PART II

JUSTIFICATION OF A DUTY TO CREDITORS

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SUMMARY

2.1 INTRODUCTION
Many commentators, in criticising directors’ duties to creditors, advance doctrinal and theoretical objections to such a duty. These objections are often related to the view that a particular commentator has regarding the nature of the corporation and its theoretical underpinnings. As a point of departure, some of the theories underlying the concept of the corporation will thus be analysed in order to assess how these theories lend themselves to make provision for a duty to creditors.\(^\text{14}\)

An extension of directors’ duties to creditors is furthermore criticised on the basis of the perceived differences between creditors and shareholders. Creditors are seen to have an exclusive contractual relationship with the company. They should therefore ensure that their interests are protected through the terms of the contract that they are free to negotiate with the company. Any breach of this contract should be addressed by way of traditional contractual remedies.\(^\text{15}\)

\(^{14}\) See *infra* par 2.2 for further discussion.

\(^{15}\) See *infra* par 2.3 for further discussion.
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Shareholders, on the other hand, are for various reasons assigned the position of primary, or sole, corporate constituents.\textsuperscript{16} Their interests are thus deserving of protection in other ways, for example the common law duties that directors owe to the company, but which in effect serve to protect shareholders’ interests.\textsuperscript{17}

A last conceptual concern is related to possible negative consequences that directorial liability to creditors for a breach of directors’ duties could have, specifically regarding the effect on director conduct\textsuperscript{18} and limited liability.\textsuperscript{19} In this regard arguments such as the fact that a duty to creditors would stifle entrepreneurial spirit; that it would deter competent people from serving on the boards of companies; and that it is contrary to the fundamental principle of limited liability and would contribute to the erosion of this cornerstone of modern company law, are advanced.

In this chapter an analysis of these objections is undertaken to assess whether they are insurmountable and whether an extension of directors’ duties to protect the interests of creditors could be justified on a sound conceptual basis.

2.2 THEORIES ON THE NATURE OF THE COMPANY

2.2.1 General

Commentators have various viewpoints on the theoretical foundations underpinning the corporation.\textsuperscript{20} These viewpoints led to the formulation of different models in terms of

\textsuperscript{16} See infra par 2.4 for further discussion.

\textsuperscript{17} The judiciary made it quite clear on various occasions that directors, in having to act in the best interests of the company, should have regard to the interests of its shareholders. See eg \textit{Dodge v Ford Motor Co} 170 NW 668 (Mich 1919); \textit{Greenhalgh v Arderne Cinemas Ltd} [1951] Ch 286 etc.

\textsuperscript{18} See infra par 2.5 for further discussion.

\textsuperscript{19} See infra par 2.6 for further discussion.

\textsuperscript{20} Cilliers & Benade \textit{Corporate Law} (2000) par 1.16 n 18 refer to Wolff “On the Nature of Legal Persons” 1938 \textit{Law Quarterly Review} 494 496, according to whom there are sixteen theories pertaining to the legal nature of the juristic person. According to these authors, however, none of these theories individually offers a satisfactory explanation of the legal of the juristic person, and of companies specifically.
which the corporation is defined. The importance of such models should not be underestimated. It is said that

[d]ifferent theories concerning the origin and purpose of corporations influence the model of company adopted and thus shape the relationship that companies have with all the participants in their economic activity and with their regulators.21

The way in which an extension of directors’ duties to creditors is approached could thus be influenced to a large extent by the model favoured by a particular person.

Theories that have been influential in shaping models of companies are the contractual, communitarian and concessionary theories.22 A further theory, namely the associative theory, could also play an important role, especially with regard to directors’ duties to creditors.23 In this section a closer look is taken at what each of these theories entail and how a duty to creditors could be influenced by a predisposition for a particular theory.

2.2.2 Contractual Theories

2.2.2.1 General

Contractarians view the company as nothing more but a number of “complex, private consensual contract-based relations, either express, or implied”,24 also referred to as a

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22 Dine Corporate Groups 3.


“nexus of contracts”.

The theory, while allowing that implied contracts may be incomplete and that gaps may be filled by company law principles, is against the mandatory application of principles and provides for parties to be free to “opt out” of rules where these do not suit their needs.

The contractarian approach has been very influential in shaping company law doctrine and it is in fact argued by some that the contractarian paradigm developed by law and economics scholars dominates the theory of corporate law.

2.2.2.2 Legal Contractualism

Dine distinguishes between two contractual theories, namely “legal contractualism” and “economic contractualism”. She explains the consequences of legal contractualism as creating an entity remote from regulatory interference and putting the corporation into the sphere of private law. A statutory manifestation of this theory is found in section 65(2) of the South African Companies Act, which provides:

The memorandum and articles shall bind the company and the members thereof to the same extent as if they respectively had been signed by each member, to observe all the provisions of the memorandum and of the articles, subject to the provisions of this Act.

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26 Iacobucci A Wise Decision 341 indicates that company law, by providing an “off-the-rack” standard form contract, serves to reduce transaction costs, since it becomes unnecessary to explicitly draft all terms of the corporate contract. See Ayres & Gertner “Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules” (1989) 99 Yale Law Journal 87 for more detail in this regard.

27 Iacobucci A Wise Decision 341. This is known as an “enabling” approach to the corporate contract.


29 Dine Corporate Groups 3 – 12.

30 Id 3 – 4.

An important consequence of the application of this theory is that the primary implied “contract”\(^{32}\) is regarded as being between the company and its members, to the exclusion of all other interested parties.\(^{33}\)

### 2.2.2.3 Economic Contractualism

According to a popular economic view the company is seen to be nothing more than a “nexus of contracts”.\(^{34}\) It is consequently regarded as a “voluntary association between shareholders”, rather than a “creation of the state”.\(^{35}\) The nature and form of the corporation is explained on the basis of bargaining dynamics, rather than legislation, which is considered to have only limited impact on any corporation.\(^{36}\) In this context the function of any system of corporate law is seen merely to provide for a reduction of transaction costs, as it provides a set of “off-the-rack legal rules that mimic what [rational] investors and their agents would typically contract to do”.\(^{37}\) These theories thus seem to emphasise economic notions such as rationality, efficiency and information.\(^{38}\)

### 2.2.3 Communitarian Theories

In terms of these theories the grant of company status is a concession by the state, creating an instrument for the state to utilise.\(^{39}\) The emphasis is thus on identification of the aims of the company with those of society, causing the loss of a strong commercial

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\(^{32}\) As is provided for in terms of s 65(2) of the South African Companies Act.

\(^{33}\) Dine Corporate Groups 6. Dean “Stakeholding and Company Law” (2001) 22 The Company Lawyer 66 67 is of a contrary opinion, however, and asserts that there is scope for recognition of contractual terms, implicit and explicit, between the company and other parties within contractual theory.

\(^{34}\) Jensen & Meckling supra.

\(^{35}\) Cheffins Company Law: Theory, Structure and Operation (1997) 41, as referred to by Dine Corporate Groups 8.

\(^{36}\) Ibid.


\(^{38}\) Keay Contractarian Concerns 675 identifies the emphasis placed on market forces and efficiency by an economic analysis of contractarianism.

\(^{39}\) Dine Corporate Groups 17.
identity for the company, because it has become a political tool with diffused goals. These theories hold the risk that sight might be lost of the commercial goal of the company.

These theories gained prominence in the “stakeholder debate”, in terms of which directors’ duties are redefined with reference to the interests of various corporate stakeholders. This approach, also referred to as the “pluralist” approach, asserts that “co-operative and productive relationships will only be optimised where directors are permitted (or required) to balance shareholders’ interests with those of others committed to the company”.

The “enlightened shareholder value” approach appears to be more moderate than the “pluralist” approach. This model permits directors to have regard, where appropriate, to the interests of other stakeholders in the company, but with shareholders’ interests

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40 Ibid. This seems to be the model favoured by the Department of Trade and Industry South African Company Law for the 21st Century: Guidelines for Corporate Law Reform (May 2004) (hereinafter South African Guidelines for Corporate Law Reform), as indicated by statements that companies are “central to a country’s economy and its prosperity – for wealth creation and social renewal” (id 4; own emphasis); that “in the running of a modern South African company consideration has to be given not only to economic factors but also to social and environmental ones” (id 26; own emphasis)’ and that a company is “a social as well as an economic institution, and accordingly that the company’s pursuit of economic objectives should be constrained by social…imperatives (id 27; own emphasis).

41 Dine Corporate Groups 20.


44 A second alternative to the traditional shareholder oriented model identified in the Consultation Paper par 5.1.1.2 and par 5.1.1.3.
The interests of other stakeholders are thus to be considered only insofar as it would promote the interests of shareholders. The enlightened shareholder value approach appears to be nothing more than an affirmation of the reality that directors are bound to consider various factors in ensuring achievement of the goal of wealth-maximisation for shareholders. It would not, however, seem to be indicative of a new trend in terms of which there is an increase in the number of interest groups with justiciable interests against company directors. In the end it is once again a confirmation of the fact that the only corporate constituency whose interests should be protected in terms of directors’ duties, is shareholders. Shareholders’

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45 Consultation Paper par 5.1.12, as referred to in South African Guidelines for Corporate Law Reform 24.

46 South African Guidelines for Corporate Law Reform 24. In terms of clause B3(1) of the English Company Law Reform Bill published in March 2005 (document available at www.dti.gov.uk/cld/chapter7.pdf), a director must act in good faith in the way which would be most likely to “promote the success of the company for the benefit of its members as a whole”. Clause B3(3) furthermore states that directors, in fulfilling this duty, “must take account (where relevant and so far as reasonably practicable)...of any need of the company to have regard to the interests of its employees” (clause B3(3)(b)(i)); “to foster its business relationships with suppliers, customers and others”; (clause B3(3)(b)(ii)); “to consider the impact of its operations on the community and the environment” (clause B3(3)(b)(iii)); and “to maintain a reputation for high standards of business conduct” (clause B3(3)(b)(iv)). This formulation of directors’ duties makes it clear that the enlightened shareholder value approach is favoured in England. Also see par B17 of the Explanatory Material to the English Company Law Reform Bill (available at www.dti.gov.uk/cld/N0000NMJ.doc) where it is expressly stated that the duty in clause B3 “enshrines in statute the principle of ‘enlightened shareholder value’”.

47 Davies Gower & Davies’ Principles of Modern Company Law (2003) (hereinafter Gower) 378 agrees that this formulation “clearly identifies the success of ‘the company’ with the benefit of the members”.

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interests are interpreted on a long-term basis, however, with the emphasis on the company being managed in a sustainable manner.\textsuperscript{48}

2.2.4 Concessionary Theories

2.2.4.1 General

Application of this theory entails that the operation and existence of the company is viewed as a concession by the state that provides the possibility to trade as a corporation, especially where limited liability is afforded in the process.\textsuperscript{49} The difference between the communitarian theories and the concession theories is that the latter accept that the state has a limited role to play in ensuring that corporate governance structures are fair and democratic, but do not force the company to realign its aims to reflect the social aspirations of the state.\textsuperscript{50}

The granting of limited liability is seen as a privilege which corporators are entitled only to subject to certain terms and conditions.\textsuperscript{51}

\textsuperscript{48} The enlightened shareholder value approach would seem to be in line with the notion of the company as proposed by commentators such as Goldenberg “Shareholders v Stakeholders: The Bogus Argument” (1998) 19 The Company Lawyer 34 36 – 37, whose view is as follows:

This obligation to have regard to the interests of shareholders is not related to the actual shareholders at any particular moment in time, but to the general body of shareholders from time to time…Accordingly, the duty of directors is to maximise the company’s value on a sustainable basis. There is nothing in law to prevent directors from having regard to the interests of third parties with whom the company has a relationship…if they judge, reasonably and in good faith, that to do so is conducive to the success of the company.

\textsuperscript{49} Dine Corporate Groups 21.

\textsuperscript{50} Ibid.

\textsuperscript{51} Dine Corporate Groups 22 regards the following extract from In re Rolus Properties Ltd (1988) 4 BCC 446 as a proper expression of the issues:

The privilege of limited liability is a valuable incentive to encourage entrepreneurs to take on risky ventures without inevitable personal total financial disaster. It is, however, a privilege which must be accorded upon terms…

Naude Die Regsposisie van die Maatskappydirekteur met Besondere Verwysing na die Interne Maatskappyverband (1970) 17 is of the opinion that the concession theory has little power of persuasion in


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2.2.4.2 Dual Concession Theory

Dine proposes a dual concession theory, the crux of which is that the company is seen as an instrument created by the contractors, but which has a real identity separate and distinct from the original contracting parties.\(^{52}\) The concept of the free entity entails the important consequence that the wishes of the original “owners” can no longer be considered paramount.\(^{53}\) This raises the question, however, as to whose interests should carry weight.\(^{54}\)

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\(^{52}\) Dine Corporate Groups 26. The principle that the company exists as an independent entity, separate from the original contractors, is a cornerstone of modern company law and was entrenched as early as 1897 by the well-known case of Salomon v Salomon & Co Ltd [1897] AC 22 (HL).

\(^{53}\) Ibid.

\(^{54}\) Dine Corporate Groups 27. See infra Ch 8 (Beneficiary of the Duty) where this issue is dealt with in more detail.
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One view is that this theory enables the application of a constituency model, seeing that
the interests of the company are no longer assumed to be those of the original contracting
partners, thus creating the opportunity for shareholders, as well as employees and
creditors, to have their interests considered.\textsuperscript{55}

The way in which the dual concession theory can be distinguished from the stakeholder
model premised on the communitarian theories, is by the fact that the company will retain
a strong commercial focus since it is the corporation’s interests that are relevant, rather
than those of the state.\textsuperscript{56}

A problem with this theory, however, is that although constituencies are identified, no
guidelines are provided as to how the potentially conflicting interests of those
constituencies should be balanced.\textsuperscript{57}

\textbf{2.2.5 Associative Theories}

The crux of the associative theory is that the members form an association, the focus of
which is to pool capital. The use of the capital contributed by the members determines
the purpose, common affairs, organization and criteria of membership.\textsuperscript{58} “The company”
is the association and exists between members and management in the conception of the
internal affairs of the company.

An important characteristic of this theory, however, is that it should not be assumed that
the members as contributors of the capital comprise only shareholders. In this regard it is
noted that

\textsuperscript{55} \emph{Id} 28.
\textsuperscript{56} Dine \textit{Corporate Groups} 29.
\textsuperscript{57} As Dine \textit{Corporate Groups} 28 herself concedes.
\textsuperscript{58} Wishart \textit{supra} 348.
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[i]f the association is comprised of members with the common purpose of the use of a pool of capital and if the members contribute with a variety of conditions on their membership, it appears to be difficult to assert that creditors are not members.\(^{59}\)

Membership of the company is thus deemed to be a flexible concept.\(^ {60}\)

2.2.6 Application to a Duty to Creditors

2.2.6.1 Contractual Theories

Application of a pure contractual theory to the company has two important consequences insofar as the extension of directors’ duties to creditors is concerned. The first is that both the legal contractual theory and the economic contractual theory are primarily concerned with the company as a “nexus of contracts” between the company and its shareholders.\(^ {61}\)

As was indicated, the theory allows that contracts may be incomplete and that gaps may be filled by company law principles.\(^ {62}\) Directors’ duties are typically seen as a “gap-filler”, or default rule upon which the parties to the contract could rely where they have not specifically agreed upon a particular course of action.\(^ {63}\) Since this “gap-filler” is applicable to the contract between the company and its shareholders, creditors are automatically excluded from the protection afforded in terms thereof.\(^ {64}\)

\(^{59}\) Id 349.

\(^{60}\) Id 353 – 354.

\(^{61}\) Iacobucci A Wise Decision 337 is of the opinion, however, that the parties to the corporate contract are the ones who bear the costs of the corporation’s failure or who reap the benefits of its success.

\(^{62}\) Keay Contractarian Concerns 672.


\(^{64}\) Some commentators hold a very definite view that any proposition that creditors should be regarded as beneficiaries of implicit contracts should be rejected and that they are to rely exclusively on protection
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Contractual theory thus does not seem to provide much scope for the recognition of a directorial duty to creditors, as it rather seems to emphasise the view that protective measures for creditors’ interests are limited to what the creditors negotiated for with the company in the actual contract between them and the company.  

2.2.6.2 Communitarian Theories

The enlightened shareholder value model, as the name indicates, is still very much premised on the notion of shareholder supremacy. Directors would not be wrong in considering interests other than those of stakeholders, but would only be permitted to do so in order ultimately to advance the interests of shareholders. In case of a conflict between the interests of shareholders and those of other stakeholders, specifically creditors for the purposes of this study, directors would automatically be required to give preference to the interests of shareholders. It is thus doubtful whether this model can serve in any meaningful way to provide protection for the interests of corporate creditors.

The stakeholder model may at first glance seem to be ideal to provide for the protection of creditors’ interests through the mechanism of directors’ duties. In terms of this model directors are, if not required to, at least permitted to consider a broad range of interests in complying with their duties to “the company”. In this instance the company’s interests are not equated exclusively with those of its shareholders, but encompass a broad range of interests of all those having a stake in the company.

negotiated in terms of the actual contract between themselves and the company. See eg Daniels “Stakeholders and Takeovers: Can Contractarianism Be Compassionate?” (1993) 43 University of Toronto Law Journal 315 344 (hereinafter Daniels Stakeholders and Takeovers).

65 In light of vehement criticism levelled against contractual theory by authors such as Branson “The Death of Contractarianism and the Vindication of Structure and Authority in Corporate Governance and Corporate Law” in Mitchell (ed) Progressive Corporate Law (1995) 93, the fact that the extension of directors’ duties to creditors does not seem to be readily acceptable in terms of contract theory, does not seem to present a serious obstacle in the development of such a duty, however.

66 According to Dean supra 69 the original and broadest definition of stakeholder is that of Freeman Strategic Management: A Stakeholder Approach (1984) 25, in terms of which a stakeholder is defined as “any party which can affect or be affected by the activities of a business”. Included in this broad definition could thus be shareholders, creditors, employees, society, the environment, suppliers, consumers, etc. A narrower definition would limit stakeholders to voluntary stakeholders, who have time, money or assets at risk as a result of the company’s activities (id 69).
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One is bound to agree with the numerous critics of this model, however, that such a diffusion of goals would lead to directors’ duties effectively becoming worthless. Holding directors accountable to everybody for everything, will lead to them being accountable to nobody for anything.67

Application of this model of the corporation will also be contrary to a core argument of this study, namely that only those stakeholders with a financial stake in the company are deserving of the protection afforded by directors’ duties.68 The protection of other stakeholders, for example the environment, society, employees and so on should be regulated in terms of specific legislation as it does not belong in the realm of company law.

2.2.6.3 Concessionary Theories

One could support Dine’s dual concession theory insofar as it does at least provide for the recognition of a commercial goal of the corporate enterprise. It is submitted, however, that application thereof should be limited to those with a financial stake in the company, namely shareholders and creditors. Criticism that may furthermore be levied against this proposition is that it provides no indication of how the interests of various groups should be balanced, as she herself concedes.69

2.2.6.4 Associative Theories

The associative theory seems to provide the most acceptable basis for an extension of directors’ duties to creditors. It recognises that contributors of capital, in other words only the financial stakeholders in the company, are entitled to the protection afforded by


68 Williamson “Boards of Directors and Fiduciary Duties” in Romano (ed) Foundations of Corporate Law (1993) 157 158 also recognises that the suppliers of finance, be it shareholders or creditors, bear a unique relation to the firm, in that the whole of their investment is potentially placed at hazard. By contrast, the suppliers of raw material, labour, etc retain possession of their productive assets.

69 Dine Corporate Groups 28.
directors’ duties. It also carries the advantage that it could fit in comfortably with existing company law principles, for example that a breach of directors’ duties is actionable by the company.

“The company” is furthermore defined with reference to its membership, which could either be its shareholders or its creditors, the acceptance of which would cause existing principles of company law to be “adequate to the task of dealing with the problem at the base of the current debate as to directors’ duties to creditors”.

Although the flexible definition of membership is supported, Wishart’s suggestion that it is “left for the group and the individual to decide whether the status of member with all its consequences will be conferred”, is not accepted. Rather than voluntary acquisition of membership, it is proposed that membership should be determined with reference to the financial situation of the company – shareholders as members where the company is financially stable, and creditors where the company is in distress. This would also be in line with the notion that the residual claimants are the ones entitled to protection afforded in terms of directors’ duties and who should be able to enforce these duties through the vehicle of the company.

The way in which Dine envisages such a model to operate – with challenges to management decisions by way of derivative action in order to defend the interests of the company and the company being the eventual “winner” of any successful action –

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70 Wishart supra 353 – 534.

71 Id 351.

72 In this respect one is inclined to agree with Dine Company Law Developments 250 that corporate governance benefits should be available to “particular persons or groups when they can show that their interests should be considered as part of the company’s interests rather than because they belong to a particular group”.

73 Id 251.
would also fit perfectly with the model for an extension of directors’ duties to creditors that is proposed in this study.\textsuperscript{74}

2.3 CREDITORS’ CONTRACTUAL RELATIONSHIP WITH THE COMPANY

2.3.1 General

Numerous commentators emphasise the contractual nature of creditors’ relationship with the company in rejecting an extension of directors’ duties to include their interests.\textsuperscript{75} The crux of this argument seems to be that it is up to creditors to protect their own interests through the terms and conditions of the contract that they negotiate with the company.\textsuperscript{76}

Commentators identified a plethora of contractual devices that creditors are free to use to protect their own interests. These include the interest rate charged and the negotiation of

\textsuperscript{74} See Ch 8 (Beneficiary of the Duty) for further discussion in this regard.

\textsuperscript{75} See eg Sealy\textit{ Directors’ “Wider” Responsibilities} 176 who states: “Creditors deal with a company as a matter of bargain, not of trust, and bargain involves risk.” This argument relies on the notion that creditors are not as vulnerable as shareholders and that they are in a position to protect their own interests through contract. Creditors are therefore not regarded as suitable beneficiaries of fiduciary duties, which, according to Smith DG “The Critical Resource Theory of Fiduciary Duty” (2002) 55\textit{ Vanderbilt Law Review} 1399 1406, provide protection “against opportunistic behavior, and the strength of that protection varies inversely with the \textit{potential for self-help on the part of the vulnerable party}” (own emphasis). A similar viewpoint seems to be advocated in \textit{South African Guidelines for Corporate Law Reform} 37:

Large creditors increasingly rely on contract to protect their investment...[t]hus a primary goal of company law should be to ensure that shareholders, as the investors of equity, are granted explicit rights and that they have effective recourse when those rights are violated.

\textsuperscript{76} Ziegel “Creditors as Corporate Stakeholders: The Quiet Revolution – An Anglo-Canadian Perspective (1993) 43\textit{ University of Toronto Law Journal} 511 516 refers to opinions that the onus rests on creditors to bargain effectively and that directors should not serve as insurers against creditors’ poor business judgment, should they fail to do so. This argument seems to hark back to the \textit{laissez-faire} approach advocated by Adam Smith in the 1850s, whose influence is still clearly visible in many of the so-called protective measures embodied in company law principles, eg the fact that the name of companies whose members enjoy limited liability should end with the abbreviation “Ltd”; compulsory registration of companies’ memorandums and articles of association; the issuing of a prospectus to potential investors, etc. All of these measures form part of the very important “doctrine of disclosure” in company law – a doctrine whose whole existence is based on the philosophy that those who have dealings with the company are adequately protected if they are provided with sufficient information to put them in a position that enables them to safeguard their own interests.
guarantees and loan covenants. Whether creditors are in fact free to negotiate with the company and whether measures such as these do indeed provide adequate protection, are open for debate. This viewpoint also focuses on the position of voluntary creditors, but fails to explain how the interests of involuntary creditors, such as delictual claimants, should be protected. Efficiency concerns furthermore exist regarding the negotiating of adequate protective measures.

2.3.2 Freedom to Negotiate

Due to the inequality of bargaining power inherent to many transactions, it is doubtful whether one can truly say that creditors are “free” to negotiate terms and conditions of a contract with the company to provide for the protection of their interests. Creditors are often in a position where they have to compete for a market share and would forego adequate protective measures in an attempt to secure a contract.

2.3.3 Adequacy of Contractual Protective Measures

2.3.3.1 Risk Compensation

It could be argued that creditors are compensated adequately for the risk that they take through the interest that they contractually demand from the company. This argument is also not without problems.

This argument firstly assumes that creditors possess sufficient information to enable them to properly assess the risk that they bargain for. Whether this is the case is an open question.

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79 Ibid.

80 Ziegel supra 530 indicates that information on a company’s financial position is often deficient and may furthermore change very quickly.
The rate of interest agreed upon furthermore reflect compensation for the risk as it is perceived at the moment of conclusion of the contract – it may, however, be ineffective to provide for unforeseen risks cropping up after conclusion of the contract.\textsuperscript{81} In this regard one has to agree that “the issue in this area is not one of mismanagement but one of creditors being exposed to risks that they did not agree to accept”.\textsuperscript{82}

The advent of insolvency would furthermore cause the compensation negotiated for by the creditors to become even less adequate.\textsuperscript{83} In the normal course of business, it is in the best interests of a company to respect its obligations, in order to gain access to subsequent infusions of capital. At the onset of insolvency the self-interest argument becomes inapplicable, however, as the company, at that stage, is not likely to contemplate further funding.\textsuperscript{84}

Insolvency could also lead to an improper wealth transfer from shareholders to creditors,\textsuperscript{85} as it would be in the best interest of shareholders for the corporation to engage

\textsuperscript{81} Botha “Directors’ Fiduciary Duties to Bondholders? Some Relationships Between Corporate Financial Management and Fiduciary Law” 1993 SA Merc LJ 287 (hereinafter Botha Duties to Bondholders); Kanda “Debtholders and Equityholders” (1992) 21 Journal of Legal Studies 431; Keay Contractarian Concerns 689; Rousseau supra 382. Daniels Stakeholders and Takeovers 344, on the other hand, suggests that creditors, being unable to anticipate all future risks, should construct a diversified portfolio of investments in order to limit the losses that they sustain on a single transaction. Keay Contractarian Concerns 692 indicates, however, that diversification is an option for some creditors, such as banks, but that it would be inapplicable for a significant number of creditors, eg many trade creditors; tort victims, etc.

\textsuperscript{82} Keay Contractarian Concerns 669 (own emphasis).


\textsuperscript{84} Rousseau supra 382.

\textsuperscript{85} “Wealth transfer” refers to the transfer of wealth from debtholders to shareholders by increasing debt or by distributing assets to shareholders. It thus comes down to an increase in the firm’s debt to equity ratio and a consequent increase of the firm’s financial risk. Van der Weide “Against Fiduciary Duties to Corporate Stakeholders” (1996) 21 Delaware Journal of Corporate Law 27 45 classifies the risk of shareholder opportunism as “theoretical”, but concedes that the potential for actual exploitation arises when a firm faces “a material probability of bankruptcy or is in financial distress”. See Barkey “The Financial Articulation of a Fiduciary Duty to Bondholders with Fiduciary Duties to Stockholders of the Corporation” (1986) 20 Creighton Law Review 47 56 – 64; Botha Duties to Bondholders 293 – 296; Corey, Marr & Spivey “Are Bondholders Owed a Fiduciary Duty?” (1991) 18 Florida State University Law Review 971 972 – 975; Iacobucci Directors’ Duties in Insolvency 401; and Rousseau supra 383 for more information.
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in and continue with risky transactions, in an attempt to avoid insolvent winding-up. Should these fail, shareholders do not stand to lose more than what they would have lost upon the winding-up of the corporation anyway. They stand to gain substantially, however, should these prove to be successful. Creditors, on the other hand, are the ones funding the increase in risk and carrying the sole burden, without any additional benefits befalling them should the ventures prove to be successful.

A mechanism is therefore necessary to compensate creditors *ex post* for the additional risk of loss that they are exposed to under such circumstances.

### 2.3.3.2 Guarantees and Loan Covenants

Guarantees and loan covenants raise problems of their own. The first is the costs and difficulties involved in documenting such transactions. The second relates to the difficulty in detecting breaches. Lastly, even if one were able to detect a breach, the time factor involved in enforcing rights is problematic.

### 2.3.4 Efficiency Concerns

Even if it is assumed that creditors are free to negotiate for the very best protective contractual measures to safeguard their interests in the corporation, having all the necessary information to do so, fears exist that this might prove very expensive. The costs involved in such an exercise might exceed the benefits that the parties may derive on the issue of wealth transfer from bondholders to shareholders. This issue is also addressed *infra* par 2.4.4.

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86 Keay *Contractarian Concerns* 669 indicates that there is empirical evidence to support the fact that managers tend to engage in excessive risk-taking once a company is in financial distress.

87 *Ibid*.

88 Sappideen *supra* 366. Also see Keay *Contractarian Concerns* 688 for criticism of guarantees as a means to protect creditors’ interests.
from it, thereby rendering the process inefficient.\textsuperscript{89} This issue may be particularly relevant insofar as small trade creditors are concerned.\textsuperscript{90}

\textbf{2.3.5 Conclusion}

The preceding discussion indicated numerous inadequacies with regard to the way in which creditors are able to protect their own interests through the terms and conditions of the contract that they negotiate with the company. The first of these is that it fails to recognise the plight of involuntary creditors of the company.

Voluntary creditors are furthermore, contrary to popular perception, not free to negotiate the terms and conditions of the contract with the company. Even if it is assumed that creditors, or at least some of them, are in such a strong bargaining position that they could influence the terms and conditions of the contract, the problem still remains that a lack of information would result in these creditors not being able to properly assess the risk that they bargain for. This process may also prove to be inefficient due to the exorbitant costs that may be involved in negotiating the “perfect” contract.\textsuperscript{91}

Another problematic aspect is that the risk that the creditors assumed might increase after conclusion of the contract, thus rendering the compensatory interest initially agreed upon, 

\textsuperscript{89} See Keay \textit{Contractarian Concerns} 676; and MacIntosh “Designing an Efficient Fiduciary Law” (1993) 43 \textit{University of Toronto Law Journal} 425 429 – 430; 435 – 442 for more detail on theories on efficiency, namely the Coase theorem; Kaldor-Hicks efficiency; and Pareto efficiency.

\textsuperscript{90} Iacobucci \textit{Directors’ Duties in Insolvency} 409.


Because of normal human limitations (foresight, knowledge, etc) the capacity to draft contracts to deal with future contingent states is inherently circumscribed and this greatly limits the utility of contracts to deal with any economic activity involving an element of futurity and uncertainty. Also, even if the future can be foreseen, the costs of negotiating a contract to deal with all contingencies that might arise would render the exercise prohibitively expensive and inefficient as the costs of contracting would exceed the benefits to be derived by the parties from having dealt with all known risks.
inadequate. As was indicated, other traditional protective measures such as guarantees and loan covenants also have limited ability to protect the interests of corporate creditors.

One is therefore inclined to agree that “[j]ust as fiduciary duties to shareholders are a response to contractual infirmities between shareholders and directors…similar contractual infirmities may also suggest shifting duties to creditors in insolvency”.  

2.4 SHAREHOLDERS v CREDITORS AS PRIMARY CORPORATE CONSTITUENTS

2.4.1 General

The supremacy of shareholders as primary, if not sole, corporate constituents, is illustrated by numerous traditional company law principles. Among these is the fact that for a long time shareholders have been regarded as the exclusive indirect recipients of directors’ duties. This is illustrated by the fact that the general meeting of shareholders is endowed with the power to ratify a breach of directors’ duties, or to institute action on behalf of the company against directors who are in breach of their duties.

The notion of shareholder supremacy is coming more and more under fire. In this section several arguments as to why shareholders should be regarded as the primary corporate constituents are referred to and an attempt is made to indicate that these arguments are not entirely convincing, thus proving that creditors should not be deprived of the protection that may be afforded to them by way of directors’ duties.

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92 Iacobucci *Directors’ Duties in Insolvency* 409. Also see Morgan & Underwood *supra* 339; Rousseau *supra* 382; and Sappideen *supra* 367 for similar arguments.

93 The company of course being the direct recipient.

94 This seems to be indicated by legislative provisions such as s 309 of the English *Companies Act* 1985; as well as judicial pronouncements on the need to consider the interests of other corporate constituents (see cases cited *infra* Ch 4 (Judicial Framework)).
2.4.2 Owners of the Company

The first reason why some would consider shareholders to be entitled to the position of sole corporate constituents is largely historical, specifically with reference to the development of the company as a modern form of business enterprise. Before general incorporation through statute was provided for, many entrepreneurs combined principles of trust law and partnerships to create their own corporate vehicle – the so-called “deed of settlement” company. In this type of company shareholders were in fact the owners of the company and it would not be difficult to see how it came to be surmised that it is their interests that should be paramount in such an undertaking. Despite introduction of general incorporation, which meant “the substitution of a metaphysical being for a collective organism or group” and a host of new legal principles, “the principles of the director’s fiduciary obligations were already well established on the basis that the members collectively were the company”, by the time that these new rules were settled authoritatively.

Add to the traditional notion of shareholders as “owners” of the firm the insights of Berle and Means with regard to the separation of ownership and control in the modern company, and one is one step further on the road of entrenching the position of shareholders as primary corporate constituents. Berle and Means made the point that


96 Grantham “Reforming the Duties of Company Directors” (1991) 12 The Company Lawyer 27 28 explains that the company is still treated as its collective membership, despite the recognition of its separate existence in Salomon v Salomon & Co Ltd [1897] AC 22, due to, amongst other reasons, its historical foundations in the “deed of settlement” company where the members did in fact collectively own the company.


98 Berle & Means The Modern Corporation and Private Property (1933) 294.
shareholders, although owners of the firm, are not in control of the firm. Control is left in the hands of managers or directors.

In order to protect their investments shareholders, as owners, would have to monitor management and ensure that they comply with their duties, which results in agency costs. If these duties are primarily perceived to address problems that shareholders could experience as a result of the separation of ownership and control, and that they are taxed with monitoring management in this way, it logically follows that they are the intended beneficiaries of such duties.

The contention that shareholders are the owners of the firm – and consequently the parties to exercise a degree of control over management – can be rejected relatively easily in light of the fact that the company is regarded as a separate entity from date of incorporation. Regarding the members collectively as the firm is therefore an out-of-date assumption and conceptually unacceptable in light of the recognition of the separateness of the corporate entity.

2.4.3 Relative Strength of Bargaining Power

Just like creditors, shareholders could enter into specific contracts, but are seen to possess inadequate bargaining power, whereas creditors are perceived to be in a position to negotiate protection for their interests in the company through terms and conditions of the contracts that they conclude with the company. As a result it is accepted that

99 Commentators identify two types of agency misbehaviour that are particularly relevant in the context of directors’ duties, namely the risk that directors may “shirk” or that they may divert corporate resources to themselves. The duty of care addressed the first problem, while fiduciary duties address the second. See eg Iacobucci A Wise Decision 343 – 345.


101 Sealy Directors as Trustees 90.

shareholders’ relationship with the company is best governed by a flexible corporate law concept of “duty”.  

Once again this argument is not entirely convincing in light of the fact that the so-called contractual protection upon which creditors are supposedly able to rely, is more perceived than real, as was already indicated. Creditors are therefore not in a stronger position than shareholders, insofar as their ability to protect their interests contractually is concerned.

2.4.4 Residual Risk-bearers

Defining shareholders as the primary corporate constituents is furthermore justified from an economic perspective, based on the view of shareholders as the “residual claimants” or “residual risk-bearers” in the corporation. Shareholders are afforded this status for various reasons.

It is assumed that the status of residual risk-bearers would provide shareholders with the appropriate incentives to make discretionary decisions. They are also viewed as the group that can best absorb any losses resulting from poor corporate performance, since other groups in the company are seen to be “wealth-constrained”, contracting only for fixed amounts rather than a percentage return on income that is not yet determined.

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104 See discussion supra par 2.3 for numerous arguments indicating that creditors’ interests are not adequately protected by means of contract.

105 King “Extending Fiduciary Principles to the Director-Creditor Relationship: A Canadian Perspective” (2002) 29 Manitoba Law Journal 243 269 holds a contrary view and is of the opinion that creditors are not entitled to any type of fiduciary duty owed to them, as they are in a position to protect their own interests through a freely negotiated contract and therefore lack the “requisite vulnerability that may now be considered a general fiduciary principle”.

106 Macey & Miller supra 405 – 407; Rousseau supra 381.

107 Easterbrook & Fischel supra 68, as referred to by Rousseau supra 381.

108 Ibid.
they bear the risk of poor corporate performance, they should be afforded the right to the company’s residual income.\textsuperscript{109}

The argument that shareholders remain the residual risk-bearers at all stages could be attacked on two fronts. The first is related to the fact that share ownership is not the risky investment that it is made out to be, since shareholders are in a position to, and often do, diversify their risk. Shareholders may thus substantially minimise their risk.\textsuperscript{110}

It must be conceded that the same argument may be applied with equal truth to creditors.\textsuperscript{111} The point remains, however, that shareholders and creditors are more similar than different in this respect. The argument that shareholders should be regarded as the primary corporate constituents, rather than creditors, based on the fact that shareholders are exposed to a greater risk, is therefore not convincing. Drawing a distinction between these two groups on the basis of their ability to manage the risk that they are exposed to thus seems to be incorrect.

The second is related to the fact that creditors in effect become the residual risk-bearers upon the company experiencing distress. Upon insolvency shareholders’ capital is already lost.\textsuperscript{112} They therefore do not stand to lose anything by the directors engaging in

\textsuperscript{109} \textit{Ibid}. Also see Kelly & Parkinson \textit{supra} 116 et seq who view this as one of the reasons why shareholder exclusivity could be justified.

\textsuperscript{110} Roach \textit{supra} 10. It must be conceded, however, that this “attack” on the argument does not hold true in respect of closely-controlled companies. In smaller companies with few shareholders also engaged in the management of the company, the option of diversification might not always exist. As an analysis of case law (see discussion \textit{infra} Ch 4 (Judicial Framework)) will indicate, this is also the type of company where creditors appear to be at their most vulnerable, since the scope for abuse of power is greater. Even should the option of diversification not be as readily available in these types of companies, it is submitted that creditors of those companies should still be entitled to the additional protection that could be afforded by way of directors’ duties, since they are most vulnerable under these circumstances.

\textsuperscript{111} Although some would question the protection that creditors could obtain for themselves by way of diversification. See eg Keay \textit{Contractarian Concerns} 692; and McDaniel “Bondholders and Corporate Governance” (1986) 41 \textit{The Business Lawyer} 413 436.

\textsuperscript{112} As is clearly indicated by the accounting principle that shareholders’ equity is represented by assets less liabilities.
a last attempt at rescuing the undertaking, but have much to gain if such attempt is successful. Such a rescue attempt might be completely unrealistic, but it would not matter to shareholders since the cost thereof will be carried by the creditors. Upon the company experiencing financial distress, limited liability thus serves to displace the risk that shareholders normally carry onto creditors, resulting in the latter effectively becoming the residual risk-bearers in the company.

Keay *Contractarian Concerns* 669 indicates that there is empirical evidence to support the fact that directors tend to engage in excessive risk-taking when the company is in financial distress.

Roach *supra* 11. This could result in what is known as the “wealth transfer problem”, “expropriation”, or “moral hazard” which recognizes that the application of the shareholder primacy norm together with the principle of limited liability, could result in the “externalisation” of costs to the detriment of creditors and others (Rousseau *supra* 388). Goddard “Corporate Personality – Limited Rescue and its Limits” in Grantham & Rickett (eds) *Corporate Personality in the 20th Century* (1998) 26, as referred to by Rousseau *supra* 381, explains the issue quite well:

Shareholders get all the benefits from the firm’s success – if a risky venture pays off, they get all the return. Yet if it fails, they do not bear the full cost of failure – creditors will bear some of its cost. The concern, from an economic perspective, is that this may lead to a form of moral hazard if shareholders are able to externalise the risk of their activities, to the extent that those risks exceed their capital contributions.

Also See Halpern, Trebilcock & Turnbull “An Economic Analysis of Limited Liability in Corporation Law” (1980) 30 University of Toronto Law Journal 117 140 – 141; and 142 – 143 for more information on the “moral hazard” that could exist as a result of limited liability; as well as sources referred to *supra* n 73.

Ibid. Morgan & Underwood *supra* 338 agree and state that when a corporation is insolvent or nearing insolvency it is not contentious to state that the company is effectively subsisting on funding provided (albeit unwillingly) by its creditors. As such it is the creditors who are then the major stakeholders of the corporation, and the interests of shareholders retreat to the background.

Also see Keay “The Duty of Directors to Take Account of Creditors’ Interests: Has It Any Role to Play” 2002 Journal of Business Law 379 386 (hereinafter Keay *Role of Directors’ Duty to Creditors*) who is of the opinion that a duty to take account of creditors’ interests could mitigate the shift of risk; Lin “Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors’ Duty to Creditors” (1993) 46 Vanderbilt Law Review 1485 1489; Rousseau *supra* 391; and Smith DG *supra* 1459. The judiciary also seems to acknowledge this fact and in some cases went so far as to state expressly that creditors occupy the position of residual owners upon insolvency of the corporation. See eg *In re Ben Franklin Retail Stores Inc* 225 BR 646 653 (Bankr ND Ill 1998), as referred to by 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 201 207.
2.4.5 Efficient Monitors of Managerial Performance

Shareholders are regarded as the most efficient monitors of directorial performance, based on the fact that they, as “owners” and residual risk-bearers, stand to lose most in case of directors not complying with their duties. Their function as a check on the exercise of directorial powers is emphasised in corporate governance reports.\footnote{Farrar \textit{Corporate Governance in Australia and New Zealand} (2001) 501 quotes the following excerpt from the Committee on the Financial Aspects of Corporate Governance London \textit{Report of the Committee on the Financial Aspects of Corporate Governance} (\textit{Cadbury Report}) (1992) to illustrate this fact:}

The trust that is placed in the ability or interest of shareholders to exercise some form of control over management would, however, seem to be misplaced.\footnote{Barnard “The Hampel Committee Report: A Transatlantic Critique” (1998) 10 \textit{The Company Lawyer} 110 114 notes that the annual general meeting “provides an illusion of participatory democracy that really makes little sense in today’s more complex world”. Also see Butcher \textit{Directors’ Duties; A New Millennium, A New Approach?} (2000) 45 who observes that there has been a “dramatic erosion of the power and control previously wielded by shareholders” in the running of companies.}

First, shareholders appear to lack interest in exercising some control over management. This fact is illustrated most clearly by the poor attendance of general meetings.\footnote{Creditors becoming the residual risk-bearers upon the company being in distress would thus seem to be justifiable from a conceptual and theoretical perspective. A practical concern in this regard is, however, that directors, fearing personal liability, could start acting like liquidators even before the company is technically insolvent, but where shareholders’ equity is already extinguished, ie where assets equal liabilities. They might deem it in their own best interest to pay off all existing debts while there are still sufficient assets to cover these, rather than to make an attempt at saving the enterprise and exposing themselves to potential personal liability in the process. This concern is further expounded upon infra par 2.5.3. Also see infra Ch 5 (Protection Afforded by Fiduciary Duties) and Ch 6 (Protection Afforded by the Duty of Care and Skill) for a submission as to how creditors becoming indirect beneficiaries of these duties would influence the \textit{content} thereof in practice.} Some
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hope was placed in the role that institutional investors, such as insurance companies, pension funds and unit trusts, could play in providing some direction to management. This hope also seems to be unfounded as institutional investors seem equally reluctant to become involved in their portfolio companies, as a result of being motivated by their own fears and ambitions; the view of themselves as traders, rather than managers; and a preference to move their investment in case of poor performance by the portfolio company, rather than to become involved in an attempt to salvage or help improve performance.


121 Referred to as the “Wall Street Walk”, which some, such as Fischel “The Corporate Governance Movement” (1982) 35 Vanderbilt Law Review 1259 1278, would regard as the “single most important safeguard to all shareholders that managers will act in their best interests”. Whether this serves as an efficient check on the abuse of directorial power is, however, debatable.

122 Id 143. See Stapledon supra 196 for further discussion of the factors that could influence the behaviour of institutional investors. Farrar supra 327 acknowledges that institutional investors have, on occasion, had behind-the-scenes consultation with management and sometimes also apply public pressure on management through the media, but in the end more often that not, operate on the basis of the “Wall Street Walk”. Goldenberg supra 35 also indicates that there has been an increase in dialogue between institutional investors and management, but continues to state that this dialogue is unfortunately too often a “dialogue of the deaf”. 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 1471 is of the opinion, however, that the “new concentration of ownership in the form of institutional investors has caused a heightened corporate discipline”. Also see Swanson “Corporate Governance: Sliding Seamlessly into the Twenty-first Century” (1996) 21 Journal of Corporate Law 417 425 – 426, who is convinced that institutional investors have been making a difference from the 1990s. There are some indications that institutional investors could be forced to play a more active role in the company. In England, eg, the Company Law Review Modern Company Law for a Competitive Economy (Final Report: Vol I) par 6.39(iii) recommends that institutional investors should be required to disclose to their clients on demand how they exercised their discretion on behalf of clients in voting and that the Secretary of State should have the power to require these investors to publish such information. The role of the institutional investor is also emphasised in the Institute of Directors King Report on Corporate Governance for South Africa 2002 and it is recommended that institutional investors should be “more transparent in their dealings with companies” (id 155).
Another reason for shareholder apathy could be the realisation that the costs of monitoring management would have to be borne by the person engaging therein, while the benefits thereof will be reaped by all.\textsuperscript{123}

Even if shareholders were interested in exercising the rights that they have in the company, they seldom question management because they feel timid or ignorant and because it is difficult to gain access to detailed information about any particular issue.\textsuperscript{124} Shareholder behaviour in public companies could thus be categorised as “apathy and short-termism” rather than “enduring interest in the long-term profitability of the enterprises in which they invest”.\textsuperscript{125}

Like creditors, shareholders’ main interest in the company thus does not seem to go beyond their financial investment. The error of the proponents of shareholder democracy is

their failure to recognize that no reason exists why investors, who provide the firm with capital in anticipation of receiving a rate of return generated by the firm’s assets, should have any input into the firm’s decisionmaking processes. On the contrary, investors are willing to supply capital, as opposed to starting and operating the enterprise themselves, precisely because they trust the expertise of professional managers.\textsuperscript{126}

\begin{flushleft}
\textsuperscript{123} Daniels “Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance” (1994 – 1995) 24 Canadian Business Law Journal 229 238 (hereinafter Daniels Must Boards Go Overboard?). Miles & Proctor supra 143 refer to this as the “free rider” effect.
\textsuperscript{124} Miles & Proctor supra 143.
\textsuperscript{126} Fischel supra 1276. This statement by Fischel seems to accord with the view held by Miles & Proctor supra 143 that shareholders are more than willing to leave the management of the corporation in the hands of the directors, who know that “their feathers will seldom be ruffled” if profit margins remain satisfactory.
\end{flushleft}
The following statement sums up the situation very accurately:

If shareholders are ineffective in safeguarding their own interests, how much less likely is it that they can effectively safeguard the public interest in proper governance. However, both legislation and Codes seem to depend only on them as providing protection against poor or fraudulent management. Some other system of regulation is clearly required.\textsuperscript{127}

It must be conceded that creditors, in all probability, would not be more effective as monitors of management performance than shareholders, thus indicating that a duty to creditors would not serve to fulfil the need for “[s]ome other system of regulation”.\textsuperscript{128} This fact, rather than seen as a negative, could, however, allay fears that creditors might interfere with the management of the company unduly.

The point remains, however, that shareholders are not entitled to their position as primary corporate constituents for being able to effectively monitor directors’ behaviour, since they are clearly ineffective in doing so, for the simple reason that they are not interested in exercising this power.

\textbf{2.4.6 Differences Between Equityholders and Debtholders}

One of the reasons behind the historic distinction at the root of the bondholder remedies issue could be that shareholders are perceived to be the “owners” of the firm, while bondholders are nothing more than “lenders”.\textsuperscript{129} As was indicated already, the view of shareholders as “owners” of the company is anachronistic and difficult to reconcile with

\textsuperscript{127} Dine \textit{Corporate Groups} 35.

\textsuperscript{128} Mitchell “The Fairness Rights of Corporate Bondholders” (1990) 65 \textit{New York University Law Review} 1165 1199 opines that this is no reason to deny them the opportunity to monitor management’s behaviour.

\textsuperscript{129} Harvey \textit{supra} 1026. Although Harvey’s comments are specifically related to bondholders, or debenture holders as it is known to us, similar arguments may apply in respect of other groups of creditors of the company. McDaniel \textit{supra} 413 succinctly summarises this viewpoint as follows:

Stockholders are owners; bondholders are creditors. Corporate law is for stockholders; contract law is for bondholders. Directors protect stockholders; the indenture protects bondholders. \textit{Those are tidy concepts, but they no longer serve modern corporate finance} (own emphasis).
the notion of separate legal personality.\textsuperscript{130} It is also interesting to note that even opponents of the extension of fiduciary duties to creditors\textsuperscript{131} would be willing to concede that “the proponents of a fiduciary duty are correct in arguing that much of the basis for distinctions between stockholder and bondholder remedies is out-dated”.\textsuperscript{132}

As will be indicated, the similarities that exist between these groups may prove to be a convincing argument for the extension of directors’ duties to include creditors’ interests.\textsuperscript{133}

The first similarity lies in the fact that the function of equityholders and debtholders in a company has become increasingly similar, with both groups supplying capital to the company in return for income.\textsuperscript{134} Shareholders and debtholders would thus appear to be the same in economical terms, as they are all security holders with differing claims on the assets and cash flow of an enterprise. The investor who buys shares and the investor who lends money are, as a matter of economics, engaged in the same kind of activity and are motivated by the same basic objectives. Both are making a capital investment and both expect to get their money back plus a return on their investment.\textsuperscript{135}

Specifically with regard to debenture holders, it may also be argued that the boundaries between debt and equity instruments are becoming more and more blurred, with some

\begin{footnotesize}
\textsuperscript{130} See discussion \textit{supra} par 2.4.2.
\textsuperscript{131} Eg Harvey \textit{supra} 1023, who specifically argues against the extension of such a duty to bondholders.
\textsuperscript{132} \textit{Id} 1025.
\textsuperscript{133} Commentators such as Kanda \textit{supra} 432 hold a different opinion, however, and feel that arguments stressing economic similarities between debtholders and equityholders may carry “superficial appeal”, but that the extension of fiduciary duties to debtholders would create new problems, rather than solve existing ones.
\textsuperscript{134} Harvey \textit{supra} 1028.
\textsuperscript{135} Sappideen \textit{supra} 382. Also see McDaniel \textit{supra} 417.
\end{footnotesize}
classes of shares displaying marked debt features and *vice versa*. On this basis it may therefore be argued convincingly that the legal distinction in available remedies have also become outmoded\(^{137}\) and one would have to agree that “[t]he blurring of securities and of investors may be a signal for a reconsideration of fiduciary boundaries”.\(^{138}\)

### 2.4.7 Conclusion

As indicated in the preceding discussion, the reasons for affording shareholders the privilege of being primary, or sole, corporate constituents seem to be unconvincing. In addition creditors are more similar to shareholders than many commentators seem to realise.

Should one also consider the viewpoints that “the hallmark of a fiduciary relation is that the relative legal positions are such that one party is at the mercy of the other’s discretion”\(^{139}\) and that the rationale for “both the loyalty duty and the decidedly strict approach to enforcing that duty rests in the vertical character of the property fiduciary’s relationship with the beneficiaries”, which verticality “implies that a gross imbalance of power exists between the parties”,\(^{140}\) there seems to be no reason why creditors, rather than shareholders, should be viewed as the primary indirect beneficiaries of directors’ duties in certain circumstances – they are indeed at the mercy of the directors and one cannot deny that there exists a significant imbalance of power in their relationship with company management.

Making shareholders the exclusive indirect beneficiaries of directors’ duties therefore does not seem justifiable.

\(^{136}\) Corey, Marr & Spivey *supra* 979; Harvey *supra* 1028; McDaniel *supra* 417.

\(^{137}\) *Ibid*.

\(^{138}\) Corey, Marr & Spivey *supra* 979.


2.5 EFFECT OF A DUTY TO CREDITORS ON DIRECTORS’ BEHAVIOUR

2.5.1 General

Many commentators, in expressing their concerns regarding the extension of a directorial duty to include the interests of creditors, raise the argument that such a step would have a negative impact on director conduct. The first fear relates to the concern that an extended duty would lead to a fragmentation of duties, which could have undesirable consequences. A second concern is that a duty to creditors would cause directors to become excessively risk averse, with a consequent negative impact on the wealth creating capacity of the company. It is finally suggested that increased exposure to personal liability might deter competent persons from serving on the boards of companies. In this section a closer look is taken at these concerns and some suggestions will be offered as to how these fears could be allayed.

2.5.2 Fragmentation of Duties

A number of commentators advance the argument that a fragmentation of directors’ duties could lead to numerous undesirable consequences pertaining to director conduct. This first potential pitfall relates to the difficult position in which directors would find themselves should they be expected to “simultaneously serve the twin masters of the stockholders and the bondholders”.\(^{141}\) In the end directors, especially those of large companies, might find themselves in the unenviable position of being expected “as a matter of business to consider the claims of many competing interests, while being legally answerable to only one”.\(^{142}\)

The second concern that is raised in respect of directors being required to consider the interests of a variety of corporate constituents is that instead of making life more difficult for them, it could in fact have the opposite effect in serving to lessen their plight. It is feared that a broad definition of “duty” could eventually result in management being able to operate without any form of external control, since duties to all would entail that

\(^{141}\) Harvey supra 1040 – 1041. This is referred to as the “too many masters” argument by some. See eg Macey & Miller supra 412.

\(^{142}\) Sealy Directors as Trustees 90.
management would be able to justify almost any action on the basis that it benefits some group. This would in effect mean that one loses all control over the propriety of decisions of directors.\footnote{143}

These may seem like valid points of criticism. It must be kept in mind, however, that it is suggested that the primary beneficiary of directors’ duties would remain the company.\footnote{144} Upon the company experiencing distress\footnote{145} the interests of the company are redefined to provide for the protection of creditors’ interests, rather than those of shareholders.

Directors would thus not be expected to balance the competing interests of a number of corporate constituents. This suggested model for a duty to creditors should also go some way towards allaying fears that an extension of duties to include creditors’ interests could result in the disappearance of meaningful control over directorial conduct.

2.5.3 Increased Risk Averseness

According to the traditional view the objective of the company is to maximise shareholders’ wealth, which objective can only be achieved if managers have a fiduciary duty to shareholders to pursue this objective.\footnote{146} It is feared that a duty to creditors could give rise to the problem of insufficient risk taking, as directors, fearing personal liability, 

\footnote{143}{Berle “For Whom Corporate Managers Are Trustees: A Note” (1932) 45 Harvard Law Review 1365 1367 – 1369 notes that}

\[\text{[w]hen the fiduciary obligation of the corporate management and “control” to stockholders is weakened or eliminated, the management and “control” become for all practical purposes absolute.}\]

Also see Chapman \textit{supra} 213; Dawson \textit{supra} 81; and Sealy \textit{Directors’ “Wider” Responsibilities} 175.

\footnote{144}{See discussion \textit{infra} Ch 8 (Beneficiary of the Duty) for more detail in this regard.}

\footnote{145}{A continuous duty to creditors is not advocated, but rather one that is “triggered” upon the company in question experiencing economic or financial distress. See discussion \textit{infra} Ch 7 (Point in Time When the Duty Arises) for more detail in this regard.}

\footnote{146}{According to MacIntosh \textit{supra} 425 wealth maximisation is the traditional answer to the question of the function of corporate law. Also see Botha \textit{Duties to Bondholders} 296; Pascoe & Anderson “Peeking under the veil: Creditor’s rights against directors behaving badly” (2002) 16:4 \textit{Commercial Law Quarterly} 12 13.}
might become risk averse in order to prevent personal liability for failing to protect the interests of creditors. This could lead to a decline in the ability of the company to serve its purpose as a tool of wealth maximisation.\footnote{Chaver & Fried “Manager’s Fiduciary Duty Upon the Firm’s Insolvency: Accounting for Performance Creditors” (2002) 55 Vanderbilt Law Review 1813 1823; Daniels Must Boards Go Overboard? 248 – 249.}

It cannot be denied that companies need to take risks to prosper.\footnote{Schwarz “Rethinking a Corporation’s Obligations to Creditors” (1996) 17 Cardozo Law Review 647 686.} Sealy stated very eloquently that

directors must be free to take risks and to judge what risks their business should take. We must not lose sight of the fact that it is the principal function of the limited liability company, and of company law, to facilitate this risk-taking; without it, the worlds \textit{sic} railways would not have been built and we would have had no Industrial Revolution, no modern technology.\footnote{Sealy Directors’ “Wider” Responsibilities 181.}

In this regard it must be emphasised, however, that it is not proposed that a directorial duty to creditors should be structured in such a way that all corporate failures should result in directors incurring personal liability to creditors of the company.\footnote{This would distinguish the company as business vehicle from the sole proprietorship, eg, where the sole proprietor would incur liability in case of the business failing despite having been honest and diligent.} In case of a duty to creditors being triggered,\footnote{See infra Ch 7 (Point in Time When the Duty Arises) for more information on the circumstances that could “trigger” a duty to creditors.} directors should, as always, comply with their fiduciary duties and the duty of care and skill\footnote{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 these duties.} and should only be held personally liable in case of a breach of these duties. Upon a duty to creditors being triggered, directors must, however, keep in mind that creditors became the indirect beneficiaries of these duties and should be able to indicate that their interests were considered.
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All risk-taking should therefore not come under attack, but only irresponsible risk-taking. The financial position of the company in question should be a good indicator of the acceptable levels of risk-taking that directors should engage in. Directors of a company experiencing distress should not engage in excessively risky transactions with what is in effect at that stage, creditors’ money. On a practical level, principles applicable to directors’ duty to act with care and skill may be valuable in providing a legal framework within which it would be possible to determine whether directors engaged in responsible or irresponsible risk-taking.

Risk averseness is thus not always the devil it is made out to be and may serve an important function with regard to the protection of the interests of corporate creditors under the right circumstances.

It is furthermore submitted that sacrificing creditor protection is not a suitable way of addressing the potential problem of directors becoming risk averse. Another way, and one which would seem to be preferable to sacrificing creditor protection, is to provide diligent directors with relief from liability where the circumstances warrant it.

2.5.4 Reluctance to Serve on Company Boards

A final undesirable result of a duty to creditors and a consequent increase in potential personal liability could be that competent persons would be unwilling to serve on the

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153 Keay Contractual Concerns 683.
154 Ibid.
155 Ibid. Davis “Corporate Assets as a Trust: for Whom are Corporate Officers Trustees in Insolvency? The Role of Incentives in Maintaining the Trust” (2003) 12 International Insolvency Review 113 124 makes a similar point.
156 See discussion infra Ch 6 (Protection Afforded by the Duty of Care and Skill) for more detail in this regard.
157 See Kraakman “Corporate Liability Strategies and the Costs of Legal Controls” (1984) 93 Yale Law Journal 857 858 – 867 for a discussion on the importance of such measures. Measures such as these would, of course, only succeed in this regard should they prove to be effective in providing relief from liability to deserving directors. See infra Ch 9 (Relief from Liability) for further information regarding various such measures and their efficacy.

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boards of companies. However, this argument functions on an empirical basis that is not well-established. One is therefore inclined to agree with the viewpoint that the contention that there will be a “dearth of people willing to serve on boards of directors…is not all that convincing”.

Furthermore, even should concerns in this regard indeed prove to be true, it is submitted that such concerns may once again be addressed through the provision of adequate measures providing deserving directors with relief from liability.

2.6 EFFECT OF A DUTY TO CREDITORS ON LIMITED LIABILITY

Limited liability is considered as one of the cornerstones of modern company law. A further conceptual point against a duty to creditors is that it would encroach upon this crucial principle. The main concern in this regard seems to centre on the potential negative impact on directors’ risk-taking ability. The following statement provides a good illustration of this sentiment:

Any reformulation of directors’ duties to take account of the interests of creditors and others has to accommodate the concepts of risk, and allow for the fact that directors must be free to take risks and to judge what risks their business should take. We must not lose sight of the fact that it is the principal function of the limited liability company, and of

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160 Id 451.

161 See discussion infra Ch 9 (Relief from Liability) for more detail in this regard.

162 Easterbrook & Fischel supra 40 – 62, as referred to by Booth “Limited Liability and the Efficient Allocation of Resources” (1994) 89 Northwestern University Law Review 140 144 – 145, list numerous reasons why limited liability is considered crucial, namely the fact that limited liability decreases investors’ need to monitor management; decreases the need for shareholders to monitor each other; allows for the free transfer of shares; allows an efficient market to arise; allows investors to diversify; and allows corporate managers to invest in riskier projects that offer greater rewards.
company law, to facilitate this risk-taking; without it, the world’s railways would not have been built and we would have had no Industrial Revolution, no modern technology.\(^\text{163}\)

There are various counter arguments to this point. First, limited liability was initially enacted for the benefit of shareholders – not directors.\(^\text{164}\) This inference is supported by the fact that the initial legislation introducing limited liability in England, the \textit{Limited Liability Act} 1855,\(^\text{165}\) itself provided for the personal liability of directors to creditors for the amount of dividends paid where the directors knew that the company was insolvent, or that the dividend payment could render the company insolvent.\(^\text{166}\)

This provision could be considered as insignificant, since directors’ liability to creditors was limited to very specific circumstances and to the amount of the dividend. It provides an indication, however, of the realisation that the persons in control of company assets, namely the directors, should behave in a responsible fashion towards company creditors.\(^\text{167}\)

\(^{163}\) Sealy \textit{Directors’ “Wider” Responsibilities} 181, in a paragraph titled “Limited Liability and Risk”.

\(^{164}\) Nicholls “Liability of Corporate Officers and Directors to Third Parties” (2001) 35 \textit{Canadian Business Law Journal} 1 2 phrases it clearly:

\begin{quote}
That the landmark House of Lords decision in \textit{Salomon v A Salomon & Co} dealt with the limited liability of shareholders, \textit{not corporate directors}, there can be no doubt. Indeed, the term “limited liability” historically could only ever logically have referred to an immunity enjoyed by shareholders (own emphasis).
\end{quote}

\(^{165}\) Watson & Willekes “Economic Loss and Directors’ Negligence” 2001 \textit{Journal of Business Law} 217 218 also make the point that “protecting shareholders from liability…is what the corporate veil from \textit{Salomon} onwards was intended to do” (own emphasis). Gower 180 indicates, however, that the doctrine of limited liability is “traditionally conceived as concerning itself with the protection of the shareholders’ assets, but functionally it can be seen as a wider doctrine”.

\(^{166}\) In terms of s 9 of the \textit{Limited Liability Act}.

\(^{167}\) Cooke \textit{supra} 154 makes the following important observation with regard to s 9 of the \textit{Limited Liability Act}:
Holding directors personally liable for failing properly to consider the interests of creditors under particular circumstances would thus, strictly speaking, not encroach upon the principle of limited liability, as the liability of shareholders would still be limited to the amount that they contributed towards the company’s capital.

Secondly, limited liability should be viewed as a privilege, rather than a right granted to a corporation, in order to encourage increased corporate accountability.

This provision in the Limited Liability Act is, however, one further indication of the nature of the relation of shareholder and director to the capital fund with which both are concerned. The directors were, until the middle of the nineteenth century, trustees and managers of the joint stock fund formed by way of a deed of settlement...The shareholders were subscribers to the fund, after which they either gained or lost by the directors’ operations. Their power to interfere in the management was limited by the deed of settlement, and it had been the practice of the Courts to construe the terms of these deeds to give as little power of meddling as possible. Thus the shareholders were in the hands of the directors, as the general principle of limited liability recognized; it was the directors who should be fixed with the duty of safeguarding creditors’ interests in the company’s available balance (own emphasis).

See infra Ch 7 (Point in Time When the Duty Arises) for a discussion of the circumstances when directors would become liable to consider creditors’ interests.

Keay “The Director’s Duty to Creditors: When Is it Triggered?” (2001) 25 Melbourne University Law Review 11; Morgan & Underwood supra 339. The judiciary also seems to recognise this point. In Nicholson v Permakraft(NZ) Ltd (1985) 3 ACLC 453 459, eg, the judiciary justified an extension of duties to creditors on the basis that “limited liability is a privilege”. Also see S v Hepker 1973 1 SA 472 (W) 484 in which the concomitant duty is recognised by the following statement:

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 (own emphasis).

Those adhering to the contract theory of the corporation would argue against such an assertion, however, and would view limited liability as a term of the contract among shareholders and creditors, rather than as a state-conferred privilege. See Ribstein “Limited Liability and Theories of the Corporation” (1991) 50 Maryland Law Review 80 for more information in this regard.
Chapter 2                                                                                     Conceptual Justification

One should also keep in mind that limited liability caused creditors to be much worse off than before.\textsuperscript{170} It is true that safeguards were put in place, but these safeguards were very modest and could overall be regarded as a very ineffectual trade-off for the limited liability shareholders.\textsuperscript{171}

Limited liability also poses the danger of providing “numerous opportunities for deviant conduct by management”,\textsuperscript{172} enforcing the argument that creditors of companies be offered adequate protection against such conduct. This last point must be emphasised – limited liability in itself does not seem to be the major culprit in prejudicing creditors’ interests,\textsuperscript{173} but rather the opportunity that is created for directors to misbehave as a result, causing prejudice to creditors.

From a theoretical and conceptual point of view it is therefore submitted that an argument against an extension of directors’ duties to consider creditors’ interests on the basis that it erodes the fundamental principle of limited liability, cannot be upheld.\textsuperscript{174} A duty to

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\textsuperscript{170} It is recognised by Corkery “Defaulting Director/Guarantors – Recovering Money from Company Officers for Creditors” (1986) 10 Adelaide Law Review 492 that

[I]limited liability was supposed to encourage investment in commercial and industrial ventures. It did that. But from the first it was apparent that some of the “investors” in these limited liability companies, namely those who became unsecured creditors, had lost much. Limited liability was often enjoyed at their expense.

Also see Giugni & Ryan “Company Directors’ Spheres of Responsibility: Primary and Secondary Duties” 1988 New Zealand Law Journal 437 439 et seq for a discussion on the initial resistance to the introduction of limited liability, for fear of it leading to an increase in fraud; excessive speculation, etc.

\textsuperscript{171} Ziegel supra 513. Dabner “Directors’ Duties – The Schizoid Company” (1988) 6 Company & Securities Law Journal 105 114 agrees that limited liability placed creditors in a less than enviable position and that it would consequently seem only fair “that the creditor receives some advantages to offset this detriment”.

\textsuperscript{172} Ziegel supra 530 (own emphasis).

\textsuperscript{173} Grundfest “The Limited Future of Unlimited Liability: A Capital Market Perspective” (1992) 102 Yale Law Journal 387 421 argues that “the evidence is hardly overwhelming that limited liability causes a significant increase in a corporation’s willingness to engage in risky behaviour”.

\textsuperscript{174} One could take this argument one step further, however, and bemoan the fact that director liability to creditors encroaches on the principle of a company as a separate legal entity, supposedly liable for its own
creditors rather seems to have the effect of encroaching on the principle of separate legal personality of the company, with somebody other than the company being held liable for the payment of its debts.\textsuperscript{175}

### 2.7 CONCLUSION

There are numerous points of conceptual criticism against the extension of directors’ duties to creditors. One of the main conceptual arguments against such extension is that the protection afforded to creditors’ interests should be limited to what they negotiated for in terms of the contract that they concluded with the company. If these protective measures are inadequate, they have only themselves to blame.

This view may, to a large extent, be attributed to the emphasis placed on the contractual theory that many regard as underpinning the company, as well as the perceived differences between debtholders and equityholders.

The contractual theory of the company no longer enjoys unqualified support\textsuperscript{176} and it is submitted that the associative theories proposed by commentators such as Dine and Wishart would be infinitely more suitable for the modern company.

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\textsuperscript{175} From a practical perspective it must be conceded that such a development could impact negatively on directors’ risk-taking ability – a concern broached by numerous commentators. As was already indicated, however, it is not proposed that a duty to consider the interests of creditors should preclude all risk-taking. Directors should remain free to take business risks, but should be guided by the financial situation of the company to determine the acceptable level of risk-taking. See discussion \textit{supra} par 2.5.3.

\textsuperscript{176} Branson \textit{supra} 93; De Mott \textit{supra} 88; Dine \textit{Corporate Groups} 35.
Contractual protection for creditors’ interests is furthermore feigned protection, because of the fact that creditors are often not in a position to adequately assess the risk that they are contracting for and even if they were, they still experience the problem that their freedom to contract is curtailed, thus depriving them of the opportunity to negotiate for adequate protective measures.

The reasons for automatically assigning to shareholders the position of primary, or sole, corporate constituents, namely that equityholders are different from debtholders and consequently deserving of a different type of protection for their interests; that shareholders are the equitable owners of and residual risk-bearers in the company; that shareholders are unable to protect their interests through contractual measures; and that shareholders are able to exercise effective control over management, were also shown to be unconvincing. The availability of hybrid securities also indicate an increased blurring of the traditional boundary between shareholders on the one hand and debtholders on the other.

Fears that a duty to creditors, with a concomitant increase in directors’ exposure to personal liability, could impact negatively on directors’ behaviour are perhaps not unfounded. It is submitted, however, that these fears should not be addressed by way of a tempering of directors’ duties, but rather through measures providing deserving directors with relief from liability in appropriate circumstances.\(^{177}\)

This point of criticism furthermore neglects to recognise that acceptance of a duty to creditors might yield some benefits. Increased vulnerability to personal liability could provide directors with an incentive “to keep themselves apprised of what is going on in their companies”.\(^{178}\)

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\(^{177}\) This aspect will be dealt with in more detail below. See *infra* Ch 9 (Relief from Liability).

\(^{178}\) Keay *Role of Directors’ Duty to Creditors* 409.
Any fear that a duty to creditors will erode the fundamental concept of limited liability could also be dispelled. In this regard it is furthermore argued that creditors, who were rightly seen as the group to bear the detrimental impact of limited liability from the start, should be provided with adequate safeguards.

In the end the conceptual points of criticism that are normally presented when engaging in discussion on the extension of directors’ duties to include the interests of creditors, do not seem to present insurmountable obstacles. It is therefore submitted that creditors should be afforded the protection of an extension of directors’ duties to include their interests and that such an extension is justifiable on a conceptual basis.

However, the need for such a development may be questioned in light of the fact that measures aimed at the protection of creditors’ interests do exist. A second issue that needs to be addressed is therefore whether the extension of directors’ duties to include creditors’ interests is indeed necessary. It will only be possible to provide an answer to this question after having analysed the efficiency of existing measures to provide protection for creditors’ interests. This aspect is addressed in the next chapter.
CHAPTER 3
EVALUATION OF ALTERNATIVE REMEDIES

SUMMARY

3.1 INTRODUCTION
3.2 STATUTORY MEASURES PROVIDING FOR DIRECTORS’ PERSONAL LIABILITY
3.3 TYPICAL INSOLVENCY REMEDIES
3.4 PIERCING THE CORPORATE VEIL
3.5 CONCLUSION

3.1 INTRODUCTION

Those opposed to the extension of directors’ duties to include the interests of creditors, often base their opposition on the fact that there are adequate alternative remedies available to creditors for the protection of their interests. Remedies that are often referred to in this regard include traditional insolvency remedies, the disregarding of the separate legal personality of the company and especially statutory

\[\text{\textsuperscript{179}}\] See eg Fourie “Die Plig van Direkteure Teenoor Maatskappyskuldeisers” 1992 SA Merc LJ 25 49 – 50, who is of the opinion that

\[\text{\textsuperscript{179}}\] a 424 in beginsel voldoend beskerming aan skuldeisers bied om hulle belange te beskerm, en dat ’n plig soortgelyk aan dié wat in Australië, Nieu-Seeland en Engeland aan direkteure opgelê is om skuldeiserbelange by insolvensie of dreigende insolvensie in ag te neem, nie op hierdie tydstip in Suid-Afrika nodig is nie.

He qualifies this statement, however, in n 177, with reference to numerous problems that exist with regard to the application of s 424. Also see Havenga “Directors’ Fiduciary Duties Under Our Future Company-law Regime” 1997 SA Merc LJ 311 321 who opposes a duty to creditors, because “s 424 of our Companies Act gives substantial protection to company creditors”, as well as Sealy “Directors’ Duties – An Unnecessary Gloss” (1988) 47 Cambridge Law Journal 175 who feels that “judicial utterances” pertaining to a duty to creditors, examined in context, would boil down to nothing more than extraneous words of censure directed at conduct which anyway comes within some well-established rule of law, such as the law imposing liability for misfeasance, the expropriation of corporate assets or fraudulent preference.
provisions in terms of which directors may be held personally liable for fraudulent, reckless, wrongful, or insolvent trading.  

In this chapter the emphasis is on statutory provisions in terms of which directors may incur personal liability for engaging in fraudulent, reckless, wrongful, or insolvent trading, as this is the remedy that is most often offered as an alternative to directors’ duties to creditors. The jurisdictions referred to in this regard are South Africa, Australia, New Zealand and England, as all of them provide for the statutory liability of directors in this way. The other two jurisdictions used throughout this study, namely Canada and the United States of America, do not have equivalent provisions. However, some background is provided as to how the Canadian oppression remedy could be applied to fulfil a similar function. An equivalent remedy is unknown in the United States of America, which jurisdiction will therefore be disregarded for the purposes of this particular aspect of the current study.

For the sake of completeness reference is also made to typical insolvency remedies, as well as the “piercing of the veil” doctrine, before a conclusion is reached on whether there is room or need for an alternative remedy by way of an extension of directors’ duties to include creditors’ interests.

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180 These provisions are formulated differently in various jurisdictions. See discussion infra par 3.2.

181 Infra par 3.2.1.

182 Infra par 3.2.2.1.

183 Infra par 3.2.2.2.

184 Infra par 3.2.2.3.

185 Infra par 3.2.2.4.

186 According to Wood “World Corporate Law – Mapping the Real Differences” (2003) 24 The Company Lawyer 34 35 in Delaware “the idea that directors could be personally liable for not stopping in time or incurring credit while insolvent seems to be a total heresy”.

187 Infra par 3.3. The inadequacy of these remedies in protecting creditors’ interests will also be referred to in subsequent discussions, where relevant.

188 Infra par 3.4.

189 Infra par 3.5.
Chapter 3 Alternative Remedies

3.2 STATUTORY MEASURES PROVIDING FOR DIRECTORS’ PERSONAL LIABILITY

3.2.1 South Africa

The South African Companies Act provides for the personal liability of those involved in the managing of the business of the company in a reckless or fraudulent manner in terms of section 424(1). This provision reads as follows:

> When it appears, whether it be in a winding-up, judicial management or otherwise, that any business of the company was or is being carried on recklessly or with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court may, on the application of the Master, the liquidator, the judicial manager, any creditor or member or contributory of the company, declare that any person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct.

As was mentioned earlier, numerous commentators oppose the extension of directors’ duties to include creditors’ interests on the basis that provisions such as section 424(1) of the South African Companies Act provide sufficient protection of their interests. Closer inspection reveals that this is not necessarily the case and that various elements of section 424(1) may become obstacles in the path of adequate creditor protection. These elements are discussed in more detail below.

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191 S 424(3) furthermore provides that a person who was knowingly involved in conducting the business of the company fraudulently or recklessly, shall be guilty of an offence.

192 It must be noted that an exhaustive analysis of s 424(1) is not provided in this regard, but that only those aspects that would indicate that there is room and need for an alternative remedy are highlighted. See De Koker Die Roekelose en Bedrieglike Dryf van Besigheid in die Suid-Afrikaanse Maatskappyereg LLD UOVS (1996) for an extensive analysis of this particular provision, as well as the following contributions by various commentators for more detail on particular aspects of this provision: Brusser “S 424 and the Single ‘Reckless or Fraudulent’ Conduct” 1985 SA Company LJ 11; Cassim “Fraudulent or ‘Reckless’ Trading and Section 424 of the Companies Act” 1981 SALJ 162; Fourie “Dorklerk Investments (Pty) Ltd v Bhyat 1980 1 SA 443 (W): Roekelose of Bedrieglike Optrede – Artikel 424 van die Maatskappyyewet 61 van 1973” 1980 THRHR 328; Havenga “Director’s Personal Liability for Reckless Trading” 1998 THRHR 719; Hyman “Directors’ Liability for Company’s Debts” 1980 SA Company LJ E-1; Hyman “More on Directors’ Liability for Debts” 1981 SA Company LJ E-21; Luiz “Extending the Liability of Directors” 1988 SALJ 788; Luiz & Van der Linde “Trading in Insolvent Circumstances – Its Relevance to Sections 311 and 424 of the Companies
Chapter 3  

Alternative Remedies

### 3.2.1.1 Applicants

In terms of section 424(1) the Master of the High Court, the liquidator, the judicial manager, any creditor or member or contributory of the company, may apply for an order in terms of this section.

#### 3.2.1.1.1 Question as to Whether Claim Should be Quantified

Regarding an application brought by a creditor, the question arose as to whether such claim should be quantified by acceptable evidence. In *Dorklerk Investments (Pty) Ltd v Bhyat* the court decided that it could not exercise its discretion against the respondent “where the applicant makes so nebulous a claim, which is unliquidated except that it has been admitted as a claim against the company in liquidation”.

In *Cronje v Stone* the court held a contrary opinion, however, and made it clear that a specific amount need not be claimed in order to be able to rely on the protection provided by section 424(1).

In yet another case, *Retail Management Services (Edms) Bpk v Schwartz*, the court addressed this issue by distinguishing between applications brought by creditors and those brought by liquidators. In the former case a creditor is deemed to have sufficient information to be able to prove the existence of his claim, as well as the quantification thereof and is therefore required to do so. The same does not apply in respect of applications brought by the liquidator, however.

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193 1980 1 SA 443 (W).
194 *Id* 448.
195 1985 3 SA 597 (T).
196 *Id* 604.
197 1992 2 SA 22 (W).
198 *Id* 29.
Chapter 3

Alternative Remedies

3.2.1.1.2 Effect of Implementation of Compromise in terms of Section 311 on Locus Standi of Creditor

A contentious issue is whether creditors retain the right to rely on the remedy afforded by section 424(1) after a compromise in terms of section 311 has been sanctioned and implemented. In some instances the judiciary stated that the implementation of a compromise in terms of section 311 would have the effect of precluding any right to rely on the protection envisaged by section 424(1). 200

In other instances the opposite viewpoint was held, with the court expressly stating that “‘creditor of the company’ in section 424(1) must be construed so as to include a person in respect of whom there was an existing indebtedness at the time when the compromise was sanctioned”. 201 Should this interpretation of “creditor” be followed, 202 the sanctioning and implementation of a compromise in terms of section 311 will not have the effect of depriving creditors of their locus standi to bring an application in terms of section 424(1).

200 See eg Stegman J in Ex parte De Villiers: In re MSL Publications (Pty) Ltd 1990 4 SA 59 (W) 87, who is of the opinion that any compromise or arrangement will have the effect of “averting the danger” of personal liability in terms of s 424(1). He repeated this viewpoint in Ex parte De Villiers: In re Carbon Developments 1992 2 SA 95 (W) 107 - 108, expressly stating that a s 311 compromise which specifically provides for the extinction of all the company’s debts and liabilities has the effect that s 424(1) can no longer function, as a debt or other liability of the company is the very foundation upon which any declaration of personal liability on the part of a wrongdoing company representative must stand…and that when that foundation ceases to exist…the wrongdoing company representatives who might otherwise have been declared personally responsible in terms of s 424(1) cease to be amenable to any such declaration.

201 Pressma Services (Pty) Ltd v Schuttler 1990 2 SA 411 (C) 418. This viewpoint is subscribed to in Lordan v Dusky Dawn Investments (Pty) Ltd (in liq) 1998 4 SA 519 (SE) 529, the court stating that s 424 would serve no purpose if creditors do not refer to creditors at the time of the alleged wrongful act; as well as in Kalinko v Nisbet 2002 5 SA 766 (W) 776.

202 Hambidge & Luiz “Compromise and Personal Liability under Section 424 of the Companies Act: Two Judicial Approaches” 1991 SA Merc LJ 123, although welcoming the decision in Pressma Services v Schuttler supra, feel that it contains a “rather strained interpretation of the term ‘creditor of the company’” and would prefer that s 311 be amended to provide expressly that the sanctioning of a compromise will not cause rights of creditors to proceed against directors to be extinguished. Sigwadi “Compromise and Personal Liability under Section 424 of the Companies Act 61 of 1973” 2003 SA Merc LJ 387 agrees with this submission. He also suggests, as an alternative, an amendment to s 424(1) to indicate that “creditor” refers to a creditor at the time of the reckless or fraudulent conduct.
Unfortunately the Supreme Court of Appeal\textsuperscript{203} side-stepped this issue in \textit{Ex parte De Villiers: In re Carbon Developments},\textsuperscript{204} stating that it was not necessary for it to decide “this interesting and difficult question”.\textsuperscript{205}

\textbf{3.2.1.2 Winding-Up, Judicial Management or Otherwise}

An application under section 424(1) may be brought when the company is in “winding-up, judicial management or otherwise”. It is uncertain what circumstances are envisaged by the phrase “or otherwise”.

The predecessor of the present section 424(1), section 185\textit{bis} of the previous \textit{Companies Act},\textsuperscript{206} was only applicable if it appeared during the course of winding-up or judicial management that the business of the company was conducted in a particular manner. Section 424(1) expressly extends this provision to apply to circumstances other than those where the company is in the process of being wound up or under judicial management. It thus seems clear that the legislature specifically intended the section 424(1) remedy to be available in respect of trading companies as well.

This interpretation is supported by an \textit{obiter} statement in, for example, \textit{Bowman v Sacks},\textsuperscript{207} which indicates that the court has no doubt that the “addition of the words ‘or otherwise’ causes the section to be available also when a company is not being wound up or under judicial management”.\textsuperscript{208} The same viewpoint was reiterated in \textit{Body Corporate of Greenwood Scheme v 75/2 Sandown (Pty) Ltd},\textsuperscript{209} where the court stated in no uncertain terms that a director could be held liable even if the company

\textsuperscript{203} Or Appellate Division of the Supreme Court, as it was known when the judgment was delivered.
\textsuperscript{204} 1993 1 SA 493 (A).
\textsuperscript{205} Id 501.
\textsuperscript{206} Act 46 of 1926.
\textsuperscript{207} 1986 4 SA 459 (W).
\textsuperscript{208} Id 462.
\textsuperscript{209} 1999 3 SA 480 (W).
was in a sound financial position and there was no necessity for it to be wound up or placed under judicial management.\textsuperscript{210}

However, in \textit{L & P Plant Hire BK v Bosch},\textsuperscript{211} a case dealing with the interpretation of section 64 of the \textit{Close Corporations Act}\textsuperscript{212} – the corresponding provision to section 424 of the South African \textit{Companies Act} – the Supreme Court of Appeal emphasised that the aim of this provision is to protect creditors from the detrimental consequences of a reckless or fraudulent carrying on of business. Should a close corporation still be able to meet its obligations to creditors, despite its business being carried on recklessly or fraudulently, the remedy provided for by this provision could not be relied upon.\textsuperscript{213}

\textbf{3.2.1.3 Recklessly}

The aforesaid persons may only be held liable in terms of section 424(1) if they were involved in managing the business of the company in a particular manner. Conduct that is firstly frowned upon is the managing of the business of the company in a manner that is “reckless”. The judiciary defined “recklessness” with reference to “gross negligence” on various occasions.\textsuperscript{214} In \textit{Mafikeng Mail (Pty) Ltd v Centner (No 2)}\textsuperscript{215} it was furthermore made clear that an error of judgment, even a gross error of judgment, would not be considered as reckless, provided that the defendant can show that thought and reflection went into the decision taken.\textsuperscript{216} The judiciary continued to

\textsuperscript{210} \textit{Id} 487.

\textsuperscript{211} 2002 2 SA 662 (SCA).

\textsuperscript{212} Act 69 of 1984 (hereinafter \textit{Close Corporations Act}).

\textsuperscript{213} This decision is supported by commentators, such as Matlala “Note on Personal Liability for the Debts of a Close Corporation Which is Able to Pay” 2004 \textit{Stell LR} 295 303 who feels that it is “a true reflection of the rationale behind section 64 of the Close Corporations Act as well as section 424 of the Companies Act”.

\textsuperscript{214} See eg \textit{Fisheries Development Corporation of SA Ltd v Jorgensen} 1980 4 SA 156 (W) 170; \textit{Ex parte Lebowa Development Corporation Ltd} 1989 3 SA 71 (T) 111; \textit{Philotex (Pty) Ltd v Snyman} 1998 2 SA 138 (SCA) 144; \textit{Triptomania Twee (Pty) Ltd v Connolly} 2003 3 SA 558 (C) 562. A similar definition was applied in cases that dealt with criminal liability in terms of s 424(3). See eg \textit{S v Goertz} 1980 1 SA 269 (C); \textit{S v Parsons} 1980 2 SA 397 (D); and \textit{S v Harper} 1981 2 SA 638 (D).

\textsuperscript{215} 1995 4 SA 607 (W).

\textsuperscript{216} \textit{Id} 613.
state that business conduct could be regarded as reckless if there is no plausible explanation for the conduct complained of.\footnote{Ibid.}

Judicial opinion thus seems settled that the term “reckless” in section 424 of the South African \textit{Companies Act} denotes “gross negligence”.\footnote{Some uncertainty may be created by s 64 of the \textit{Close Corporations Act}, however, which refers to business being carried on “recklessly, with gross negligence or with intent to defraud”, apparently indicating that “recklessly” and “with gross negligence” are two separate concepts.}

Which yardstick should, however, be used to determine whether particular conduct constitutes gross negligence or not? Stegmann J is of the opinion that “recklessly” implies the existence of an “objective standard of care that would be observed by the reasonable man in conducting the business of the company concerned in the particular circumstances”.\footnote{\textit{Ex parte Lebowa Development Corporation Ltd} supra 111. This interpretation was repeated in \textit{Ozinsky v Lloyd} 1992 3 SA 396 (C) 414.} A subjective element is added, however, in that one has to consider the circumstances under which the reasonable businessman had to manage the business of the company.\footnote{According to the court in \textit{Ozinsky v Lloyd} supra 414, the subjective factors that may play a role are the scope of the company’s business operations; its assets and liabilities; working capital; cash flow; access to capital and the prospects of payment when particular debts were incurred.}

The court also made use of a hybrid objective/subjective yardstick in determining whether directors acted with gross negligence in \textit{Philotex (Pty) Ltd v Snyman}.\footnote{\textit{Supra}.} The test is objective insofar as the conduct of the director is compared to that of a notional reasonable person, or even “reasonable businessman”,\footnote{\textit{Id} 147.} and subjective insofar as the notional person belongs to the same group of persons as the defendant.\footnote{\textit{Id} 143; 148.} In this instance the objective yardstick thus seems to propose a minimum standard of conduct, whereas the subjective yardstick may serve to impose a higher standard.
3.2.1.4 Fraudulently

Personal liability may also be incurred where a person managed the business of the company with the intent to defraud creditors of the company or another person, or for any fraudulent purpose. Various opinions exist as to what is to be understood by this phrase.

In the first case dealing with section 424(1), *Dorklerk Investments (Pty) Ltd v Bhyat*, the court interpreted “fraudulent” or “intent to defraud” with reference to two cases. The first is *In re William Leitch Brothers*, where it was stated:

> [I]f a company continues to carry on business and to incur debts at a time when there is to the knowledge of the directors no reasonable prospect of the creditors ever receiving payment of those debts, it is, in general, a proper inference that the company is carrying on business with intent to defraud…

In the second case, *In re Patrick and Lyon*, “fraudulent” was interpreted to mean “real dishonesty involving, according to current notions of fair trading among commercial men at the present day, real moral blame”.

In *Ex parte Lebowa Development Corporation Ltd* the court furthermore indicated that a successful action based on fraud does not rest on the creditor having to prove that the representor obtained goods on credit while knowing that there was no prospect of the company Honouring its obligations. All that needs to be proven is that the representor was aware of a risk that the company might not be able to pay, even

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24 Supra.

25 The conduct complained of in this case involved the directors denuding the company of assets through the payment of sums of money lawfully owing to themselves by the company, while the applicant was engaged in an action against the company. The company eventually lost its final appeal, but had no money left with which to pay the applicant’s claims for damages and costs. The court decided in the end that “conduct of the kind alleged by the applicant against the respondent cannot be said to be fraud or recklessness in the carrying on ‘of the business of the company’” (*id* 447).

26 (*1932*) 2 Ch 71.

27 *Id* 77.

28 1933 Ch 786.

29 *Id* 790.

30 Supra.
though he honestly believed it more than likely that the company would be able to pay.\textsuperscript{231} The court continued to state that fraud is “the dishonest exposure of the creditor’s economic interests to unauthorised risk”, with reference to a company obtaining credit without disclosing “a known risk (such as must always be present when a company trades in insolvent circumstances) that the terms of payment may not be honoured…even if the company’s representative honestly believed that the risk was not great and that the creditor would ultimately be paid”.\textsuperscript{232}

In \textit{Ex parte Lebowa Development Corporation Ltd}\textsuperscript{233} the court indicated that fraud “necessarily involves and element of conscious deceit” and that the test is “invariably subjective”.\textsuperscript{234}

\textbf{3.2.1.5 Consequences of a Successful Application}

If a person is found guilty of the conduct described by 424(1), the court may order that such a person “shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct”.\textsuperscript{235}

\textbf{3.2.1.5.1 Liability for Which Debts?}

A question that is posed is whether directors are liable for all the debts of the company, or whether liability is limited to debts incurred after a particular point in time.

It is made clear in \textit{Cronje v Stone}\textsuperscript{235} that a court could distinguish between debts incurred prior to the business of the company being conducted recklessly or fraudulently, and those incurred thereafter. Liability in terms of section 424(1) could thus be limited to those debts that were incurred during the period in which those

\textsuperscript{231} \textit{Id} 105.

\textsuperscript{232} \textit{Id} 106. Also see \textit{Ex parte De Villiers: In re Carbon Developments} 1992 2 SA 95 (W) 148 – 149, where the court indicated that fraud is not limited to \textit{dolus directus}, ie where the directors deliberately make false representations to trade creditors to induce them to provide goods or services on credit, but that it includes \textit{dolus eventualis}, ie instances where the directors expose creditors to an unforeseen risk with reckless disregard as to whether or not they suffer a loss as a result of this exposure.

\textsuperscript{233} \textit{Supra}.

\textsuperscript{234} \textit{Id} 103.

\textsuperscript{235} \textit{Supra}.
involved in managing the business of the company behaved in a fraudulent or reckless manner.\textsuperscript{236}

A different viewpoint is held in \textit{Kalinko v Nisbet},\textsuperscript{237} however, where the court made it clear that the time when the debt was incurred is irrelevant, but that one should rather look at whether the alleged wrongful conduct negatively influenced current debts.\textsuperscript{238}

\subsection*{3.2.1.5.2 Creditors Who Are Benefited}

If an applicant was successful with an application to hold those in charge of the company liable for its debts, it could be asked whether such persons are liable to the particular creditor, or whether the success of the application must be construed for the benefit of all the creditors of the company.

The court addressed this question in \textit{Bowman v Sacks},\textsuperscript{239} but did not provide a definite answer. It allowed that the wording of section 424(1) permits the court to declare a director liable to a specific creditor in a determined amount on the application of that creditor.\textsuperscript{240} The court stated, however, that sometimes it will be “more appropriate…to exercise the Court’s power to the advantage of all creditors and not only the applying creditor” and continued to state that the purpose of section 424(1) is not to “alter priorities amongst creditors as a matter of allowing favoured treatment”.\textsuperscript{241} The view held in \textit{Fundstrust (Edms) Bpk (in likwidasie) v Marais},\textsuperscript{242} is

\begin{footnotesize}
\begin{enumerate}
\item Id 606 – 607.
\item Supra.
\item Id 777. Also see \textit{Nel v McArthur} 2003 4 SA 142 (T) 156, where the court justifies the conclusion that “all debts” are covered by s 424, and not only those specifically arising from the reckless conduct, on the basis that no causative link is required by s 424.
\item Supra.
\item Id 464.
\item Ibid.
\item 1997 3 SA 470 (K).
\end{enumerate}
\end{footnotesize}
that the proceeds of a successful action brought by a liquidator will form part of the assets of the company to be distributed amongst the general body of creditors.\textsuperscript{243}

In terms of one opinion there seems to be no reason why the court should not direct payment to the creditor or creditors who suffered as a consequence of the fraudulent or reckless trading, as long as the company is not yet in liquidation.\textsuperscript{244} In Philotex (Pty) Ltd v Snyman,\textsuperscript{245} however, the court made an order for payment of specific amounts to specific creditors, despite the company being in liquidation.

Havenga bemoans the uncertainty that exists with regard to the party to whom the court may order the payment envisaged by this provision and submits that section 424 is in need of amendment in this respect, as the section will only then “become a truly effective remedy in the hands of company creditors”.\textsuperscript{246}

3.2.1.5.3 Punitive Element

The court recognises the presence of a punitive element in section 424(1), to the extent that liability is not limited to damage or advantages that are proven to be causatively linked.\textsuperscript{247} A director may therefore incur liability exceeding the amount that he reaped by way of pecuniary benefits, or the amount of financial prejudice caused to the company.\textsuperscript{248} According to the court the punitive element should not be over-emphasised. It will be present “mainly to the extent to which liability is not measured by damage or advantages which are proven to be causatively linked” and is consequently present “as an acceptable result rather than in the avowed object”.\textsuperscript{249}

\begin{itemize}
\item \textsuperscript{243} Id 475. Also see Terblanche v Damji 2003 5 SA 489 (C) 515, where the court expressed the view that it is important to consider the interests of the general body of creditors where the company is wound up.
\item \textsuperscript{244} Brusser “Actions against Delinquent Directors” 1985 SA Company LJ 33 43 (hereinafter Brusser Delinquent Directors).
\item \textsuperscript{245} Supra.
\item \textsuperscript{246} Havenga “Creditors, Directors and Personal Liability under Section 424 of the Companies Act” 1992 SA Merc LJ 63 69.
\item \textsuperscript{247} Bowman v Sacks supra 465; Howard v Herrigel 1991 2 SA 660 (A) 672; Philotex (Pty) Ltd v Snyman supra 142; Terblanche v Damji supra 511.
\item \textsuperscript{248} Ibid.
\item \textsuperscript{249} Bowman v Sacks supra 465.
\end{itemize}
3.2.1.6 Evaluation

Creditors should be permitted the additional protection that could be afforded in terms of an extension of directors’ duties to include their interests. It is submitted that section 424(1), although undeniably providing a great measure of protection of the interests of creditors, cannot function alone in providing sufficient protection for their interests.

This submission is based on the following arguments. The first pertains to the numerous uncertainties that still exist in respect of the application of section 424(1), despite the relatively large number of cases in which the judiciary attempted to clarify the content of this provision. It is, for example, uncertain whether creditors’ claims against the company should be quantified, or whether a compromise in terms of section 311 would extinguish any rights that a creditor may have to bring an application in terms of section 424(1).

The second relates to the protection offered by section 424(1). Creditors are protected against directors who acted recklessly, which the judiciary interpreted on various occasions to mean with gross negligence, or fraudulently. What seems clear is that fault is required for director liability in both instances. This effectively excludes the possibility of creditors being able to use section 424(1) to hold directors liable who acted without fault, whereas they would be able to do so in respect of directors who acted in breach of their fiduciary duties.

Section 424(1) thus seems to cover conduct more akin to a breach of the duty of care and skill. There is one important difference, however. Creditors will be afforded the remedy in terms of section 424(1) only where directors acted with gross negligence, whereas liability on the basis of a breach of the duty of care and skill is not limited to instances of gross negligence. Recent developments furthermore seem to indicate a willingness on the part of the judiciary in some jurisdictions to apply a hybrid objective/subjective yardstick, similar to that used for determining recklessness for the

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250 Brusser Delinquent Directors 33 terms this type of measure “the most potent weapon which creditors have in exercising a restraining influence on over-sanguine corporate management.”
purposes of section 424(1), in deciding whether a director acted in breach of the duty of care and skill in stead of the traditional subjective measurement, indicating that a higher standard of conduct is expected for compliance with the duty of care and skill.\textsuperscript{251} In light of the above, it seems that an extension of directors’ common law duties to include creditors’ interests may in some respects provide wider protection for corporate creditors.

It must be conceded, however, that section 424(1) provides wider protection for creditors’ interests than the common law directors’ duties in other respects. The statutory provision is, for example, not limited to companies that are insolvent or experiencing financial distress,\textsuperscript{252} but may even provide creditors with a remedy in instances where the company is financially sound and trading successfully.\textsuperscript{253} Even though creditors seem to be better off under section 424(1) in this respect, it is questionable on policy grounds whether one should allow creditors to act against directors of companies who are able to meet their obligations. Allowing the opposite would lead to a total erosion of the principle of separate legal personality and it is submitted that the view advocated by the Supreme Court of Appeal in \textit{L & P Plant Hire BK v Bosch}\textsuperscript{254} should be preferred.

The remedy afforded by section 424(1) also seems to be more extensive than those provided for in case of a breach of the common law duties, as it contains a punitive element. Directors in breach of their fiduciary duties are traditionally liable only for the amount of the benefit that they reaped for themselves or the loss caused to the

\textsuperscript{251} See discussion \textit{infra} Ch 6 (Protection Afforded by the Duty of Care and Skill) for more detail.

\textsuperscript{252} Further on in this study it is indicated that a duty to creditors only comes into being upon the company in question experiencing financial or economic distress, as one may argue that creditors of companies that are financially sound do not need such protection. See discussion \textit{infra} Ch 7 (Point in Time When the Duty Arises) for more detail.

\textsuperscript{253} As is seemingly indicated by the phrase “or otherwise”. The recent judgment in \textit{L & P Plant Hire BK v Bosch supra} created doubt, however, as to whether creditors will be able to proceed against directors, even if they did act recklessly or fraudulently, if the company is still in a position to discharge its debts.

\textsuperscript{254} \textit{Supra}. 
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company, and in case of a breach of the duty of care and skill liability is limited to the damages caused to the company.

Once again, even though creditors seem to enjoy greater protection under section 424(1) insofar as the remedy is concerned, policy concerns may be raised once more in this regard. A concern that persists insofar as personal liability of directors is concerned, is the fact that directors, well aware of the sword of personal liability constantly hanging over their heads, might become excessively risk averse, or even refuse to accept appointments as directors. In this regard it is submitted below that the balance between accountability and entrepreneurial freedom may be maintained by providing directors with relief from personal liability under particular circumstances. Measures that may provide such relief include section 248 of the South African Companies Act, in terms of which a court may excuse a director from liability, provided that he acted reasonably and honestly. It seems that this particular measure is available only in respect of liability resulting from a breach of common law duties and not to provide relief from statutory liability, as envisaged by section 424(1). Section 424(1) itself furthermore contains no defences that may be used by directors to escape personal liability. This may have a detrimental effect on the crucial balance that needs to be maintained between accountability and entrepreneurial freedom.

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255 See infra Ch 5 (Protection Afforded by Fiduciary Duties) par 5.4 for more detail.

256 See infra Ch 6 (Protection Afforded by the Duty of Care and Skill) par 6.4 for more detail.

257 See sources referred to supra Ch 2 (Conceptual Justification) par 2.5.4.

258 See discussion infra Ch 9 (Relief from Liability) for further discussion.

259 De Koker supra 251 rightly notes that the issue on the availability of s 248 relief in respect of s 424(1) liability is theoretical in nature, as it would be very difficult for a person who managed the business of the company recklessly to prove that he acted honestly and reasonably and that he ought fairly to be excused. This could become a pertinent practical concern, however, should s 248 be amended along similar lines as s 1318 of the Australian Corporations Act 2001 (hereinafter Australian Corporations Act) or the proposed amendment of s 727(1) of the English Companies Act 1985 (hereinafter English Companies Act), namely that the requirement of “reasonableness” simply be removed. See infra par 9.2.2.4.3 for more detail.
A last point in favour of preferring common law remedies to section 424(1) lies in the general legal principles applicable to the distribution of an insolvent estate, with specific reference to the pari passu rule. It is proposed that the proceeds of a successful action based on a breach of the duty to creditors, be applied to the general body of creditors and not for the benefit of only a number of creditors.\textsuperscript{260} Section 424(1) does, however, seem to allow for the possibility that applicant creditors may exclusively enjoy the fruits of a successful application in terms of section 424(1), leaving other creditors out in the cold.

By way of summary, it is conceded that section 424(1) does provide protection for the interests of corporate creditors. Unfortunately a number of uncertainties and problems exist with regard to the application of this provision, which necessitates the conclusion that creditors’ interests are not adequately protected by the remedy afforded in terms thereof.\textsuperscript{261} However, the extension of directors’ common law duties to include creditors’ interests may provide wider protection in certain circumstances. The protection of creditors’ interests by way of extended directors’ duties furthermore seems more desirable in light of policy considerations pertaining to directors’ risk-taking ability. An extended duty, if modeled as suggested in this study, also seem to be more in line with general insolvency law principles regarding the distribution of an insolvent’s assets.

Finally, it may also be argued that the mere existence of a remedy as provided for by section 424(1) should not necessarily preclude creditors from relying on common law remedies of director’s duties to protect their interests.\textsuperscript{262} Members are afforded the

\begin{footnotesize}
\textsuperscript{260} See discussion \textit{infra} Ch 8 (Beneficiary of the Duty).

\textsuperscript{261} The Institute of Directors \textit{King Report on Corporate Governance for South Africa} 2002 144 acknowledges that this provision has been criticized for being both “difficult and expensive to implement”. Also see De Koker \textit{supra} 398 – 401 for his summary of the deficiencies inherent to s 424(1). This compels him to conclude that “the lack of effectiveness and the undesirability of section 424 in its present form necessitate legal reform in this field” (id 448).

\textsuperscript{262} In \textit{Food & Nutritional Products (Pty) Ltd v Neumann} 1986 3 SA 464 (W) 477 the court stated that “it would follow with reference to the common law right that the remedy provided in terms of s 424 was not intended to be in substitution of any remedy available in terms of the common law”. In \textit{Ex parte Lebowa Development Corporation Ltd supra} 109, referred to with approval in \textit{Kalinko v Nisbet supra} 774, the judiciary also acknowledged that this provision “supplements the common law remedies in certain circumstances: \textit{it does not replace them}” (own emphasis). Even though these statements
\end{footnotesize}
right to lodge an application in terms of section 424(1), as well as the right to enjoy the protection afforded by directors’ common law duties – there seems to be no reason why creditors should not be afforded a similar privilege.

3.2.2 Comparative Study

As was indicated in the discussion immediately above, there is ample room for an alternative remedy to section 424(1) of the South African Companies Act. It is possible that corresponding provisions in other jurisdictions are more successful in protecting the interests of creditors, thereby removing the need for an alternative remedy such as an extension of directors’ duties. One has to investigate, therefore, whether amendments to section 424(1) bringing it in line with these provisions, may improve the protection afforded to corporate creditors to such an extent that an extension of directors’ common law duties to creditors becomes unnecessary.

3.2.2.1 Australia

Section 588G of the Australian Corporations Act, the equivalent of section 424(1) of the South African Companies Act, is titled “Directors’ duty to prevent insolvent trading by company” and resulted from recommendations made by the Harmer Committee.\(^{263}\) The committee noted that there was a clear need for further reform of the insolvent trading provisions to address concerns associated with insolvent trading.\(^{264}\)

The relevant parts of this provision read as follows:

(1) This section applies if:

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were made with reference to common law remedies available in respect of fraudulent trading, as enunciated in *Orkin Bros Ltd v Bell* 1921 TPA 92, the principle remains the same. The idea of statutory remedies existing alongside their common-law counterparts is not foreign, with the South African Companies Act itself providing for common-law remedies to be retained in conjunction with statutory remedies, eg in terms of s 86(5) and s 163.


(a) a person is a director of a company at the time when the company incurs a debt; and

(b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and

(c) at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be; and

(d) that time is at or after the commencement of this Act.

(1A) …

(2) By failing to prevent the company from incurring the debt, the person contravenes this section if;

(a) the person is aware at that time that there are such grounds for so suspecting; or

(b) a reasonable person in a like position in a company in the company’s circumstances would be so aware.

In addition, section 588H contains specific defences that directors may rely on to escape liability. These include a director having reasonable grounds to expect solvency; reliance upon a competent and reliable person by the director; illness or some other good reason that prevented a director to influence the financial affairs of the company, and the fact that the director took all reasonable steps to prevent the company from incurring the debt.

A contravention of section 588G, should the director not be able to prove one of the defences in section 588H, could result in the director receiving a civil penalty;

265 A table in s 588G(1A) deems debts to be incurred at certain times in relation to specific financial transactions, mostly related to laws of capital maintenance and one relating to s 588FB “uncommercial transactions”. See Morrison “The Addition of Uncommercial Transactions to S 588G and Its Implications for Phoenix Activities” (2002) 10 Insolvency Law Journal 229 (hereinafter Morrison Uncommercial Transactions) for a detailed synopsis on uncommercial transactions.

266 S 588H(2).

267 S 588H(3).

268 S 588H(4).

269 S 588H(5).

270 In terms of s 1317EA(3).
criminal penalty;\textsuperscript{271} and being ordered to pay compensation to the company.\textsuperscript{272} In light of uncertainties regarding the application of this provision, it is doubtful whether the Harmer Committee succeeded in addressing all concerns pertaining to insolvent trading.\textsuperscript{273}

The first problem is that section 588G retained much of the previously problematic drafting, with specific reference to the phrases “incurring a debt” and “reasonable grounds”.\textsuperscript{274}

\textsuperscript{271} In terms of s 1317FA.

\textsuperscript{272} In terms of s 588J(1).


\textsuperscript{274} Morrison \textit{Australian Insolvent Trading Prohibition} 156.
The scope of application of section 588G is furthermore limited, in that only specific transactions are covered, namely the incurring of a debt. This phrase is extended somewhat in terms of section 588G(1A) which allows for “deemed debts”.  

Section 588G is also narrowly formulated and prohibits the incurring of debts only where the company is insolvent, or where the incurring of the debt could render the company insolvent. From the point of view of corporate creditors, this effectively limits the protection afforded in terms of this provision. From the point of view of directors it will be very difficult to accurately determine a point of insolvency, as is required by the provision, thereby rendering them vulnerable to potential personal liability.

This problem is exacerbated by the fact that it is not clear what is to be understood by “insolvency”. In terms of section 95A a person who is unable to pay all his debts as

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275 Apart from one transaction related to s 588FB “uncommercial transactions” which is regarded as a “deemed debt”, “deemed debts” are mostly related to laws of capital maintenance and refer to transactions such as the payment of dividends; a reduction of share capital; buying back of shares; redeeming redeemable preference shares; the issue of redeemable preference shares that are redeemable otherwise than at its option; and providing financial assistance for the purpose of acquisition of shares in that company or its holding company. A transaction is defined as an “uncommercial transaction” in terms of s 588FB(1)

if it may be expected that a reasonable person in the company’s circumstances would not have entered into the transaction, having regard to:

(a) the benefits (if any) to the company of entering into the transaction; and

(b) the detriment to the company of entering into the transaction; and

(c) the respective benefits to other parties to the transaction of entering into it; and

(d) any other relevant matter.

The addition of “uncommercial transactions” might serve to extend the scope of s 588G. Morrison Uncommercial Transactions 231 indicates, however, that s 588FB only applies in respect of transactions that took place while the company was insolvent, or which actually rendered the company insolvent. Uncommercial transactions while the company was on the brink of insolvency, or which did not render the company insolvent by itself, would thus not be covered.

276 Id 167.
and when they become due and payable, is deemed insolvent. Judicial approaches have differed, however, in their interpretations of the terms “due” and “payable”.

A further problem with section 588G relates to creditors’ *locus standi*. Creditors are dependent on the liquidator to institute proceedings in terms of this provision. They may institute action themselves at least six months after the beginning of winding up, and only with the written consent of the liquidator. Should the liquidator refuse to consent within three months, the creditor must serve upon the liquidator a notice of intention to commence proceedings and apply to the court for leave to commence action.

In light of the limited application of and limited protection offered by section 588G, as well as concerns regarding *locus standi*, it seems clear that creditors stand to benefit from the availability of an additional remedy that may be afforded by an extension of directors’ duties. The Australian *Corporations Act* itself also seems to leave room for such a remedy in terms of section 588P, which provides that an action for insolvent trading is not in derogation of any law concerning a person’s breach of duty and does not prevent proceedings being instituted in respect of such liability.

### 3.2.2.2 New Zealand

Directors’ personal liability is provided for in terms of sections 135 and 136 of the New Zealand *Companies Act*. Section 135 is titled “Reckless trading” and provides as follows:

> A director of a company must not –
>
> (a) Agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company’s creditors; or

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277 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 15.

278 S 588S.

279 S 588R.

280 Ss 588S and 588T.

281 *Companies Act* 1993 (hereinafter New Zealand *Companies Act*).
(b) Cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company’s creditors.

Section 136, titled “Duty in relation to obligations” furthermore provides as follows:

A director of a company must not agree to the company incurring an obligation unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so.

A major point of criticism against the New Zealand provisions, in particular section 135, is vagueness. In terms of section 135 a director must see to it that the business of the company is not conducted in a manner likely to create a “substantial risk of serious loss” to the company’s creditors. The legislature did not, however, provide any indication as to what is to be understood by “substantial risk” or “serious loss”.

This is regrettable from the point of view of both directors and creditors. Directors are not provided with some indication as to what is expected of them in terms of this duty, and this makes it difficult to ensure compliance with this provision in order to prevent personal liability. Creditors, on the other hand, may not be certain as to when directors are in breach of this provision, which means that they are not in a position to assess the likelihood of being successful with an action against directors on the basis of a breach of this provision.

One is inclined to agree that there is reason to doubt whether these provisions will be effective.282

3.2.2.3 England

The English legislature enacted sanctions against “fraudulent trading” and “wrongful trading” in two separate provisions, namely sections 213 and 214 of the English Insolvency Act.283 Section 213 deals with fraudulent trading and provides as follows:

(1) If in the course of the winding-up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose…


283 Insolvency Act 1986 (hereinafter English Insolvency Act).
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(2) The court on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on the business in [that] manner are to be liable to make such contributions (if any) to the company’s assets as the court thinks proper.

Wrongful trading is dealt with by section 214 of the English *Insolvency Act*, which resulted from recommendations made by the Cork Committee. This section was enacted to address concerns regarding the ineffectiveness of the fraudulent trading provision in protecting the interests of corporate creditors. The relevant parts of this provision read as follows:

(1) Subject to subsection (3) below, if in the course of the winding up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company’s assets as the court thinks proper.

(2) This subsection applies in relation to a person if--

(a) the company has gone into insolvent liquidation,

(b) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and

(c) that person was a director of the company at that time;

…

(3) The court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection (2)(b) was first satisfied in relation to him that person took every step with a view to minimising the potential loss to the company’s creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken.

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(4) For the purposes of subsections (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both-

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and

(b) the general knowledge, skill and experience that that director has.

(5) The reference in subsection (4) to the functions carried out in relation to a company by a director of the company includes any functions which he does not carry out but which have been entrusted to him.

(6) For the purposes of this section a company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up.

(7) In this section “director” includes a shadow director.

Numerous factors cause one to doubt the effectiveness of section 214 to provide adequate protection of the interests of corporate creditors. The first is that the duty to minimise loss to creditors only comes into operation once it is clear, or should be clear, that the company is beyond redemption. Any conduct by directors prior that point in time is irrelevant for the purposes of section 214. The directors may very well have caused the company to reach this point of no return – creditors may, however, have no remedies to address directors’ actions that led to the demise of the company. Section 214 thus only catches a “limited span of negligent directorial conduct” and does not provide directors with any incentive to act with care during the

286 It must be emphasised once again that this is not an attempt to provide a detailed analysis of s 214 and the problems inherent thereto, or even a detailed comparison with s 424(1) of the South African Companies Act, but rather an overview of issues that indicate that this remedy alone is not adequate for the protection of creditors’ interests. The following sources may be consulted for a general discussion on the application and/or shortcomings of s 214: Bhattacharyya “Re Hydrodan (Corby) Ltd – Shadow Directors and Wrongful Trading” (1994) 15 The Company Lawyer 151; Bhattacharyya “Shadow Directors and Wrongful Trading Revisited” (1995) 16 The Company Lawyer 313; Doyle “Anomalies in the Wrongful Trading Provisions” (1992) 13 The Company Lawyer 96; Payne & Prentice “Civil Liability of Directors for Company Debts under English Law” in Ramsay (ed) Company Directors’ Liability for Insolvent Trading (2000) 190.

existence of the company, but only when it is reasonably certain that it was going to fail.288 Section 214(2)(a) furthermore seems to indicate that the wrongful trading action is only triggered by formal winding-up.289

Second, it must be noted that any proceedings against directors in terms of section 214 may only be instituted by the liquidator.290 Liquidators by and large will be reluctant to make use of the opportunity presented by section 214291 – probably for fear of having to bear the costs of an unsuccessful action.292 This leads to section 214 being largely under-utilised to a large extent.

In terms of section 214 the court also has a discretion to limit the amount for which the director is liable.293 In case of a breach of a common law duty, however, there will be no question of the court being able to exercise its discretion to reduce the amount that the company is entitled to recover.294

A final aspect in which section 214 seems to fall short, is that it offers a limited remedy. As is the case with section 424(1) of the South African Companies Act, only compensatory relief but no injunctive relief is offered.

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290 S 214(1).

291 Arsalidou supra 20 indicates that a survey showed that 65% of directors involved in disqualification proceedings in England were allegedly trading at risk to creditors with knowledge of insolvency, without liquidators pursuing compensation for wrongful trading.

292 The reason for this fear may be well understood in light of In re MC Bacon Ltd [1991] Ch 127, where the liquidator was ordered to pay the costs of an unsuccessful action. The court furthermore did not allow the liquidator to recover these costs from the company’s assets, with the result that any claim for costs by the liquidator ranked with unsecured creditors.

293 S 214(1).

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From a policy point of view the fact that section 214, like its South African counterpart, offers little to directors in the way of defences, seems to be undesirable. The court made it clear in *In re Produce Marketing Consortium Ltd*295 that the relief offered in terms of section 727 of the English *Companies Act* will not be available to directors involved in proceedings in terms of section 214.296 The court seems to have left a back door open for the application of section 727 along with section 214 in *In re DKG Contractors Ltd.*297 It is by no means certain, however, that this makes a convincing case that directors will be able to rely on the protection offered by section 727.

The only defence offered by section 214 is that directors who are able to show that they “took every step with a view to minimising the potential loss to the company’s creditors” that they ought to have taken,298 will escape liability. “Every step” is not defined by the English *Insolvency Act*, however, and it is a matter of conjecture as to what would be considered as adequate steps in order to minimise the potential loss.299 Some seem to think that cessation of trade could be such a step,300 with the potential detrimental effect that directors may opt for premature liquidation in an attempt to avoid personal liability in terms of section 214.301

295 [1989] 3 All ER 1.

296 S 727 is the equivalent of s 248 of the South African *Companies Act*. See discussion infra Ch 9 (Relief from Liability) par 9.2.2 for more detail.

297 [1990] BCC 903 (Ch).

298 S 214(3).

299 Hicks “Advising on Wrongful Trading: Part 2” (1993) 14 *The Company Lawyer* 55 57 indicates that since s 214(3) refers to every step that a director *ought to have taken* and not only “every step”, it seems to require directors to take every “reasonable step”. This would include a director keeping himself adequately informed of the company’s affairs; raising the matter with the board members; getting a full review of the position with professional assistance; and ensuring properly recorded decision-making (*id* 58, with reference to the Institute of Directors Guide to Boardroom Practice: “Companies in Financial Difficulties”). Also see Yeung “Can a Director Protesteth Too Much: Is Protesting Enough to Escape Liability for Wrongful Trading?” (1997) 15 *Company & Securities Law Journal* 339 for a discussion of the issue whether resignation may offer protection against liability for wrongful trading.

300 See eg Gillespie *supra* 272.

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With regard to section 214 having been described as a “sharp” and “powerful” weapon against wayward directors,\(^{302}\) one is inclined to agree with Schulte that

the liquidator has been handed a defective weapon and has allies that have failed to commit properly to the battle...the wrongful trading provisions are achieving neither their private nor public law functions because usage is thwarted both substantively and procedurally.\(^{303}\)

Section 214 therefore seems to be no more than a “paper tiger”,\(^{304}\) and it appears that there is ample room for the alternative remedy that may be afforded through an extension of directors’ duties in England.\(^{305}\)

### 3.2.2.4 Canada

As was mentioned already, the Canadian legislature did not provide for a specific statutory provision aimed at curtailing fraudulent, reckless, wrongful, or insolvent trading. The so-called “oppression remedy”, provided for by section 241 of the *Canada Business Corporations Act*,\(^{306}\) may be utilised, however, to provide creditors with some right of action against delinquent directors. In terms of this provision:

1. A complainant may apply to a court for an order under this section.
2. If, on an application under subsection (1), the court is satisfied that in respect of a corporation or any of its affiliates
   
   (a) any act or omission of the corporation or any of its affiliates effects a result,
   
   (b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner, or
   
   (c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner

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\(^{302}\) Hicks “Advising on Wrongful Trading” (1993) 14 *The Company Lawyer* 16, as referred to by Schulte *supra* 81.

\(^{303}\) Schulte *supra* 81.


\(^{305}\) Some commentators, such as Arsalidou *supra* 19, even go so far as to regard ss 213 and 214 as mere supplements to the general duty that directors have to take the interests of creditors into consideration.

\(^{306}\) *Canada Business Corporations Act* RS 1985, c C-44 (hereinafter *CBCA*).
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that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer, the court may make an order to rectify the matters complained of.

(3) In connection with an application under this section, the court may make any interim or final order it thinks fit including, without limiting the generality of the foregoing,

... (j) an order compensating an aggrieved person;

...

A person who wishes to access the oppression remedy must fall within the definition of “complainant” as per section 238 of the CBCA. In terms of this provision “complainant” is defined as

(a) a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates,

(b) a director or an officer or a former director or officer of a corporation or any of its affiliates,

(c) the Director, or

(d) any other person who, in the discretion of a court, is a proper person to make an application under this Part.

The primary concern in respect of the Canadian oppression remedy relates to *locus standi*. Creditors, in general, are firstly afforded limited *locus standi* to approach the court for relief in terms of this provision, in that they are dependent on the court exercising its discretion to hold them as a “proper person” to make an application.\(^{307}\) The remedy is only available in limited circumstances, however, and the Canadian judiciary indicated that it will not allow debt actions routinely being turned into oppression actions.\(^{308}\)

\(^{307}\) S 238(d).

\(^{308}\) *Royal Trust Corporation of Canada v Hordo* (1993) 10 BLR (2d) 96 (Ont CJ (Gen Div)) par 12, 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 (hereinafter Sarra *Director and Officer Liability*) 240.
Apart from the fact that creditors enjoy limited *locus standi* in terms of this remedy, a further problem is the fact that creditors are not treated equally in terms of section 238. A bondholder, as a registered holder or beneficial owner of a security of the corporation, will be defined as a complainant for the purposes of section 241. However, other creditors do not enjoy a similar benefit.

Uncertainty is also created by the apparent discrepancy between sections 241(2) and 238. Section 241(2), in listing the categories of persons who may indicate that they suffered as a result of oppressive conduct, refers to “any security holder, creditor, director or officer”. It is difficult to surmise why creditors are included in section 241(2) but excluded from section 238, and what abuses the drafters had in mind.

The Canadian oppression remedy therefore also seems to be unable to provide adequate protection for creditors’ interests and one is inclined to agree that this provision, “[a]lthough capable of doing rough justice…invites idiosyncratic decisions and lacks sound criteria for the protection of creditors’ interests”.

### 3.3 TYPICAL INSOLVENCY REMEDIES

#### 3.3.1 General

Some may argue that creditors should rely on insolvency law measures to protect their interests. Protective measures referred to in this regard typically include statutory provisions or common law measures in terms of which transactions concluded by an insolvent company prior to insolvent winding-up can be set aside by the liquidator.

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309 S 238(a).

310 Own emphasis.

311 Ziegel “Creditors as Corporate Stakeholders: The Quiet Revolution – An Anglo-Canadian Perspective” (1993) 43 *University of Toronto Law Journal* 511 527. He concludes that the answers to this question are “vague and quite unsatisfactory for so important a provision”. See Thomson “Directors, Creditors and Insolvency: a Fiduciary Duty or a Duty Not to Oppress?” (2000) 58 *University of Toronto Faculty of Law Review* 3151 for a contrary opinion.

312 Ziegel supra 531.

313 The South African *Companies Act* itself contains no reference to the measures provided for in terms of the *Insolvency Act* 24 of 1936 (hereinafter South African *Insolvency Act*). S 339 of the South African *Companies Act* does, however, provide that provisions of the law of insolvency will apply *mutatis mutandis* to companies in insolvent liquidation in respect of any matter not specifically
Transactions that could be set aside by the liquidator in terms of statute include dispositions not for value; voidable preferences; and undue preferences. Creditors furthermore have a common law right to have transactions in fraud of creditors set aside. The appropriate action in this regard is the actio Pauliana.

3.3.2 Statutory Voidable Dispositions

3.3.2.1 Dispositions Not for Value

A “disposition not for value” refers to a transaction in terms of which the insolvent company disposed of assets without receiving fair consideration in return. These assets may be recovered by the liquidator under specific circumstances. Should the disposition have occurred more than two years prior to the insolvent liquidation of the company, the transaction may be set aside by the court if the liquidator is able to prove that the liabilities of the company exceeded its assets immediately after the disposition was made. Where the disposition occurred within two years of the insolvent liquidation of the company, the onus is on the person benefited by the disposition to prove that, immediately after the disposition was made, the assets of the company exceeded its liabilities, in order to ensure that the transaction is not set aside by the court. The liquidator carries the onus of proof regarding the date of the disposition.

3.3.2.2 Voidable Preferences

“Voidable preferences” pertain to transactions in terms of which one or some creditors are preferred over the others, for example by receiving full payment of their

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314 In terms of s 26(1)(a) and (b) of the South African Insolvency Act.

315 In terms of s 29(1) of the South African Insolvency Act.

316 In terms of s 30(1) of the South African Insolvency Act.

317 Fenhalls v Ebrahim 1956 4 SA 723 (D).

318 Examples of dispositions not for value include donations (Estate Jager v Whittaker 1944 AD 246 250); the sale of assets for an insignificant amount (Bloom’s Trustee v Fourie 1921 TPD 599 601) etc.

319 S 26(1)(a) of the South African Insolvency Act.

320 S 26(1)(b) of the South African Insolvency Act.

debts prior to liquidation, whereas the other creditors are left to try and salvage what they can from the insolvent estate. Such payments may be recovered from creditors who enjoyed preference, provided that the transaction occurred no more than six months prior to liquidation and that the liabilities of the company immediately thereafter exceeded its assets.  

3.3.2.3 Undue Preferences

“Undue preferences” refer to transactions where the company disposed of property at a time when liabilities already exceeded assets, with the intention of preferring one of its creditors above another.

3.3.3 Common Law Remedy: Actio Pauliana

The common law actio Pauliana can be instituted to set aside transactions in fraud of creditors. The requirements to be successful with this action, as set out in Hockey v Rixom, are that the disposition is of such a nature that the debtor’s assets are diminished thereby; that the person who receives from the debtor does not receive his own property; that there should be intention to defraud, and that the fraud should have its effect.

An important difference between the common law actio Pauliana and the statutory voidable dispositions is the fact that the statutory measures only become available upon the debtor being formally sequestrated. The actio Pauliana, on the other hand,
is available even though the debtor is not sequestrated, or in case of a company, being wound up.\textsuperscript{328}

The person relying on the \textit{actio Pauliana} is, however, required to prove that the debtor was insolvent when the disposition in fraud of creditors took place.\textsuperscript{329}

\subsection*{3.3.4 Evaluation}

It is submitted that the statutory measures pertaining to voidable dispositions do not provide adequate protection of the interests of creditors for numerous reasons. A significant shortcoming that exists insofar as the “voidable preferences” provision is concerned is that it covers only those preferences that occurred within a six month period prior to liquidation. Ensuring that a company is wound up seven months after a transaction was concluded with the effect that one creditor was preferred over another will therefore prevent application of this provision.\textsuperscript{330}

A practical example may best illustrate how the extension of directors’ duties to creditors could provide much needed protection in this regard. Directors signed as sureties for a debt owed to the bank. The directors, well aware of the precarious financial situation of the company, decide to use all available funds to reduce the debt owed to the bank and thus ensure that they would escape personal liability for the payment thereof, should the company go into insolvent liquidation. The substantial

\begin{itemize}
  \item \textsuperscript{328} \textit{Fenhalls v Ebrahim} supra 723; \textit{Commissioner of Customs and Excise v Bank of Lisbon International Ltd} 1994 1 SA 205 (N) 210. See \textit{Boraine Die Leerstuk van Vernietigbare Regshandelinge in die Insolvensiereg} LLD UP (1995) 203 – 207 for more detail.
  
  \item \textsuperscript{329} The basic requirement that a debtor had to be insolvent when a particular transaction took place, in order to invoke the \textit{actio Pauliana}, was ignored by the court in \textit{Commissioner of Customs and Excise v Bank of Lisbon International Ltd} supra. \textit{Boraine} supra 208 – 221 provides a detailed discussion of this case and rightly notes that this will be an unjustified extension of the scope of the \textit{actio Pauliana}, as it will be difficult to infer intention to defraud should the debtor have made the disposition while still solvent. He concludes that there should at least be some evidence indicating insolvency on the part of the debtor in cases where the debtor is not yet formally sequestrated or being wound up (\textit{id} 220). Also see \textit{Thomas & Boraine “Ownership of Money and the actio Pauliana”} 1994 \textit{THRHR} 678; \textit{Malan & Pretorius “Money, Bank Accounts and Tracing”} 1994 \textit{TSAR} 387; as well as \textit{Nedcor Bank Ltd v ABSA Bank Ltd} 1995 4 SA 727 (W) 729 for criticism of this decision.
  
  \item \textsuperscript{330} \textit{Fisher “Preferences and Other Antecedent Transactions: Do Directors Owe a Duty to Creditors?”} (1995) 8 \textit{Corporate and Business Law Journal} 203 observes somewhat cynically in this regard that the advice of a “last-resort lawyer” to a creditor client would be: “Just hope and pray that the company isn’t wound up for six months”.
\end{itemize}
debt to the bank is paid off seven months prior to the company being wound-up due to its inability to pay its debts.

The directors in the above example clearly preferred one creditor to others in furtherance of their own interests. The liquidator will not be able to recover the payments to the bank in terms of the voidable preference provision, however, as these occurred more than six months prior to the company being wound-up on the basis of its insolvency. If it is accepted, however, that creditors enjoy the protection afforded by directors’ duties, these monies may be recovered on the basis that the directors failed to comply with their fiduciary duties, in that they did not avoid a conflict of interest.331

In this respect one may argue that statutory “undue preferences” can provide creditors with some protection, in that no time frame is linked to the application of either of them. A liquidator will therefore be able to recover money that was paid to prefer one creditor to another, irrespective of when this transaction took place.

In that case he will have to prove, however, that such payment occurred while liabilities exceeded assets. Proving that liabilities exceeded assets at the time of payment may present difficulties, as companies may tend to neglect keeping proper accounting records when the going gets rough.332 The liquidator will also have to prove the intention to prefer. Proving intention is notoriously difficult.

The second requirement for the institution of the actio Pauliana, namely that the person who receives from the debtor does not receive his own property, prevents the actio Pauliana from being applied in a preference scenario.333 The actio Pauliana

Fisher supra warns that developments with regard to directors’ duties to creditors will make the above advice worthless, as the six month period will be irrelevant, indicating the important function that can be fulfilled by an extension of directors’ duties.

Keay “The Duty of Directors to Take Account of Creditors’ Interests: Has It Any Role to Play” 2002 Journal of Business Law 379 397 indicates that the “establishment of insolvency is fraught with problems”. This particular problem is also experienced with regard to dispositions not for value, as well as voidable preferences.

Boraine supra 218 indicates that the only possible exception to this general rule would seem to be the case where an existing debt is paid at the same time that other creditors demand payment from the debtor.
will therefore not be available in the above circumstances either, as this transaction may typically be classified as a “preference”.

The preceding discussion indicates that the possibility of not one of the traditional insolvency remedies being available under a particular set of facts is not too far-fetched. In such instances the extension of directors’ duties to include creditors’ interests may play an invaluable role in providing creditors with much needed protection.

The traditional insolvency remedies are also considered inadequate for other reasons. The actio Pauliana, for example, offers a very limited remedy in some instances. It is recognised that the primary objective of the actio Pauliana is to have particular transactions set aside. A disposition ex titulo lucrativo may be set aside to the extent that the person who received the debtor’s property, was benefited thereby. A codification of the actio Pauliana, as suggested by Boraine “Towards Codifying the actio Pauliana” 1996 SA Merc LJ 213, could alter the situation in respect of the actio Pauliana. The South African Law Commission seems reluctant do so, however, and in Working Paper 41 of Project 63 Voidable Dispositions and Dispositions that May Be Set Aside and the Effect of sequestration on the Spouse of the Insolvent (1991) par 3.80 it is merely stated that the actio Pauliana, although still available, is rarely used. It must be conceded that s 424(1) of the South African Companies Act may possibly be applied in the above scenario. In a previous discussion it was indicated, however, that s 424(1) also displays a number of shortcomings that may render it ineffective in the protection of creditors’ interests (see discussion supra par 3.2.1.6).

Keay supra 398; and Petkovic “Directors’ Duties and the Intrusion of Creditors’ Interests” (1989) 4 Journal of International Banking Law 166 170. Also see Trethowan “Directors’ Personal Liability to Creditors for Company Debts” (1992) 20 Australian Business Law Review 41 52, who provides a helpful analysis of how insolvency law remedies would fail in a number of cases in which directors’ duties to creditors were mooted, eg Walker v Wimborne (1975 – 1976) 137 CLR 1 (due to difficulty in proving intent); Grove v Flavel (1986) 43 SASR 410 (because payments were not made within the six month period prior to winding-up); Kinsela v Russell Kinsela Pty Ltd (in liq) (1986) 4 NSWLR 722 (as a result of uncertainty as to whether the type of transaction in this case could be regarded as a “disposition”); and Jeffree v National Companies & Securities Commission (1989) 15 ACLR 217 (hereinafter Jeffree v NCSC; in which case the insolvency law remedies could not be applied as Jeffree’s actions resulted in avoiding insolvent winding-up of the company which remained a dormant shell). Even though these are not South African cases, the typical insolvency remedies in these jurisdictions operate in a similar way as in South Africa. These shortcomings are thus equally alarming in a South African context.

Boraine supra 222 and authority there referred to.

Scharff’s Trustee v Scharff supra 476, as referred to by Boraine supra 222.
disposition *ex titulo onerosa* may, however, only be set aside if the debtor intended to defraud creditors *and* the person receiving the property was aware of this intention.\(^{338}\)

A reason why the efficacy of statutory remedies specifically is questioned, is the fact that they only become available once the company is in formal liquidation, at which time there is little left for unsecured creditors.\(^{339}\)

Creditors are furthermore dependent on liquidators to institute action and may only proceed with such actions themselves if the liquidator fails to do so.\(^{340}\) They must, however, indemnify the liquidator against the costs of proceedings in such cases.\(^{341}\)

A last reason why traditional insolvency law remedies may be regarded as inadequate, is that they have limited application in respect of the type of transactions that are covered.\(^{342}\) A loss caused to corporate creditors as a result of directors breaching their duty to act with care and skill; their duty to act *bona fide* in the best interests of the company; or their duty to maintain an unfettered discretion will, for example, not be covered by traditional insolvency law remedies. These remedies also do not address the effect of changes in risk of the firm.\(^{343}\)

\(^{338}\) *Hockey v Rixom* supra 118, as referred to by Boraine supra 222.

\(^{339}\) 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. 339 rightly note that “by the time insolvency law becomes relevant there is often little to be salvaged on behalf of creditors, particularly unsecured creditors”. Although this concern is mentioned with specific reference to a Canadian case, it is equally relevant in a South African context where these remedies also only become available under the limited circumstance of the company being formally wound-up due to its inability to pay its debts. As was indicated already, this problem does exist not in respect of the application of the *actio Pauliana*.

\(^{340}\) The same is not true in respect of the *actio Pauliana*. See Boraine supra 221, who is of the opinion that creditors would have *locus standi* to proceed on their own behalf with the *actio Pauliana* since sequestration or liquidation is not a prerequisite for the institution of the action.

\(^{341}\) S 32(1) of the South African *Insolvency Act*.

\(^{342}\) Schwarz “Rethinking a Corporation’s Obligations to Creditors” (1996) 17 *Cardozo Law Review* 647 653.

A remedy afforded by an extension of directors’ duties may also have some advantages over insolvency law remedies, as a result of the fact that directors may incur personal liability in case of the former, whereas the protection afforded by the latter is effected through the recovery of monies from a third party. The exposure to potential personal liability may have the added advantage of serving as an incentive to encourage responsible managerial behaviour.

The narrow confines within which traditional insolvency law remedies operate thus compels one to doubt their efficiency in protecting the interests of creditors of companies.

3.4 PIERCING THE CORPORATE VEIL

A last remedy that is sometimes suggested for the protection of creditors’ interests is the disregarding of the separate legal personality of the company, or the “piercing” or “lifting” of the “corporate veil”. This doctrine is by no means unknown in South Africa and on a number of occasions the judiciary attempted to provide a principled basis to explain the circumstances under which it would exercise its discretion to disregard the separate legal personality of a company.

In *Lategan v Boyes* the court stated, for example, that it would be willing to “brush aside the veil of corporate identity…where fraudulent use is made of the fiction of

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345 In this regard one is inclined to agree with 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 201 203 that it is a fundamental analytic fact that judicial decisions in which a breach of fiduciary duty to creditors is found almost always involve diversion or disposition of assets from an insolvent or near insolvent entity for the benefit of insiders or shareholders – the type of conduct regulated by fraudulent transfer, preference, and illegal dividend statutes. *It cannot be ignored, however, that fiduciary liability to creditors is not limited to the technical confines of such statutes and has been used more expansively.*

346 1980 4 SA 191 (T).
legal personality”\textsuperscript{347}. In \textit{Botha v Van Niekerk}\textsuperscript{348} the court indicated that it would not be willing to disregard the juristic personality of the company based on mere equity, but that the applicant would have to be able to show that an \textit{unconscionable injustice} occurred.\textsuperscript{349}

The Appellate Division of the Supreme Court\textsuperscript{350} deviated from the previous approach in terms of which the separate identity of a company would only be disregarded under specific circumstances\textsuperscript{351} in \textit{Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd}\textsuperscript{352} and instead used a balancing of interests approach. In terms of this approach the court would balance the need to preserve the separate identity of the company against policy considerations which arise in favour piercing the corporate veil, should fraud, dishonesty or other improper conduct found to be present.\textsuperscript{353}

One of the main concerns regarding this doctrine’s ability to offer meaningful protection for creditors’ interests, is uncertainty as to when the judiciary would be willing to exercise its discretion to disregard the separate existence of the company.\textsuperscript{354}

\textsuperscript{347} \textit{Id} 201 (own emphasis).

\textsuperscript{348} 1983 3 SA 513 (W).

\textsuperscript{349} \textit{Id} 524 – 525.

\textsuperscript{350} Now known as the Supreme Court of Appeal.

\textsuperscript{351} Referred to as the “categorizing approach” by Domanski “Piercing the Corporate Veil – A New Direction?” 1986 \textit{SALJ} 224.

\textsuperscript{352} 1995 4 SA 790 (A).

\textsuperscript{353} \textit{Id} 803. This approach seems to correspond with the approach suggested by Domanski \textit{supra} 231 – 233, a suggestion based on an American case decided by the Louisiana Supreme Court, \textit{Glazer v Commission on Ethics for Public Employees} 431 So 2d 752 (La 1983).

\textsuperscript{354} This is a point raised by numerous commentators. See eg Carrol “Corporate Parents and Tort Liability” in Gillooly (ed) \textit{The Law Relating to Corporate Groups} (1993) 91 101, who is of the opinion that “there is no predictable basis on which the courts will lift the corporate veil”; Cilliers & Luiz “The Corporate Veil – An Unnecessarily Confining Corset?” 1996 \textit{THRHR} 523 who note that “[i]t is uncertain what circumstances our courts may regard as appropriate for the lifting of the corporate veil and upon what theoretical basis it is justifiable”; Ottolenghi “From Peeping Behind the Corporate Veil to Ignoring it Completely” (1990) 53 \textit{Modern Law Review} 338, who states: “Notwithstanding much endeavour, no conclusive answer has yet been given to the question of when the courts will lift the veil”; Sarra “The Corporate Veil Lifted: Director and Officer Liability to Third Parties” (hereinafter Sarra \textit{Corporate Veil}) (2001) 35 \textit{Canadian Business Law Journal} 55 58, who observes that the Canadian courts have been “somewhat inconsistent as to when they will consider lifting the corporate veil”; and Strydom & Du Plessis “Ontsluiering by Maatskappye en Beslote Korporasies: ’n
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It is true that some uncertainty in common law is not a problem and that “[b]y its nature it is incremental decision-making”.\textsuperscript{355} Within that context, however, a person should be entitled to some certainty as to when their actions could lead to personal liability.\textsuperscript{356} The same argument applies to creditors who should, in that context, be allowed some certainty as to when they would have a chance of success with an application to have the separate personality of the company disregarded.

A second reason why the protective ability of this doctrine is questioned, is the conservative, if not reluctant, approach followed by the judiciary in applying this doctrine. This reluctance seems to be prevalent in all jurisdictions discussed,\textsuperscript{357} except for the United States of America.\textsuperscript{358}

\textsuperscript{355} Sarra Corporate Veil 67.

\textsuperscript{356} Ibid.

\textsuperscript{357} Farrar Corporate Governance in Australia and New Zealand (2001) 37 comments on the conservative approach of the Australian judiciary in this regard with reference to a number of cases and comments that there have been “similar conservative trends in New Zealand and Canadian case law”. With regard to the position in England, Davies Gower and Davies’ Principles of Modern Company Law (2003) (hereinafter Gower) 189 notes that the doctrine of lifting the veil plays a small role in British company law, once one moves outside the area of particular contracts or statutes. Even where the case for applying the doctrine may seem strong, as in the under-capitalised one-person company, which may or may not be part of a larger corporate group, the courts are unlikely to do so.

The South African judiciary’s hesitancy to “pierce the corporate veil” seems to be evident in light of the statement in Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd supra 803 that “our Courts should not lightly disregard a company’s separate personality, but should strive to give effect to and uphold it”. Commentators seem to agree with this stance. See eg Domanski supra 235 who indicates that South African courts should apply the new test “cautiously and with the protection of that separate personality as a foremost consideration” and that “in most cases the corporate veil will resist judicial piercing”; as well as Larkin “Regarding Judicial Disregarding of the Company’s Separate Identity” 1989 SA Merc LJ 277 298.

\textsuperscript{358} Farrar supra 37 notes that the conservative approach followed elsewhere is “in stark contrast to the greater willingness of US courts to pierce the veil on a number of different policy bases...”. With regard to the approach of the United States judiciary Booth “Limited Liability and the Efficient Allocation of Resources” (1994) 89 Northwestern University Law Review 140 161 n 77 notes that “it is curious that the courts would be as willing as they seem to be to ignore the mandate of limited liability for corporate shareholders...and order piercing of the corporate veil”. Gower supra 190 indicates,
The uncertainty with regard to this doctrine, as well as the judicial reluctance in applying it, therefore leads to the conclusion that this remedy is not adequate in protecting the interests of corporate creditors.\(^{359}\)

### 3.5 CONCLUSION

In this section various measures that could be applied towards the protection of the interests of corporate creditors, such as statutory director liability for fraudulent, reckless, wrongful, or insolvent trading; insolvency law remedies; or piercing of the corporate veil, were analysed and evaluated.

Section 424(1) which provides for the statutory liability for reckless or fraudulent trading is plagued by problems and uncertainties, which impact negatively on its ability to provide protection for the interests of corporate creditors. Certain aspects regarding the application thereof could furthermore give rise to policy concerns.\(^{360}\)

The argument that the existence of a statutory remedy precludes reliance on a common law alternative also seems unconvincing. It is thus submitted that there is ample scope for the additional remedy that could be provided by an extension of directors’ duties to consider creditors’ interests.

A comparative study showed that equivalent provisions in other jurisdictions are also beset with problems of their own.\(^ {361}\) Any movement to amend section 424 to bring it in line with some of these provisions would therefore not serve to improve the lot of creditors.

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\(^{359}\) Glasbeek “More Direct Director Responsibility: Much Ado About...What?” (1995) 25 Canadian Business Law Journal 416 446 rightly notes that making directors...personally responsible will help attain objectives which are much harder to realize if reliance needs to be placed on poorly premised piercing of the corporate veil techniques.

\(^{360}\) See supra par 3.2.1.6. for a detailed evaluation of problem areas that may detrimentally affect the position of corporate creditors.

\(^{361}\) See supra par 3.2.2.
corporate creditors to the same extent than would an extension of directors’ duties to
include their interests.

Traditional insolvency law remedies were also shown to be inadequate. This is
largely attributable to their limited application and the strict confines within which
they have to operate.\footnote{362}{See supra par 3.3.4 for a detailed discussion.}

The reluctance on the part of the judiciary to exercise its discretion to “pierce the
corporate veil” also causes this potential remedy to be largely ineffective.\footnote{363}{See supra par 3.4 for more detail.}

One is therefore compelled to conclude that all of the remedies usually offered for the
protection of creditors’ interests are fraught with problems and uncertainties and not
able to adequately safeguard the interests of corporate creditors.

Application of these remedies may also give rise to policy concerns pertaining to
directors’ risk-taking ability, which may to an extent be addressed if the alternative
remedy of extending directors’ duties to creditors is utilised.

One is thus inclined to agree that

\begin{quote}
..there are deficiencies and weaknesses in all of the claims available to a liquidator
and, hence, every consideration should be given to a claim of breach of duty of
directors of the company.\footnote{364}{Keay supra 405 (own emphasis).}
\end{quote}

It is one thing, however, to admit the need for an additional remedy, specifically
through the extension of directors’ duties to include creditors’ interests. Another issue
altogether is whether such an extension of directors’ duties is possible within the
existing legal framework. This issue is addressed in the next part of this study.\footnote{365}{See discussion infra Ch 4 – Ch 9.}