PART I

GENERAL ORIENTATION

CHAPTER 1

INTRODUCTION

SUMMARY

1.1 BACKGROUND

Since statutory recognition of limited liability in England in 1855, many expressed concern for the position of corporate creditors.[1] The recent spate of spectacular corporate collapses[2] has once again thrown the spotlight on the unenviable position in which corporate creditors find themselves and has raised the issue of directors' liability once more. Pertinent questions in this regard are how personal liability could serve to prevent such occurrences, or at least improve the lot of corporate creditors.

Prior to these corporate failures, the judiciary in some jurisdictions[3] seemingly attempted to provide corporate creditors with improved protection against director misconduct by way of an extension of the traditional directors' duties to include the interests of

[1] See Giugni & Ryan "Company Directors' Spheres of Responsibility: Primary and Secondary Duties" 1988 *New Zealand Law Journal* 437 439 *et seq* for a discussion of the initial resistance to the introduction of limited liability, for fear of it leading to an increase in fraud; excessive speculation, etc.

[2] This appears to be a worldwide trend. Well-known failures include Worldcom and Enron in the USA; OneTel and HIH in Australia; and Parmalat in Italy. South Africa can boast its own corporate failures, eg CNA; Macmed; LeisureNet, etc.

[3] Countries in which the judiciary contributed to the development of the law in this way include Australia, New Zealand, England, Canada and the USA.

creditors.[4] The South African judiciary did not follow suit and at present an action based on a breach of directors' fiduciary duties or their duty to act with care and skill, does not seem to be available to local corporate creditors.[5]

It could be said, however, that "[t]he development of legal doctrine follows economic necessity".[6] The indignation caused by recent corporate failures could thus create an environment in which the judiciary might feel pressured to recognise that creditors are entitled to rely on the protection that could be afforded to them by way of directors' duties and even to permit them to bring action against directors based on a breach of their common law duties.

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[4] This extension of traditional directors' duties is often referred to as "directors' duties to creditors". Keay "The Directors' Duty to Take into Account Creditors' Interests: When Is It Triggered?" (2001) 25 *Melbourne University Law Review* 315 317 makes the point that this is a "generally accepted shorthand way" of referring to this development. Wherever this phrase is used, it should be interpreted in the same way and should not be read as a preference for a particular model for the extension of directors' duties.

[5] Some indication of a willingness to recognise that creditors' interests merit consideration by directors could be found in the judgments in *S v Hepker* 1973 1 SA 472 (W) 484, where the court stated:

> The 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...(own emphasis);

and more recently in *Kerbyn 178 (Pty) Ltd v Van den Heever* 2000 4 SA 804 (W) 817, where the court, with reference to the applicant's submission that there could be no question of a 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*...(own emphasis).

[6] Varallo & Finkelstein "Fiduciary Obligations of Directors of the Financially Troubled Company" (1992) 48 *The Business Lawyer* 239.

1.2 PURPOSE OF STUDY

The purpose of this study is therefore to investigate the viability of an extension of directors' existing common law duties to include creditors' interests and to recommend legislative amendments where current legal principles appear to be inadequate in providing the necessary framework for such an extension of directors' duties.

1.3 EXPOSITION

However, the opposition to such a duty expressed by numerous commentators indicates that gaining general acceptance for the extension of directors' duties might prove difficult. Arguments of those opposing expanded directors' duties could be divided into three main categories. The first category relates to arguments based on policy and conceptual principles, with opponents attempting to indicate that an extension of directors' duties would be contrary to fundamental company law dogma and unacceptable in light of policy concerns. Arguments under the second category question the need for an extension of directors' duties, asserting that there are already sufficient and adequate remedies available for the protection of creditors' interests. The third category is not so much concerned with whether an extension of directors' duties could be justified, but deals with concerns regarding the application of such a duty. In general the view seems to be that numerous perceived practical problems and uncertainties pertaining to the operation of an extended directorial duty indicate that this development is undesirable.[7]

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[7] The following statement by Worthington "Directors' Duties, Creditors' Rights and Shareholder Intervention" (1991) 18 *Melbourne University Law Review* 121 151 provides a good summary of the arguments against an extension of directors' duties to include creditors' interests:

> [N]o analysis of the director-creditor relationship provides any sound reasons for imposing fiduciary duties on directors to act in the best interests of creditors. Where such a duty to creditors has been proposed, no means of effectively dealing with the problems of standing to sue and ratification have been suggested. Creditors' interests are in fact already adequately protected by existing equitable and common law principles and statutory provisions.

In this study an attempt is made to prove that these arguments are not convincing and that an extension of directors' duties to include creditors' interests is both justifiable and feasible.

The justification of an extension of directors' duties to include creditors' interests is attempted in part II of this study, consisting of two chapters. In Chapter 2 it is argued that expanded directors' duties are justifiable on conceptual grounds. Existing remedies available to creditors are evaluated in Chapter 3 in order to indicate that these might not be as adequate as many commentators would like to think, thereby providing further justification for a duty to creditors.

Justification of a duty to creditors is one thing. However, as Berle[8] noted:

> You cannot abandon emphasis on "the view that business corporations exist for the sole purpose of making profits for their stockholders" until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else.[9]

The aim of Part III of this study is therefore to offer such a "scheme" or framework for the practical application of expanded directors' duties. In this regard an attempt is made to establish the framework envisaged for such a duty by the judiciary in those jurisdictions where directors' duties to creditors were mooted. This takes place through an analysis of existing case law on the topic.

Existing principles pertaining to directors' fiduciary duties and duty to act with care and skill are examined in Chapters 5 and 6 respectively in order to establish whether these are suitable for protecting creditors' interests and to establish whether creditors could indeed benefit from an extension of these duties to include their interests.

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[8] Berle "For Whom Corporate Managers *Are* Trustees: A Note" (1932) 45 *Harvard Law Review* 1365.

[9] *Id* 1367.

A pertinent question with regard to directors' duties to creditors is whether this is a continuous duty, or whether it is "triggered" by particular events during the company's existence. An answer to this question is offered in Chapter 7 which deals with the moment when the duty should arise.

Many commentators also struggle with the model that should be applied when extending directors' duties to include creditors' interests. Two options appear to be available, namely mediating a duty to creditors through the company, or recognising creditors as the direct recipients of the duty. This issue is addressed in Chapter 8 where a model is suggested as to whom the beneficiaries of directors' duties should be.

In the last chapter of Part III, Chapter 9, the focus is placed on the maintenance of the crucial balance between accountability and the risk-taking ability of directors that could be upset by increased personal liability. It is submitted that measures providing directors with relief from liability under appropriate circumstances could make a significant contribution towards ensuring that this balance is maintained. These measures have to be adequate, however, to ensure their effectiveness in this regard. In Chapter 9 a closer look is taken at these measures to assess whether they are capable of fulfilling this important function.

Part IV of this study, consisting of Chapter 10, contains conclusions and recommendations regarding an effective directorial duty to creditors.

1.4 LIMITATION OF SCOPE

This focus of this study is on directors' common law duties to creditors. Any statutory obligations to creditors are therefore not discussed in detail, and are only referred to where relevant for the purposes of this study.

It should furthermore be noted that other parties, for example managers, might also labour under fiduciary obligations or the duty of care and skill. This study is concerned specifically with the duties that *directors* owe to creditors. Any duty that other parties might have to consider the interests of creditors falls outside the scope of this study and does not receive any attention.

A discussion of the issue as to whether directors owe a duty to other parties, for example employees or the society, also falls outside the scope of this study. It should be emphasised, in fact, that this study is concerned solely with the duty of directors to *creditors*, whose interests merit the protection afforded in terms of directors' duties, since they are financial stakeholders in the company.

It should also be kept in mind that the "creditors" mentioned in proposing an extension of directors' duties to "creditors", refer to the general body of creditors. Claims that individual creditors might have against directors for acts performed in the exercise of their power, for example purely delictual claims, fall outside the scope of this study and are not dealt with.

1.5 METHODOLOGY

This study is based on an analysis of local legal principles, followed by a comparative study in order to determine whether any answers are to be found in other jurisdictions, should the South African system display shortcomings. The jurisdictions that were decided upon for the purposes of the comparative study are Australia, New Zealand, England, Canada and the United States of America, with specific reference to the state of Delaware.[10]

[10] Company law in the USA, or corporation law as it is known there, is still predominantly state law. Focus will be placed on corporation law in the state of Delaware, for being regarded as very influential in matters of corporation law. Weiss "The Effect of Director Liability Statutes on Corporate Law and Policy" (1989) 14 *Journal of Corporation Law* 637 639 indicates that Delaware is the "dominant state" in this regard. According to Weiss *supra* 640 this would seem to be the case for a number of reasons, such as the fact that its corporate code is flexible and liberal; that it provides a highly developed body of corporate case law, which provides guidance and flexibility, etc. Another reason why the state of Delaware was selected is because it is one of the states in the USA that chose not to enact a non-shareholder constituency statute. The question as to whether directors owe duties to creditors is therefore approached on a non-statutory basis, as in the other jurisdictions referred to in this study.

England was chosen for the obvious reason that South African company law and the South African *Companies Act*[11] are largely premised on English company law.[12] The other jurisdictions are also based on principles of English company law. However, in Australia and New Zealand a number of new developments took place that would indicate a moving away from a pure English foundation. These may prove very informative when South Africa embarks upon a review of its own company law. Canada furthermore presents a good example of how a legal system in which principles of English and American law are often combined, functions effectively.

The courts in these jurisdictions also refer to one another in certain cases when confronted with the issue of directors' duties to creditors.[13] A comparative study focusing on these jurisdictions would therefore provide a good holistic view of how such a duty could function, or how it is perceived to function by the judiciary.

[11] Act 61 of 1973.

[12] Cilliers & Benade *Corporate Law* (2000) par 2.03.

[13] See eg *Canbook Distribution Corporation v Borins* (1999) 45 OR (3d) 565 (Ont SCJ) par 16, where the Canadian court refers to the legal position in England, Australia and New Zealand regarding directors' duties to creditors.