The model articles provided by the South African *Companies Act* (Table A and Table B of Schedule 1) do not specifically contain clauses to this effect. Naude *Die Regsposisie van die Maatskappydirekteur met Besondere Verwysing na die Interne Maatskappyverband* (1970) 128 indicates that a contract between a director and the company of which he is a director would not be voidable, if authorised in terms of the articles of association. Directors could, however, still be held liable for any benefit obtained by way of concluding a contract with the company under certain circumstances (*id* 129 *et seq*).

¹⁵⁹⁷ See eg Baker *supra*; Birds *supra*; Blackman *supra*; Farrar & Hannigan *Farrar's Company Law* (1998) 425 *et seq*; Gregory *supra*; and Parkinson "The Modification of Directors' Duties" 1981 *Journal of Business Law* 335.

¹⁵⁹⁸ According to Baker *supra* 191 a distinction should be drawn between clauses that are *modificatory* and clauses that are *abrogatory*. An abrogation of directors' duties would not be allowed, whereas a modification of directors' duties, for example by substituting disclosure to the directors rather than the general meeting, would be permitted (*id* 193 – 194). Birds *supra* 400 distinguishes between various categories of directors' duties, namely those that can be excluded, eg the duty to act for a proper purpose; duties that can be modified, eg the duty not to make secret profits and the duty to disclose interests in company contracts; and lastly duties that cannot be regulated in the articles at all, eg any

nuance, these solutions generally seem to provide for the fact that the general meeting plays a centre role in excusing directors from certain duties, or in granting directors permission for certain acts.¹⁵⁹⁹

The emphasis placed on the role of the general meeting in this regard may have undesirable consequences should a duty to creditors come into play. If it is assumed that the rule against self-dealing in effect provides that a director may not act in a matter in which he has an interest without the permission of the company,¹⁶⁰⁰ and that such permission may be granted in terms of the articles of association,¹⁶⁰¹ creditors will be forced to accept contracts concluded by the directors with the company, even if these contracts were concluded after the creditors became the primary corporate constituents.

breach of a duty that involves wilfulness or fraud. Parkinson *supra* 337 – 338 disagrees with the solutions suggested by both Baker and Birds and suggests a distinction between duties that are “releasable” and those that are not, on the basis of whether breach of a particular duty is ratifiable, or not. This distinction is then further refined, as all duties that are ratifiable, are not necessarily releasable, eg the proper purpose duty (*id* 343 – 344). The judiciary, when confronted with this issue in *Movitex Ltd v Bulfield* [1988] BCLC 104, distinguished between “duties” and “disabilities”. According to the judiciary it is strictly speaking not correct to say that a director has a *duty* to avoid a conflict of interest (*id* 125). More accurate would be to state that, should a director place himself in a position where such a conflict arises, the court will set aside the transaction without inquiring whether the director acted in breach of his duties to the company. Modification of this principle in terms of the articles would thus not constitute exempting a director from liability for a breach of his duties, as this principle is not concerned with a duty (*id* 120). Blackman *supra* 549 acknowledges that the solution offered by the judiciary seems to have gained general acceptance, but criticises it for being contrary to accepted doctrine (*id* 550; with reference to *Aberdeen Railway Co v Blaike Brothers* (1854) 1 Macq 461 471). As an alternative he suggests that the principle against “self-dealing” be distinguished from the principle prescribing “fair-dealing” (*id* 552). The crux of the rule against self-dealing is that a director may act in a matter in which he has an interest, provided that permission was granted by the general meeting after full disclosure by the director (*id* 552). The duty is therefore in fact a duty “not to act *without the permission of his company* in a matter in which he has an interest” (*id* 552). Permission granted in terms of the articles would therefore not be construed as exempting or releasing a director from the duty (*id* 552). The judiciary, in recognising the validity of such clauses, should thus be seen as making allowance for the fact that permission that can be granted by the company in general meeting, could also be granted in the articles (*id* 557).

¹⁵⁹⁹ The solution provided by the judiciary in *Movitex Ltd v Bulfield supra* does not place the focus on the role of the general meeting, but operates to classify certain “duties” as “disabilities”, thus creating room for “releasing” provisions in the articles to co-exist with the statutory prohibition against an exemption from duties. One has to agree with Blackman *supra* 550 that this solution is doctrinally unacceptable. Cranston *supra* 208 has similar reservations.

¹⁶⁰⁰ As suggested by Blackman *supra* 552.

¹⁶⁰¹ Blackman *supra* 557.

If it is accepted that the general meeting becomes powerless to ratify a breach of directors' duties once creditors become the primary corporate constituents,¹⁶⁰² any prior permission by the general meeting for directors to engage in self-dealing should also become void once the duty to consider the interests of creditors is triggered.

It is therefore submitted that releasing provisions in the articles of association, irrespective of how their co-existence with statutory provisions prohibiting exemption from directors' duties is justified or explained, become void once the duty to creditors is triggered.

9.3.3.1.3 Application of Section 247(1) in a Group Context

At first glance a comparison between the South African section 247 and equivalent provisions in Australia and New Zealand reveals a number of differences with regard to the way in which these provisions are formulated.¹⁶⁰³ These differences are superficial, however. More critical is the fact that both Australia and New Zealand afford recognition to the group concept in their prohibition of exemption and indemnification.

Section 199A of the Australian *Corporations Act* prohibits exemptions and indemnifications by “a company or related body corporate”.¹⁶⁰⁴ In New Zealand a

¹⁶⁰² As the judiciary generally seems to do. See discussion *supra* Ch 4 (Judicial Framework) par 4.6 and cases there referred to.

¹⁶⁰³ Obvious examples are that the South African legislature deals with both exemption and indemnification in the same provision, whereas the Australian legislature makes a definite distinction between the prohibition on exemption and the prohibition on indemnification, treating them in separate subsections. New Zealand legislation, on the other hand, does not even contain a reference to *exemption* and deals exclusively with *indemnification*.

¹⁶⁰⁴ Ss 199A(1); (2); and (3) (own emphasis). S 9 defines a related body corporate as a “body corporate that is related to the first-mentioned body by virtue of section 50”. S 50 provides:

Where a body corporate is:

- (a) a holding company of another body corporate; or
- (b) a subsidiary of another body corporate; or
- (c) a subsidiary of a holding company of another body corporate;

the first-mentioned body and the other body are related to each other.

company is not permitted to indemnify a “director...of the company *or a related company*”.¹⁶⁰⁵ The South African and possibly also the English provision,¹⁶⁰⁶ only applies in respect of an exemption or indemnity provided by “a company” to “any director...of *the company*”.¹⁶⁰⁷

In Australia and New Zealand it is therefore not possible for a subsidiary, for example, to indemnify a director of a holding company against liability, or exempt him from such liability. The prohibition against indemnification and exemption in section 247, as well as section 310¹⁶⁰⁸, on the other hand, only seem to extend to indemnification or exemption granted by a company to its own directors. In South Africa and England it should for example be possible for a subsidiary to indemnify a director of a holding company against liability resulting from a breach of his duties.¹⁶⁰⁹

¹⁶⁰⁵ S 162(1); own emphasis. Also see ss 162(3), (4) and (7), where reference is made to directors of the company, as well as related companies. Although “related company” is not expressly defined in the New Zealand *Companies Act*, it is assumed that it also refers to companies operating in the same group.

¹⁶⁰⁶ Due to the wording of the English s 310, with specific reference to the words “or otherwise” in the phrase declaring void indemnification in terms of “any provision, whether contained in a company’s articles or in any contract with the company, *or otherwise*” (own emphasis), it is uncertain whether contracts of indemnity with persons other than the company, for example its holding or subsidiary company, are prohibited by this provision. The view of the Company Law Review *Modern Company Law for a Competitive Economy: Final Report Vol I* (London, DTI, 2002) par 6.3 is that this prohibition should only apply to contracts of indemnity with the company and to such provisions in the company’s constitution, as these are the only matters which directors may influence unduly. The Company Law Review sees no objection to such contracts being negotiated with somebody other than the company itself. Application of the *eiusdem generis* rule may achieve the same result.

¹⁶⁰⁷ S 247(1); own emphasis.

¹⁶⁰⁸ As well as s 310, should the view held by the Company Law Review referred to *supra* n 249 be taken as correct.

¹⁶⁰⁹ A further difference between the South African and English provisions and equivalent provisions in Australia and New Zealand pertains to the specific liability that a director may not be indemnified against. It seems that the South African and English legislature only prohibited indemnification against or exemption from liability *to the company itself*. The Australian prohibition on *exemption* reads like its South African equivalent in this respect, in that a director may not be exempted from “a liability *to the company*” (s 199A(1); own emphasis). The Australian prohibition on *indemnification* extends much further, however, in that a director may not be indemnified against a liability owed to the company *or related body corporate* (s 199A(2); own emphasis); a liability for a pecuniary penalty order or compensation order (s 199A(2)(b)); or a liability owed to someone *other than the company or related body corporate* and that did not arise out of conduct in good faith (s 199A(2)(c)). The statutory provision in New Zealand is also concerned with the liability of a director to the company or a related company (s 162(4)(a)). In South Africa one may therefore encounter the result that a director of a holding company may be indemnified by the holding company against liability that the director may have to the subsidiary company. Examples of such liability include liability in terms of s 37, s 86(1) or

It is thus submitted that section 247(1) of the South African *Companies Act*, which applies only in respect of an exemption from or indemnification against liability to *the company* that resulted from a breach of the directors' duties to *the company*, is formulated too narrowly, for failing to make provision for abuses that may occur in a group context – a situation in which creditors may be specially vulnerable.¹⁶¹⁰ In this respect the Australian and New Zealand example should be followed, where indemnification against liability to a company or a related company is prohibited, as is indemnity provided by a company or a related company.

9.3.3.2 *Indemnity against Liability for Legal Expenses*

Insofar as indemnification against liability for legal expenses is concerned, all jurisdictions seem to adhere to the basic principle that directors may be indemnified against such liability, provided that the outcome of the case is in their favour.¹⁶¹¹

This principle generally seems to be fair.¹⁶¹²

In principle directors should be afforded the same protection whether the action brought against them is with regard to their duties to the company to consider the

s 226(4) of the South African *Companies Act*, should it be accepted that the prohibition in s 247(1) extends to possible statutory liability, and not only liability for a breach of common-law duties, that directors may incur. This is not possible in Australia or New Zealand. It must be conceded that the liability in this instance is statutory and not common-law liability based on a breach of directors' duties. For the sake of a holistic approach to creditor protection, note should be taken thereof, however.

¹⁶¹⁰ *Peoples Department Stores Inc (trustee of) v Wise* [1998] QJ No 3571 (QSC (Bankruptcy and Insolvency Division)) provides a prime example of how transactions between related companies may prejudice the interests of creditors of one of the companies in the group.

¹⁶¹¹ Such indemnification is regulated more strictly in New Zealand, where it is allowed only if expressly authorised in the company's constitution (s 162(3) and s 162(4)). The board of the company is furthermore under obligation to ensure that particulars of any indemnity are entered in the interests register (s 162(7)).

¹⁶¹² One may even go so far as to suggest that protection afforded in this respect may be enhanced by providing for wider access to this type of relief than in Australia, where indemnification may be granted pending the outcome of a case through loans to the directors concerned, without having to adhere to normal requirements pertaining to shareholder approval (s 212). In a South African context the prior consent of all the shareholders or a special resolution for a loan to directors under such circumstances, normally required in terms of s 226(2), will thus not be required. The directors remain liable for any money so received, however, should it become apparent at a later stage that such indemnity should not have been granted.

interests of shareholders, or with regard to their duties to the company to consider the interests of creditors.

Provisions permitting indemnification under these circumstances may attain the desired balance between safeguarding creditors' interests, by limiting such indemnification to instances where the outcome of the action is in favour of the directors, and not unnecessarily exposing directors to liability, by allowing non-delinquent directors to escape liability for legal expenses.

In order to maintain creditor protection, while providing directors with increased relief, provisions permitting indemnification against liability for legal expenses could limit such indemnification to legal expenses that was *reasonably* incurred.¹⁶¹³

9.4 DIRECTOR LIABILITY INSURANCE

9.4.1 Introduction

Another way in which directors may safeguard their own interests in the face of increased exposure to personal liability, is through director and officer liability insurance.¹⁶¹⁴ In light of statutory provisions prohibiting a company from indemnifying a director against liability for a breach of duties that attach to him,¹⁶¹⁵ it was accepted that a company may not take out and pay for such insurance on behalf of its directors. Amendments to legislation in various jurisdictions, however, will now also make it possible for companies to take out and pay for such policies on behalf of their directors.¹⁶¹⁶

¹⁶¹³ As provided for in Canada in terms of s 124(1) of the *CBCA*.

¹⁶¹⁴ Often referred to as "D & O insurance". Most of the statutory provisions applicable in the various jurisdictions in this regard do not limit such insurance to directors, but include officers and/or auditors of the company. The way in which the position of officers and auditors are affected by provisions regulating the taking out of insurance by the company on their behalf falls outside the scope of this study, however, and is not discussed further.

¹⁶¹⁵ As discussed *supra* par 9.3.2.

¹⁶¹⁶ It must be kept in mind, however, that legislative amendments will only serve to allow a company to purchase and maintain insurance on behalf of its directors. Should increased director liability result in director liability insurance contracts themselves providing for even more exclusions or becoming too expensive, its attractiveness as a method to allow directors relief from liability will be greatly reduced, resulting in insurance eventually becoming unavailable. See Bradley & Schipani *supra* 35; Radin *supra* 745; and Ross "Protecting Corporate Directors and Officers: Insurance and Other Alternatives" (1987) 40 *Vanderbilt Law Review* 775 776 – 782 for a discussion of the effect of increased litigation

In this section statutory provisions in this regard are briefly referred to, followed by a discussion of director liability insurance in the context of a duty to creditors.

9.4.2 Statutory Regulation

9.4.2.1 South Africa

Section 247(1), prohibiting a company from indemnifying directors against liability resulting from a breach of duties, was amended in 1998¹⁶¹⁷ to make express provision for a company to take out insurance on behalf of its directors. The relevant part of section 247(1) reads:

Provided that this subsection shall not be applicable to insurance taken out and kept by the company as indemnification against any liability of any director or officer towards the company in respect of any negligence, default, breach of duty or breach of trust.

There is some uncertainty as to the effect of this amendment on the position of directors. It is suggested that the purpose of amendments permitting the purchase of insurance by the company on behalf of its directors, is to protect *the company*.¹⁶¹⁸ It is uncertain, however, whether *directors* are protected in terms of the amendment to section 247(1).

According to some the introductory part of section 247(1) will become meaningless and directors' common-law duties will in effect become useless, should it be accepted that these policies also serve to protect directors.¹⁶¹⁹ It is therefore suggested that the

against directors on liability insurance. Weiss *supra* 643 refers to this as the “director and officer insurance crisis”, which became a real threat after *Smith v Van Gorkom supra*. See authority referred to in n 49. According to Manning “Reflections and Practical Tips on Life in the Boardroom after *Van Gorkom*” (1985) 41 *The Business Lawyer* 1 6 such a deterioration in insurance coverage will result in an exodus of independent directors from corporate boards. Also see Daniels & Hutton *supra* for a detailed analysis of the insurance crisis of the mid-1980s in the USA and Canada; and Finch *supra* 892 – 897 for a general discussion on the availability of director liability insurance. Other mechanisms providing some relief from liability, eg relief by the court, should therefore not be neglected. These may play a role in influencing the way in which insurers view the risk of providing cover for director liability, thus making director liability insurance more affordable. Bradley & Schipani *supra* 73 indicate that legislative measures to provide increased access to indemnity, with specific reference to s 102(b)(7) of the *DGCL*, resulted in premiums for director liability insurance beginning to level off. Also see Finch *supra* 911.

¹⁶¹⁷ By s 12 of *Companies Amendment Act* 35 of 1998.

¹⁶¹⁸ Cilliers & Benade *supra* par 10.56.

¹⁶¹⁹ *Id* par 10.57. Botha & Jooste *supra* 69 – 71 also voice concerns regarding the effect of insurance on directors' duty of care and skill and the protection afforded in terms thereof and state that insurance

only purpose of the amendment to section 247(1) is to protect *the company* and not its directors.¹⁶²⁰ The director will not be able to escape liability through the application of normal principles of insurance law, with specific reference to the principle of subrogation, in terms of which the insurance company should be able to recover the compensation paid to the company from the director.¹⁶²¹

Should this interpretation of these amendments be accepted as correct, directors stand to benefit very little, if at all, from insurance taken out by the company. The current formulation of section 247(1), however, does not seem to allow for any other interpretation than the one suggested by the learned authors referred to in the previous paragraph, as it cannot be denied that the first part of the provision will be meaningless if another interpretation is followed.

3.8.2 *Australia*

The *Corporations Act* prohibits payment of insurance premiums by a company or related body corporate on behalf of a director of the company for certain types of liability. This leads one to conclude that the taking out of insurance by the company or a related body corporate for other liability that may be incurred by directors of the company, is allowed.

The exceptions, or liability for which a company or related body corporate may not maintain insurance for directors of the company, are conduct involving a wilful breach of duty in relation to the company;¹⁶²² or a contravention of section 182 or

will “effectively remove such duty and such protection – the incentive to take care having been drastically diminished”.

¹⁶²⁰ Cilliers & Benade *supra* 10.57.

¹⁶²¹ *Ibid.*

¹⁶²² S 199B(1)(a). Kyrou *supra* 567 indicates that there has not been any judicial analysis of the phrase “wilful breach of duty” and suggests that the meaning of the phrase may be determined with reference to cases in which similar expressions had to be interpreted. According to him the meaning attached to the expression “wilful neglect or default” in *In re City Equitable Fire Insurance Co Ltd supra* may be helpful. In this case Romer J indicated that a director will not be guilty of a wilful neglect or default “unless he knows that he is committing, and intends to commit, a breach of his duty, or is recklessly careless in the sense of not caring whether his act or omission is or is not a breach of duty” (*id* 434). This leads Kyrou *supra* 567 to conclude that the phrase “wilful breach of duty” includes the situations where there is an intentional breach of duty as well as recklessness. An intentional breach of duty will

section 183.¹⁶²³ This indicates that directors may be insured against non-wilful breaches, other than breaches of sections 182 and 183, as well as the costs of defending civil or criminal proceedings, irrespective of the outcome of such proceedings.¹⁶²⁴ Farrar is of the opinion that the last-mentioned possibility seems too wide and that it should be limited to acquittal or a successful defence or settlement of a civil claim.¹⁶²⁵

Section 199C furthermore makes it clear that section 199B should not be read to authorise anything that would otherwise be unlawful¹⁶²⁶ and that anything that purports to insure a director against a liability, would be void insofar as it contravenes section 199B.¹⁶²⁷

9.4.2.3 New Zealand

The effecting of insurance¹⁶²⁸ by a company for a director of that company or a related company in respect of particular liability is regulated in more detail in New Zealand. Such insurance, for example, requires the prior approval of the board and express authorisation by the company's constitution.¹⁶²⁹ Directors who vote in favour of authorising the effecting of such insurance are furthermore required to sign a certificate stating that, in their opinion, the cost of taking out the insurance is fair to the company.¹⁶³⁰ The board also has a duty to ensure that the particulars of the

occur where the director commits an act or omission, knowing that the particular act or omission constitutes a breach of duty.

¹⁶²³ S 199B(1)(b). In terms of s 182(1) a director may not improperly use his position to gain an advantage for himself or someone else, or cause detriment to the corporation. S 183(1) furthermore provides that a person who obtains information because he is or has been a director of the corporation may not improperly use the information to gain an advantage for himself or someone else, or cause detriment to the corporation. See discussion *supra* Ch 5 (Protection Afforded by Fiduciary Duties) par 5.2.2 for more detail.

¹⁶²⁴ Farrar *Duty of Care* 164.

¹⁶²⁵ *Ibid.*

¹⁶²⁶ S 199C(1).

¹⁶²⁷ S 199C(2).

¹⁶²⁸ S 162(9) provides that the phrase to "effect insurance" "includes pay, whether directly or indirectly, the costs of the insurance".

¹⁶²⁹ S 162(5).

insurance effected for a director of the company or a related company, are entered in the interests register.¹⁶³¹

The liability in respect of which insurance may be effected, is limited to liability incurred by the director for an act or omission in his capacity as a director, excluding criminal liability,¹⁶³² costs incurred by the director in defending or settling any claim or proceeding relating to such liability,¹⁶³³ and costs incurred by the director in defending any criminal proceedings that have been brought against the director in relation to any act or omission in his capacity as a director and in which he is acquitted.

A director will be personally liable to the company for the cost of effecting the insurance if the provisions of section 162(5) or section 162(6) have not been complied with,¹⁶³⁴ or if reasonable grounds did not exist for the opinion set out in the certificate required in terms of section 162(6),¹⁶³⁵ except to the extent that the director is able to prove that it was fair to the company at the time when the insurance was effected.¹⁶³⁶

9.4.2.4 England

In terms of an amendment to section 310(3) of the English *Companies Act*,¹⁶³⁷ a company is now allowed to purchase and maintain insurance for a director against liability under subsections (1) and (2). Subsection (3) expressly states that

[t]his section does not prevent a company from purchasing and maintaining for any such officer or auditor insurance against any such liability.

¹⁶³⁰ S 162(6).

¹⁶³¹ S 162(7).

¹⁶³² S 162(5)(a).

¹⁶³³ S 162(5)(b).

¹⁶³⁴ S 162(8)(a).

¹⁶³⁵ S 162(8)(b).

¹⁶³⁶ S 162(8).

¹⁶³⁷ As per s 137(1)(a) of the *Companies Act* 1989.

If a company decides to take out such insurance, particulars thereof must be disclosed in the directors' annual report.¹⁶³⁸

9.4.2.5 Canada

The *CBCA* expressly provides that a corporation may purchase and maintain insurance for the benefit of a director against any liability incurred by the director in his capacity as a director of that corporation,¹⁶³⁹ or in his capacity as a director of another entity, if he acts in that capacity at the corporation's request.¹⁶⁴⁰ The corporation is allowed to procure such insurance, even to cover those cases where the corporation itself is unable to indemnify the director because the misconduct constituted a breach of the standards set out in section 124(1) and section 124(2).¹⁶⁴¹

9.4.2.6 United States of America

Section 145(g) of the *DGCL* authorises a corporation to buy insurance on behalf of its directors for any liability arising out of their status in the corporation and reads as follows:

A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director...of the corporation, or is or was serving at the request of the corporation as a director...of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the corporation would have the power to indemnify him against such liability...under this section.

This provision is clear on the point that the corporation enjoys this power even though it may not be able to indemnify the directors against liability. Such policies may therefore provide cover against judgments against directors and amounts paid in settlement of derivative suits, even though indemnification in respect of these amounts would not be permitted if it violates public policy.¹⁶⁴²

¹⁶³⁸ In part I of Sched 7, par 5A, as is required in terms of s 137(2) of the *Companies Act* 1989.

¹⁶³⁹ S 124(6)(a).

¹⁶⁴⁰ S 124(6)(b).

¹⁶⁴¹ Gray *The Annotated Canada Business Corporations Act* 1995 (1994) 232.

¹⁶⁴² Bradley & Schipani *supra* 33. Johnston *supra* 2000 acknowledges that many authors criticise this provision as too liberal, as it allows corporations to buy insurance covering all types of fiduciary

Director liability insurance thus serves an important role in providing access to relief from liability in cases where the corporation was not allowed to indemnify the director; in cases where the corporation refuses to indemnify the director, even though it is allowed; and in cases where indemnification is not possible due to the insolvency of the corporation.¹⁶⁴³

Director liability insurance policies generally contain a very broad statement of coverage.¹⁶⁴⁴ This broad statement is generally subject to numerous exclusions, however.¹⁶⁴⁵ The ability of a corporation to procure director liability insurance is furthermore limited by public policy considerations.¹⁶⁴⁶ These policies, for example, may not provide cover against wilful misconduct.¹⁶⁴⁷

9.4.3 Application to a Duty to Creditors

9.4.3.1 General

Numerous advantages may flow from increased cover becoming available through company-funded director liability insurance,¹⁶⁴⁸ the most important of which, for the

misconduct. He disagrees with this point of criticism, however, as the policies themselves contain exclusions on public policy grounds.

¹⁶⁴³ Bradley & Schipani *supra* 33.

¹⁶⁴⁴ Bradley & Schipani *supra* 33 indicate that these policies insure against losses resulting from wrongful acts occurring in connection with service to the corporation. Wrongful acts are defined as “any breach of duty, neglect, error, misstatement, misleading statement, omission or other act done or wrongfully attempted by the Assureds...or any matter claimed against them solely by reason of their being such Directors and Officers of the company”.

¹⁶⁴⁵ Bradley & Schipani *supra* 34 n 214 list a number of common exclusions, eg claims against directors relating to libel and slander; illegal gains for personal profit or advantage; illegal remuneration; active and deliberate dishonesty with an actual dishonest purpose and intent; amounts covered by other policies; failure to maintain insurance; corporate indemnification; and environmental matters.

¹⁶⁴⁶ *Id* 33.

¹⁶⁴⁷ *Ibid*.

¹⁶⁴⁸ Cranston *supra* 209 and Ramsay *supra* 154 indicate that increased access to director liability insurance may have the unforeseen advantage of courts imposing higher standards on directors. See Dent “The Revolution in Corporate Governance, the Monitoring Board, and the Directors’ Duty of Care” (1981) 61 *Boston Law Review* 623 653 who fears the exact opposite, namely that it may contribute to “judicial reluctance to impose stricter standards of care by instilling a feeling that more rigorous standards would only stir up more litigation for the benefit of lawyers with no corresponding benefit to shareholders”. Finch *supra* 888 – 891 lists a number of potential advantages of increased availability of director liability insurance, eg that it may improve monitoring of potential wrongdoers;

purposes of this study, is the fact that it may address the problem of unnecessary risk avoidance and delegation by directors fearing personal liability.¹⁶⁴⁹ It is therefore submitted that directors, facing increased personal liability through a duty to creditors, should be offered the protection afforded in terms of insurance taken out on their behalf by the company.¹⁶⁵⁰

It seems, however, that section 247(1), in its present form, does not answer the need for increased access to such insurance. In order to achieve the objective of providing directors with some protection against personal liability, it is necessary to reconsider the way in which legislation allowing companies to purchase insurance against losses caused by a breach of directors' duties is formulated.

A suggestion in this regard is that the provision allowing insurance to be taken out, should be dealt with in a separate subsection.¹⁶⁵¹ This will address the problem of the apparent contradiction between the first and the second part of subsection (1), which necessitates the conclusion that only the company, but not its directors, are protected in terms of such insurance.¹⁶⁵²

9.4.3.2 Statutory Regulated Access

It has been emphasised throughout this chapter, however, that a balance should be maintained between providing directors with relief from liability, while ensuring that delinquent directors do not escape liability.¹⁶⁵³

assist the firm in wealth creation; and provide for a broadly-based fund which is made available to compensate company creditors as well as members, in case of wrongful acts by directors.

¹⁶⁴⁹ Finch *supra* 891.

¹⁶⁵⁰ Finch *supra* 880 agrees that company-funded directors' insurance could balance increased potential personal liability faced by directors.

¹⁶⁵¹ As was done by the English legislature in s 310 of the English *Companies Act* – the provision most similar to s 247 of the South African *Companies Act* – where the general prohibition is contained in subsection (1) and the exceptions, eg insurance to be purchased by the company, in subsection (3).

¹⁶⁵² As was indicated by Cilliers & Benade *supra* par 10.57.

¹⁶⁵³ Weiss *supra* 659 warns that an imbalance, created by too many benefits being granted to corporate management at the expense of the corporation, will lead to “the term ‘corporate accountability’ [taking] on an oxymoronic lustre”.

Unregulated access to director liability insurance will not achieve this balance, as directors will be over-protected in that directors who are guilty of a breach of their duties will have a good opportunity of escaping liability in every instance. This will essentially remove a great part of the incentive to comply with directorial duties¹⁶⁵⁴ and will clearly also impact negatively on the way in which directors conduct themselves insofar as their duties to consider the interests of creditors are concerned.

This concern is fuelled by the fact that the party who is supposed to be protected in terms of directors' duties, namely the company itself and not even the director, has to fund such insurance.¹⁶⁵⁵ Concerns that unregulated access to director liability insurance may reduce or even extinguish liability on the part of directors are not unwarranted and it is imperative that they should be addressed.¹⁶⁵⁶

Proper formulation of legislative provisions allowing the effecting of such insurance may play an important role in assuaging fears with regard to the negative effects of increased availability of director liability insurance. In this respect suggestions that directors should inform shareholders of the extent of cover obtained and the costs thereof, as well as the whole process be over-seen by non-executive directors, may prove helpful.¹⁶⁵⁷

¹⁶⁵⁴ Cranston *supra* 209 makes the point that the purpose of the law relating to directors' duties is not only about "whether particular breaches of duty are to result in monetary payments, *but also about ensuring that directors adhere to certain fiduciary and management standards*" (own emphasis). Also see Dent *supra* 653; Ramsay *supra* 154; and Weiss *supra* 658 for similar viewpoints.

¹⁶⁵⁵ Dent *supra* 653. Finch *supra* 887 states that company-funded insurance will result in the shareholder, consumer and the employee being the penalty payer, rather than the wrongdoer; Kennedy "The Standard of Responsibility for Directors" (1984) 52 *George Washington Law Review* 624 644 refers to this as a "caricature of conventional loss-shifting"; while Weiss *supra* 658 is of the opinion that this boils down to the company reimbursing a director for liability incurred by his conduct.

¹⁶⁵⁶ At the same time one must warn against over-emphasising this concern. Corporate wrongdoing need not be addressed only in terms of director liability, but may also be prevented in ways other than the imposition of personal liability, eg the expansion of general duties of disclosure, as suggested by Finch *supra* 912. Ramsay *supra* 156 also makes the important point that there are also other forces that provide an incentive for directors to comply with their duties, eg the market for managerial services and the market for the company's shares and that "deterrence is not deemed sufficiently important to outweigh the advantages of insurance" (*id* 155).

¹⁶⁵⁷ Banks & Boxer "Greenbury, Corporate Governance and the Insurer's Role" (1996) 4 *International Insurance Law Review* 164.

Another suggestion is that all claims made under such cover should be disclosed to the general meeting, to ensure that shareholders are fully aware of directors' doings in a company, giving them the opportunity to remove the directors from office should they deem it necessary.¹⁶⁵⁸ It is furthermore submitted that company creditors should also be provided with such information, to enable them to adequately protect their own interests in the company. This information should be provided in the directors' report, along the lines of the requirement in England that the directors' report contain information regarding insurance taken out by a company on behalf of its directors.¹⁶⁵⁹ Any such benefit for a director should furthermore be disclosed in a register of interests.¹⁶⁶⁰

The New Zealand provisions may provide helpful guidelines for reformulation. In New Zealand such insurance has to be authorised in terms of the articles of association;¹⁶⁶¹ and be approved by a resolution of the board,¹⁶⁶² where the members signed a certificate specifically stating that the premiums are, in their opinion, fair to the company.¹⁶⁶³

9.4.3.3 Consequences of Non-compliance with Statutory Requirements

In South Africa, England and Canada insurance contrary to the relevant statutory provisions will, by implication, be void and in Australia this is expressly provided for by section 199C(2). Non-compliance with the statutory requirements will thus result in the director not having the benefit of any insurance, should he decide not to take out personal insurance but to rely exclusively on insurance provided for by the company.

¹⁶⁵⁸ *Ibid.* This suggestion presupposes shareholder activism, which may present a problem. See discussion *supra* Ch 2 (Conceptual Justification of a Duty to Creditors) par 2.4.5 for more information.

¹⁶⁵⁹ In terms of s 137(2) of the 1989 *Companies Act*.

¹⁶⁶⁰ As is required in New Zealand in terms of s 162(7) of the New Zealand *Companies Act*.

¹⁶⁶¹ In terms of s 162(5).

¹⁶⁶² *Ibid.*

¹⁶⁶³ In terms of s 162(6).

In New Zealand non-compliance does not result in the insurance contract becoming void, thus depriving the director of any benefit in terms thereof. In stead provision is made that the director will become personally liable to the company for the *cost* of effecting the insurance, unless he is able to prove that it was fair to the company at the time that it was effected.¹⁶⁶⁴

The latter option seems to be preferable. Granting the director the opportunity to make good to the company the expenses that it incurred with regard to the insurance policy, rather than voiding the whole transaction, will enable the director to obtain the insurance benefit without the company having to carry the financial burden thereof.

9.5 CONCLUSION

The importance of providing honest directors with adequate relief against personal liability cannot be denied. It seems obvious, on the other hand, that a very liberal approach with regard to relieving directors from liability for a breach of their duties will significantly reduce the incentive for directors to comply with their duties. It is therefore of the utmost importance to maintain the critical balance between allowing relief in meritorious cases, while ensuring that delinquent directors do not escape liability.

The question remains whether the measures referred to in this chapter are successful in attaining the required balance.

It seems that general indemnification or exemption is regulated rather strictly in most jurisdictions,¹⁶⁶⁵ and that it offers limited protection to directors. It is submitted, however, that the scope of indemnification should not be broadened, as one must tread carefully when placing the power to relieve directors from liability for a breach of

¹⁶⁶⁴ S 162(8).

¹⁶⁶⁵ Where it was considered not to be regulated strictly enough, eg in SA, it was submitted that the legal position should be revised. See discussion *supra* par 9.3.4.1.

their duties in the hands of shareholders.¹⁶⁶⁶ Such a step could nullify the potential protection that creditors may have in respect of a directorial duty for their benefit.¹⁶⁶⁷

Indemnification against legal expenses is provided for more liberally. The relief in this regard is also limited, however, in that it is only concerned with liability that directors may incur in respect of legal costs – escape from any other type of liability is not possible in terms of these provisions.

The two mechanisms of providing relief from liability may maintain the all-important balance referred to above, is the relief granted by the courts and director liability insurance. Relief granted by the courts is regarded as advantageous for two reasons. The first is that the court, through a proper exercise of its discretion, could ensure that deserving directors are relieved from liability, while delinquent directors are brought to book. Secondly, seeing that this form of relief from liability is dependent on a decision by the judiciary, it is clear that shareholders would not be able to deprive creditors of any protection they might enjoy by way of an extension of directors' duties. Director liability could furthermore be judged on a case-by-case basis, providing for individual circumstances.

For this method to achieve its purpose, care must be taken, however, that statutory provisions in this regard are properly formulated and that all uncertainties be removed. A provision such as section 248, if properly formulated, seems to be adequate and it is submitted that there is no real need for a formalised business judgment rule in South African company law.

Director and officer liability insurance also seems to offer a reasonable measure of protection to directors. As was indicated, however, the current interpretation of the

¹⁶⁶⁶ Whether it be a power that may be exercised before the breach actually occurred, eg by way of indemnification against liability for a breach of the duties, or after occurrence of the breach, eg through shareholder ratification of director conduct.

¹⁶⁶⁷ Ramsay *supra* 155 also mentions other disadvantages of indemnification, compared to, eg director liability insurance, namely the greater prospect of abuse, as well as the fact that widespread indemnification may lead to directors enjoying “total immunity from the consequences of their actions” (*id* 156).

South African provision allowing companies to take out director liability insurance does not protect directors at all. The suggested legislative reform should enhance the protection to be afforded in terms of director liability insurance. It must be kept in mind, however, that the success of such policies in protecting directors is not only dependent on the legislative framework in which they function – their effectiveness may greatly be reduced by exclusions in the policies themselves, as well as this type of insurance becoming too expensive because of the great risk imposed by increased director liability.

The existence of other effective measures of relief may greatly influence the way in which insurance companies view the potential risk that they would have to cover in terms of such policies. The fact that director liability insurance could play a crucial role in providing directors with relief from personal liability under particular circumstances, should thus not lead to the neglect of other possible means of relief, for example relief granted by the courts.

The importance of providing directors with relief from liability under suitable circumstances was emphasised in this chapter. It was shown that existing measures, if formulated and applied in the correct manner, may be quite adequate for providing directors with the required degree of relief from liability. In any reformulation of statutory provisions with regard to these measures care should, however, be taken to ensure that the balance between accountability and ensuring wealth maximization is not upset through measures that are so wide that they effectively grant directors total immunity from the consequences of their actions.

Ultimately, it is important to remember that directors, as corporate managers, “frequently occupy positions of significant responsibility and influence, and ways should not be devised to render them unaccountable to shareholders and society”¹⁶⁶⁸ and, one may add, corporate creditors.

¹⁶⁶⁸ Ramsay *supra* 156.