DIRECTORS’ DUTIES TO CREDITORS

by

SULETTE LOMBARD

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PROMOTOR: PROF DR PA DELPORT

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# TABLE OF CONTENTS

## PART I: GENERAL ORIENTATION

### Chapter 1: Introduction

1.1 BACKGROUND .................................................................................................................3

1.2 PURPOSE OF STUDY ........................................................................................................5

1.3 EXPOSITION ......................................................................................................................5

1.4 LIMITATION OF SCOPE ..................................................................................................7

1.5 METHODOLOGY ..............................................................................................................8

## PART II: JUSTIFICATION OF A DUTY TO CREDITORS

### Chapter 2: Conceptual Justification

2.1 INTRODUCTION .............................................................................................................13

2.2 THEORIES ON THE NATURE OF THE COMPANY ....................................................14
    2.2.1 General ......................................................................................................................14
    2.2.2 Contractual Theories ...............................................................................................15
        2.2.2.1 General .............................................................................................................15
        2.2.2.2 Legal Contractualism .......................................................................................16
        2.2.2.3 Economic Contractualism ................................................................................17
    2.2.3 Communitarian Theories ..........................................................................................17
    2.2.4 Concessionary Theories ..........................................................................................19
        2.2.4.1 General .............................................................................................................19
        2.2.4.2 Dual Concession Theory ..................................................................................21
    2.2.5 Associative Theories ...............................................................................................22
    2.2.6 Application to a Duty to Creditors ............................................................................23
        2.2.6.1 Contractual Theories .........................................................................................23
        2.2.6.2 Communitarian Theories ..................................................................................24
        2.2.6.3 Concessionary Theories ..................................................................................25
Chapter 2: Creditors’ Contractual Relationship with the Company

2.2.6.4 Associative Theories

2.3 Creditors’ Contractual Relationship with the Company

2.3.1 General

2.3.2 Freedom to Negotiate

2.3.3 Adequacy of Contractual Protective Measures

2.3.3.1 Risk Compensation

2.3.3.2 Guarantees and Loan Covenants

2.3.4 Efficiency Concerns

2.3.5 Conclusion

2.4 Shareholders v Creditors as Primary Corporate Constituents

2.4.1 General

2.4.2 Owners of the Company

2.4.3 Relative Strength of Bargaining Power

2.4.4 Residual Risk-bearers

2.4.5 Efficient Monitors of Managerial Performance

2.4.6 Differences between Equityholders and Debtholders

2.4.7 Conclusion

2.5 Effect of a Duty to Creditors on Directors’ Behaviour

2.5.1 General

2.5.2 Fragmentation of Duties

2.5.3 Increased Risk Averseness

2.5.4 Reluctance to Serve on Company Boards

2.6 Effect of a Duty to Creditors on Limited Liability

2.7 Conclusion

Chapter 3: Evaluation of Alternative Remedies

3.1 Introduction

3.2 Statutory Measures Providing for Directors’ Personal Liability
PART III: FRAMEWORK FOR A DUTY TO CREDITORS

Chapter 4: Judicial Framework .................................................................97
4.1 INTRODUCTION ..................................................................................97
4.2 TYPE OF DUTY ..................................................................................100
   4.2.1 Introduction ..............................................................................100
   4.2.2 Australia ..................................................................................101
   4.2.3 New Zealand ..........................................................................102
   4.2.4 England .................................................................................103
   4.2.5 Canada ...................................................................................104
   4.2.6 United States of America .......................................................105
4.3 POINT IN TIME WHEN THE DUTY ARISES ....................................106
   4.3.1 Introduction ..............................................................................106
   4.3.2 Australia ..................................................................................106
   4.3.3 New Zealand ..........................................................................108
   4.3.4 England .................................................................................109
   4.3.5 Canada ...................................................................................110
   4.3.6 United States of America .......................................................111
4.4 BENEFICIARY OF THE DUTY ..............................................................114
   4.4.1 Introduction ..............................................................................114
   4.4.2 Australia ..................................................................................116
   4.4.3 New Zealand ..........................................................................116
   4.4.4 England .................................................................................118
   4.4.5 Canada ...................................................................................119
   4.4.6 United States of America .......................................................121
4.5 PROTECTED CREDITORS .................................................................121
   4.5.1 Introduction ..............................................................................121
   4.5.2 Australia ..................................................................................122
   4.5.3 New Zealand ..........................................................................123
   4.5.4 England .................................................................................124
4.5.5 Canada.....................................................................................................................125
4.5.6 United States of America........................................................................................125

4.6 POWER OF THE GENERAL MEETING TO RATIFY A BREACH OF THE DUTY .125
4.6.1 Introduction.............................................................................................................125
4.6.2 Australia..................................................................................................................126
4.6.3 New Zealand...........................................................................................................126
4.6.4 England ...................................................................................................................127
4.6.5 Canada.....................................................................................................................128
4.6.6 United States of America........................................................................................128

4.7 CONCLUSION................................................................................................................128

Chapter 5: Protection Afforded by Fiduciary Duties.......................................................132
5.1 INTRODUCTION ...........................................................................................................132
5.2 SOURCES AND FORMULATION................................................................................135
5.2.1 South Africa............................................................................................................135
5.2.2 Australia..................................................................................................................136
5.2.3 New Zealand...........................................................................................................137
5.2.4 England ...................................................................................................................138
5.2.5 Canada.....................................................................................................................142
5.2.6 United States of America........................................................................................142

5.3 RELEVANT ELEMENTS ...............................................................................................143
5.3.1 Acting in Good Faith in the Best Interests of the Company ...................................143
5.3.1.1 General...........................................................................................................143
5.3.1.2 Requirement of Good Faith ...........................................................................144
5.3.1.3 Defining the Interests of the Company ..........................................................145
5.3.2 Maintaining an Unfettered Discretion ....................................................................150
5.3.2.1 General...........................................................................................................150
5.3.2.2 Nominee Directors.........................................................................................150
5.3.3 Avoiding a Conflict of Interests..............................................................................155
5.3.3.1 General...........................................................................................................155
5.3.3.2 Unwarranted Personal Benefit ................................................................. 156
5.3.3.3 Contracts with the Company ................................................................. 156

5.4 CONSEQUENCES OF BREACH OF DUTY ......................................................... 157
5.4.1 General ...................................................................................................... 157
5.4.2 Setting Aside of Transaction ................................................................. 157
5.4.3 Civil Personal Liability .............................................................................. 158
  5.4.3.1 Extent of Personal Liability ................................................................. 158
  5.4.3.2 Basis of Personal Liability ................................................................. 159
  5.4.3.3 Defendant .......................................................................................... 161
    5.4.3.3.1 Defining “Director” ....................................................................... 161
    5.4.3.3.2 De Facto Directors ........................................................................... 163
    5.4.3.3.3 Non-executive Directors ............................................................... 165
    5.4.3.3.4 Puppet, Dummy or Stooge Directors and Shadow Directors .......... 166
  5.4.4 Pecuniary Penalty Orders ......................................................................... 168

5.5 APPLICATION TO A DUTY TO CREDITORS ...................................................... 169
5.5.1 Sources ..................................................................................................... 169
5.5.2 Formulation ............................................................................................... 171
5.5.3 Relevant Elements of Fiduciary Duties ...................................................... 174
  5.5.3.1 Acting in Good Faith in the Best Interests of the Company ................. 174
  5.5.3.2 Maintaining an Unfettered Discretion .................................................. 177
  5.5.3.3 Avoiding a Conflict of Interests ........................................................... 181
5.5.4 Consequences of Breach ............................................................................ 182
  5.5.4.1 Remedy ............................................................................................... 182
    5.5.4.1.1 Personal Liability .......................................................................... 182
    5.5.4.1.2 Pecuniary Penalty Order .............................................................. 183
  5.5.4.2 Basis of Liability .................................................................................. 183
  5.5.4.3 Defendant ........................................................................................... 184

5.6 CONCLUSION .................................................................................................. 185
Chapter 6: Protection Afforded by the Duty of Care and Skill

6.1 INTRODUCTION

6.2 SOURCES AND FORMULATION

6.2.1 South Africa

6.2.2 Australia

6.2.3 New Zealand

6.2.4 England

6.2.5 Canada

6.2.6 United States of America

6.3 RELEVANT ASPECTS

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

6.3.1.1 Duty of Care

6.3.1.2 Duty of Skill

6.3.1.3 Duty of Diligence

6.3.2 Required Standard

6.3.3 Distinction Between Executive and Non-Executive Directors

6.3.4 Reliance on Others

6.3.4.1 South Africa
6.3.4.2 Australia .......................................................................................................................... 217
6.3.4.3 New Zealand .................................................................................................................... 218
6.3.4.4 England ........................................................................................................................... 218
6.3.4.5 Canada ............................................................................................................................ 219
6.3.4.6 United States of America .............................................................................................. 219

6.4 CONSEQUENCES OF BREACH ............................................................................................... 220
6.4.1 South Africa .......................................................................................................................... 220
6.4.2 Australia ............................................................................................................................. 221
6.4.3 New Zealand ....................................................................................................................... 222
6.4.4 England ............................................................................................................................... 222
6.4.5 Canada ............................................................................................................................... 222
6.4.6 United States of America ..................................................................................................... 223

6.5 APPLICATION TO A DUTY TO CREDITORS ........................................................................ 225
6.5.1 Sources .................................................................................................................................. 225
6.5.2 Formulation .......................................................................................................................... 228
6.5.3 Relevant Aspects .................................................................................................................. 229
   6.5.3.1 Required Standard .......................................................................................................... 229
      6.5.3.1.1 Duty of Care ............................................................................................................. 229
      6.5.3.1.2 Duty of Skill ............................................................................................................ 233
   6.5.3.2 Distinction Between Executive and Non-executive Directors ........................................ 234
   6.5.3.3 Reliance on Others ........................................................................................................ 234
6.5.4 Consequences of Breach ..................................................................................................... 236
   6.5.4.1 Basis of Liability .............................................................................................................. 236
   6.5.4.2 Suitability of Remedy ..................................................................................................... 238
   6.5.4.3 Inadequate Information .................................................................................................. 238
   6.5.4.4 Judicial Reluctance ........................................................................................................ 241

6.6 CONCLUSION ............................................................................................................................ 243
# Chapter 7: Point in Time When the Duty Arises

## 7.1 INTRODUCTION

## 7.2 DEFINING THE TRIGGERS

### 7.2.1 Insolvency

#### 7.2.1.1 General

#### 7.2.1.2 Definition of Insolvency in Cases dealing with Directors’ Duties to Creditors

- **Australia**: 251
- **New Zealand**: 252
- **England**: 252
- **United States of America**: 253

#### 7.2.1.3 Definition of Insolvency in Context of Application of Section 424(1)

- **Commercial or Factual Insolvency?**: 254
- **Debt Subordination**: 256

#### 7.2.1.4 Definition of Insolvency in Other Statutory Measures Aimed at the Protection of Creditors

- **Balance Sheet and/or Commercial Insolvency?**: 259
- **Objective Test**: 261
- **Under-capitalized Companies and Debt Subordination**: 262

### 7.2.2 “Doubtful Solvency”

#### 7.2.2.1 General

#### 7.2.2.2 Definitions and Guidelines Provided by Commentators

#### 7.2.2.3 Suggested Definition of “Doubtful Solvency”

### 7.2.3 “Actions Causing Insolvency”

#### 7.2.3.1 General

#### 7.2.3.2 Suggested Formulation of “Actions Causing Insolvency”

## 7.3 FACTORS INFLUENCING PREFERENCE FOR A TRIGGER

### 7.3.1 General
7.3.2 Need for Precision...................................................................................................269
7.3.3 Need for Risk-taking...............................................................................................270
7.3.4 Director Reaction ....................................................................................................272
7.3.5 Increase in Cost.......................................................................................................274
7.3.6 Role of the Judiciary ...............................................................................................274
7.3.7 Reconciling Triggers with Conceptual Justification for a Duty to Creditors .......276
  7.3.7.1 General...........................................................................................................276
  7.3.7.2 Insolvency and “Doubtful Solvency” ............................................................276
  7.3.7.3 “Actions Causing Insolvency” .......................................................................278
7.4 PRACTICAL APPLICATION OF THE TRIGGERS.....................................................279
  7.4.1 Insolvency and “Doubtful Solvency” .....................................................................279
  7.4.2 “Actions Causing Insolvency” ................................................................................282
  7.4.3 Summary .................................................................................................................284
    7.4.3.1 Insolvency or “Doubtful Solvency as Triggers” ............................................284
    7.4.3.2 “Actions Causing Insolvency” as Trigger......................................................285
7.5 CONCLUSION................................................................................................................285

Chapter 8: Beneficiary of the Duty ....................................................................................291
8.1 INTRODUCTION ...........................................................................................................291
8.2 ORTHODOX VIEW ........................................................................................................294
  8.2.1 Interest of the Company..........................................................................................294
  8.2.2 Enforcement of Directors’ Duties ...........................................................................296
  8.2.3 Ratification of a Breach of Directors’ Duties ..........................................................297
    8.2.3.1 Distinction between Ratifiable and Unratifiable Wrongs .................................297
    8.2.3.2 Ratification by Directors as Shareholders.......................................................300
    8.2.3.3 Ratification by Unanimous Consent ...............................................................303
8.3 JUDICIAL METHODS FOR EXTENDING DIRECTORS’ DUTIES TO CREDITORS ..........................................................305
  8.3.1 Indirect Duty Method............................................................................................305
    8.3.1.1 Beneficiary of Duty....................................................................................305
9.2.2.2 Australia..........................................................................................................................337
9.2.2.3 England..........................................................................................................................338
9.2.2.4 Evaluation..........................................................................................................................338
  9.2.2.4.1 Applicability of Relieving Provisions in Case of Statutory Liability ...338
  9.2.2.4.2 Uncertainty Regarding Proceedings to which Relieving Provisions
Will Apply ........................................................................................................................................341
  9.2.2.4.3 Anomaly in that Person who Acted Negligently Is Entitled to Relief
  if He Acted Reasonably ............................................................................................................342
  9.2.2.4.4 Extent of the Court’s Discretion ..............................................................................344
9.2.3 The Business Judgment Rule .............................................................................................345
  9.2.3.1 United States of America .............................................................................................345
  9.2.3.2 Australia..........................................................................................................................349
  9.2.3.3 Evaluation ......................................................................................................................352
    9.2.3.3.1 Arguments in Favour of a Statutory Business Judgment Rule ..........352
      9.2.3.3.1.1 Judiciary’s Stance on Pronouncing on Business Decisions ......352
      9.2.3.3.1.2 Encouragement of Risk-Taking ...................................................352
      9.2.3.3.1.3 Need for Protection at the Moment When Directors Take
        Business Judgments .................................................................................................353
    9.2.3.3.1.4 Arguments from Fairness and Expediency ..................................353
    9.2.3.3.2 Arguments against a Statutory Business Judgment Rule ......................354
      9.2.3.3.2.1 Superfluity of a Statutory Business Judgment Rule .................354
      9.2.3.3.2.2 Limited Application of and Protection Afforded by the Rule ....355
      9.2.3.3.2.3 Creation of Formalism .......................................................................356
      9.2.3.3.2.4 Realism About Shareholder Litigation Risk ................................356
      9.2.3.3.2.5 Effect of a Statutory Rule On the Content of a Duty of Care ......356
      9.2.3.3.2.6 Doctrinal Conflicts ...........................................................................358
      9.2.3.3.2.7 Uncertainty Regarding Parameters of the Business Judgment
        Rule .........................................................................................................................358
9.2.4 Application to a Duty to Creditors ....................................................................................359
9.3 INDEMNIFICATION...............................................................................................................362
9.3.1 Introduction ............................................................................................................. 362
9.3.2 Statutory Regulation ............................................................................................... 362
  9.3.2.1 South Africa ................................................................................................... 363
  9.3.2.2 Australia ......................................................................................................... 364
  9.3.2.3 New Zealand .................................................................................................. 366
  9.3.2.4 England .......................................................................................................... 368
  9.3.2.5 Canada ............................................................................................................ 369
  9.3.2.6 United States of America ............................................................................... 369
9.3.3 Application to a Duty to Creditors .......................................................................... 374
  9.3.3.1 General Indemnity and Exemption ................................................................ 374
    9.3.3.1.1 General .................................................................................................. 374
    9.3.3.1.2 Section 247(1) and Modifying or Releasing Provisions in Articles of Association ............................................................................................................ 376
    9.3.3.1.3 Application of Section 247(1) in a Group Context ....................................... 379
  9.3.3.2 Indemnity against Liability for Legal Expenses ............................................ 381
9.4 DIRECTOR LIABILITY INSURANCE ......................................................................... 382
  9.4.1 Introduction ............................................................................................................. 382
  9.4.2 Statutory Regulation ............................................................................................... 383
    9.4.2.1 South Africa ................................................................................................... 383
    9.4.2.2 Australia ......................................................................................................... 384
    9.4.2.3 New Zealand .................................................................................................. 385
    9.4.2.4 England .......................................................................................................... 386
    9.4.2.5 Canada ............................................................................................................ 387
    9.4.2.6 United States of America ............................................................................... 387
  9.4.3 Application to a Duty to Creditors .......................................................................... 388
    9.4.3.1 General ........................................................................................................... 388
    9.4.3.2 Statutory Regulated Access ........................................................................... 389
    9.4.3.3 Consequences of Non-compliance with Statutory Requirements ............... 391
9.5 CONCLUSION ................................................................................................................ 392
PART IV: CONCLUSION

Chapter 10: Conclusion .......................................................................................................396

10.1 BACKGROUND ...........................................................................................................396

10.2 JUSTIFICATION OF A DUTY TO CREDITORS ..........................................................397
   10.2.1 Conceptual Justification of a Duty to Creditors ....................................................397
   10.2.2 Need for a Duty to Creditors .................................................................................398
       10.2.2.1 Statutory Personal Liability .........................................................................398
       10.2.2.2 Typical Insolvency Remedies ......................................................................400
       10.2.2.3 Piercing the Veil ..........................................................................................400

10.3 FRAMEWORK FOR A DUTY TO CREDITORS ............................................................401

10.4 DEVELOPMENT OF A DUTY TO CREDITORS ..........................................................406

10.5 CONCLUDING REMARKS .........................................................................................407

APPENDICES

Summary ................................................................................................................................411

Opsomming .........................................................................................................................413

Bibliography: Books and Theses .......................................................................................417

Bibliography: Law Journals .................................................................................................423

Bibliography: Bills and Reports ..........................................................................................441

Table of Cases .....................................................................................................................445

Table of Statutes ..................................................................................................................457
PART I

GENERAL ORIENTATION

Chapter 1: Introduction

.................................................................3
CHAPTER 1
INTRODUCTION

SUMMARY

1.1 BACKGROUND
1.2 PURPOSE OF STUDY
1.3 EXPOSITION
1.4 LIMITATION OF SCOPE
1.5 METHODOLOGY

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

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

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

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

\(^3\) Countries in which the judiciary contributed to the development of the law in this way include Australia, New Zealand, England, Canada and the USA.
Chapter 1

Introduction

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

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

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

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

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

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

[t]he question is not whether shareholders might have an action, but whether an action is available to creditors...(own emphasis).

Chapter 1

Introduction

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

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

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

[N]o analysis of the director-creditor relationship provides any sound reasons for imposing fiduciary duties on directors to act in the best interests of creditors. Where such a duty to creditors has been proposed, no means of effectively dealing with the problems of standing to sue and ratification have been suggested. Creditors’ interests are in fact already adequately protected by existing equitable and common law principles and statutory provisions.
Chapter 1

Introduction

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

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

Justification of a duty to creditors is one thing. However, as Berle\(^8\) noted:

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

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

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

\(^8\) Berle “For Whom Corporate Managers Are Trustees: A Note” (1932) 45 Harvard Law Review 1365.

\(^9\) Id 1367.
A pertinent question with regard to directors’ duties to creditors is whether this is a continuous duty, or whether it is “triggered” by particular events during the company’s existence. An answer to this question is offered in Chapter 7 which deals with the moment when the duty should arise.

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

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

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

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

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

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

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

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

10 Company law in the USA, or corporation law as it is known there, is still predominantly state law. Focus will be placed on corporation law in the state of Delaware, for being regarded as very influential in matters of corporation law. Weiss “The Effect of Director Liability Statutes on Corporate Law and Policy” (1989) 14 Journal of Corporation Law 637 639 indicates that Delaware is the “dominant state” in this regard. According to Weiss supra 640 this would seem to be the case for a number of reasons, such as the fact that its corporate code is flexible and liberal; that it provides a highly developed body of corporate case law, which provides guidance and flexibility, etc. Another reason why the state of Delaware was selected is because it is one of the states in the USA that chose not to enact a non-shareholder constituency statute. The question as to whether directors owe duties to creditors is therefore approached on a non-statutory basis, as in the other jurisdictions referred to in this study.
England was chosen for the obvious reason that South African company law and the South African *Companies Act*\textsuperscript{11} are largely premised on English company law.\textsuperscript{12} The other jurisdictions are also based on principles of English company law. However, in Australia and New Zealand a number of new developments took place that would indicate a moving away from a pure English foundation. These may prove very informative when South Africa embarks upon a review of its own company law. Canada furthermore presents a good example of how a legal system in which principles of English and American law are often combined, functions effectively.

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

\textsuperscript{11} Act 61 of 1973.

\textsuperscript{12} Cilliers & Benade *Corporate Law* (2000) par 2.03.

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

JUSTIFICATION OF A DUTY TO CREDITORS

Chapter 2: Conceptual Justification .................................................................13

Chapter 3: Evaluation of Alternative Remedies ...............................................55
CHAPTER 2
CONCEPTUAL JUSTIFICATION

SUMMARY

2.1 INTRODUCTION
2.2 THEORIES ON THE NATURE OF THE COMPANY
2.3 CREDITORS’ CONTRACTUAL RELATIONSHIP WITH THE COMPANY
2.4 SHAREHOLDERS v CREDITORS AS PRIMARY CORPORATE CONSTITUENTS
2.5 EFFECT OF A DUTY TO CREDITORS ON DIRECTORS’ BEHAVIOUR
2.6 EFFECT OF A DUTY TO CREDITORS ON LIMITED LIABILITY
2.7 CONCLUSION

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.\textsuperscript{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.\textsuperscript{15}

\textsuperscript{14} See \textit{infra} par 2.2 for further discussion.

\textsuperscript{15} See \textit{infra} par 2.3 for further discussion.
Shareholders, on the other hand, are for various reasons assigned the position of primary, or sole, corporate constituents.\(^{16}\) 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.\(^{17}\)

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\(^{18}\) and limited liability.\(^{19}\) 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.\(^{20}\) These viewpoints led to the formulation of different models in terms of

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\(^{16}\) See *infra* par 2.4 for further discussion.

\(^{17}\) 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 *Dodge v Ford Motor Co* 170 NW 668 (Mich 1919); *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286 etc.

\(^{18}\) See *infra* par 2.5 for further discussion.

\(^{19}\) See *infra* par 2.6 for further discussion.

\(^{20}\) Cilliers & Benade *Corporate Law* (2000) par 1.16 n 18 refer to Wolff “On the Nature of Legal Persons” 1938 *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.
Chapter 2                                                                                     Conceptual Justification

which the corporation is defined. The importance of such models should not be
underestimated. It is said that
different 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.  

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. A further theory, namely the associative
type, could also play an important role, especially with regard to directors’ duties to
creditors. 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”, also referred to as a

21 Dine The Governance of Corporate Groups (2000) 1 (hereinafter Dine Corporate Groups). Also see

22 Dine Corporate Groups 3.

23 Wishart “Models and Theories of Directors’ Duties to Creditors” (1991) 14 New Zealand Universities
Law Review 323 348 proposes that an associative theory be applied regarding the legal nature of the
250 (hereinafter Dine Company Law Developments) an Essex University team is developing an associative
model of the company.

24 Keay “Directors’ Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection
Iacobucci “A Wise Decision? An Analysis of the Relationship between Corporate Ownership Structure and
A Wise Decision) distinguishes between true contracts, eg contracts concluded with creditors, and
metaphorical contracts, eg the so-called corporate contract between shareholders and the company.
“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.

Chapter 2

Conceptual Justification

An important consequence of the application of this theory is that the primary implied “contract”\textsuperscript{32} is regarded as being between the company and its members, to the exclusion of all other interested parties.\textsuperscript{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”.\textsuperscript{34} It is consequently regarded as a “voluntary association between shareholders”, rather than a “creation of the state”.\textsuperscript{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.\textsuperscript{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”.\textsuperscript{37} These theories thus seem to emphasise economic notions such as rationality, efficiency and information.\textsuperscript{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.\textsuperscript{39} The emphasis is thus on identification of the aims of the company with those of society, causing the loss of a strong commercial

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

\textsuperscript{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.

\textsuperscript{34} Jensen & Meckling supra.

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

\textsuperscript{36} Ibid.


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

\textsuperscript{39} Dine Corporate Groups 17.
identity for the company, because it has become a political tool with diffused goals.\textsuperscript{40} These theories hold the risk that sight might be lost of the commercial goal of the company.\textsuperscript{41}

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,\textsuperscript{42} 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”.\textsuperscript{43}

The “enlightened shareholder value” approach\textsuperscript{44} 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

\begin{flushright}
\textsuperscript{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).

\textsuperscript{41} Dine Corporate Groups 20.

\textsuperscript{42} See eg Dean supra who uses the terms “stakeholding” and “pluralism” interchangeably, as well as Kelly & Parkinson “The Conceptual Foundations of the Company: A Pluralist Approach” in Parkinson, Gamble & Kelly The Political Economy of the Company (2000) 113.


\textsuperscript{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.
Chapter 2                                                                                     Conceptual Justification

retaining primacy. 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.

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
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. The concept of the free entity entails the important consequence that the wishes of the original “owners” can no longer be considered paramount. This raises the question, however, as to whose interests should carry weight.

a South African context, where it is possible for an association to acquire legal personality through conduct. Apart from this, he also concludes that incorporation through registration caused this theory to lose much of its appeal. Apparent support for the concessionary theory and the notion of no privilege without responsibility do, however, appear from statements by the South African judiciary. See eg S v De Jager 1965 2 SA 616 (A) 624 – 625, where the court agreed with the following statement in In re Cleadon Trust Ltd [1938] 4 All ER 518 533:

The privilege of limited liability which Parliament has given to members of companies registered under the Companies Act is given upon the footing of conditions the observance of which by directors is of general importance to the public…(own emphasis);

S v Ressel 1968 4 SA 224 (A) 233, which cited the following extract from Cooper v Luxor (Eastbourne) Ltd [1939] 4 All ER 411 (CA) 418 – 419 with approval:

The public policy on which the principle of limited liability is given to companies, private as well as public, is that the Directors shall observe the trust which Parliament has placed in them;

as well as the statement by the Constitutional Court in Bernstein v Bester 1996 2 SA 751 (CC) 796:

The establishment of a company as a vehicle for conducting business on the basis of limited liability is not a private matter. It draws on a legal framework endorsed by the community and operates through the mobilisation of funds belonging to members of that community. Any person engaging in these activities should expect that the benefits inherent in this creature of statute will have concomitant responsibilities.

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).

Ibid.

Dine Corporate Groups 27. See infra Ch 8 (Beneficiary of the Duty) where this issue is dealt with in more detail.
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

\footnotesize{\textsuperscript{55} Id 28.}

\footnotesize{\textsuperscript{56} Dine Corporate Groups 29.}

\footnotesize{\textsuperscript{57} As Dine Corporate Groups 28 herself concedes.}

\footnotesize{\textsuperscript{58} Wishart supra 348.}
Chapter 2  Conceptual Justification

If 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.  

Membership of the company is thus deemed to be a flexible concept.

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.

As was indicated, the theory allows that contracts may be incomplete and that gaps may be filled by company law principles. 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. 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.

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
Chapter 2                                                                                     Conceptual Justification

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. 65

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. 66

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).
Chapter 2                                                                                     Conceptual Justification

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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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


\textsuperscript{68} Williamson “Boards of Directors and Fiduciary Duties” in Romano (ed) \textit{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.

\textsuperscript{69} Dine \textit{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”. 70

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”, 71 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. 72 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 73 –

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

### 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.\footnote{See eg Sealy Directions’ “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 Vanderbilt Law Review 1399 1406, provide protection “against opportunistic behavior, and the strength of that protection varies inversely with the potential for self-help on the part of the vulnerable party” (own emphasis). A similar viewpoint seems to be advocated in 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.}

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.\footnote{Ziegel “Creditors as Corporate Stakeholders: The Quiet Revolution – An Anglo-Canadian Perspective (1993) 43 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 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.} 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...
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.
Chapter 2  
Conceptual Justification

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. 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”.

The advent of insolvency would furthermore cause the compensation negotiated for by the creditors to become even less adequate. 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.

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

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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.

82 Keay Contractarian Concerns 669 (own emphasis).


84 Rousseau supra 382.

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.
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.


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. This issue may be particularly relevant insofar as small trade creditors are concerned.

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.

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, 

89 See Keay Contractarian Concerns 676; and MacIntosh “Designing an Efficient Fiduciary Law” (1993) 43 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.

90 Iacobucci 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.

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 entrancing the position of shareholders as primary corporate constituents. Berle and Means made the point that

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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,\textsuperscript{99} 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.\textsuperscript{100} 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.\textsuperscript{101}

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.\textsuperscript{102} As a result it is accepted that

\textsuperscript{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 \textit{A Wise Decision} 343 – 345.


\textsuperscript{101} Sealy \textit{Directors as Trustees} 90.

\textsuperscript{102} Macey & Miller “Corporate Stakeholders: A Contractual Perspective” (1993) 43 \textit{University of Toronto Law Journal} 401 417.
Chapter 2                                                                                     Conceptual Justification

shareholders’ relationship with the company is best governed by a flexible corporate law concept of “duty”. 103

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. 104 Creditors are therefore not in a stronger position than shareholders, insofar as their ability to protect their interests contractually is concerned. 105

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. 106 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. 107 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. 108 As


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

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\textsuperscript{109} \textit{Ibid.} Also see Kelly & Parkinson \textit{supra} 116 \textit{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.
\end{flushleft}
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{117}

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{118}

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{119} Some

\footnotetext[116]{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 content thereof in practice.}

\footnotetext[117]{Farrar Corporate Governance in Australia and New Zealand (2001) 501 quotes the following excerpt from the Committee on the Financial Aspects of Corporate Governance London Report of the Committee on the Financial Aspects of Corporate Governance (Cadbury Report) (1992) to illustrate this fact: The shareholders as owners of the company elect the directors to run the business on their behalf and hold them accountable for its progress...[they] have delegated many of their responsibilities as owners to the directors who act as their stewards. \textit{It is for the shareholders to call the directors to book} if they appear to be failing in their stewardship \textit{and they should use this power}. While they cannot be involved in the direction and management of their company, \textit{they can insist on a high standard of governance}...(own emphasis).}

\footnotetext[118]{Barnard “The Hampel Committee Report: A Transatlantic Critique” (1998) 10 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 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.}
Chapter 2  
Conceptual Justification

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.\footnote{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.}

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.\footnote{124}{Miles & Proctor supra 143.}


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.\footnote{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.}
Chapter 2                                                                                     Conceptual Justification

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.\(^{127}\)

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”.\(^{128}\) 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.

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”.\(^ {129}\) As was indicated already, the view of shareholders as “owners” of the company is anachronistic and difficult to reconcile with

\(^{127}\) Dine *Corporate Groups* 35.
\(^{128}\) Mitchell “The Fairness Rights of Corporate Bondholders” (1990) 65 *New York University Law Review* 1165 1199 opines that this is no reason to deny them the opportunity to monitor management’s behaviour.
\(^{129}\) Harvey *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 *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. *Those are tidy concepts, but they no longer serve modern corporate finance* (own emphasis).
the notion of separate legal personality. It is also interesting to note that even opponents of the extension of fiduciary duties to creditors 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”.

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.

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. 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.

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

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130 See discussion supra par 2.4.2.
131 Eg Harvey supra 1023, who specifically argues against the extension of such a duty to bondholders.
132 Id 1025.
133 Commentators such as Kanda 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.
134 Harvey supra 1028.
135 Sappideen supra 382. Also see McDaniel supra 417.
classes of shares displaying marked debt features and vice versa.\textsuperscript{136} On this basis it may therefore be argued convincingly that the legal distinction in available remedies have also become outmoded\textsuperscript{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”.\textsuperscript{138}

\textbf{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”\textsuperscript{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”,\textsuperscript{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.

\textsuperscript{136} Corey, Marr & Spivey \textit{supra} 979; Harvey \textit{supra} 1028; McDaniel \textit{supra} 417.

\textsuperscript{137} \textit{Ibid.}

\textsuperscript{138} Corey, Marr & Spivey \textit{supra} 979.

\textsuperscript{139} Weinrib “The Fiduciary Obligation” (1975) 25 University of Toronto Law Journal 1 7.

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”. 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”.

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

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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.\textsuperscript{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.\textsuperscript{144} Upon the company experiencing distress\textsuperscript{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.

\textbf{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.\textsuperscript{146} It is feared that a duty to creditors could give rise to the problem of insufficient risk taking, as directors, fearing personal liability,

\begin{itemize}
\item \textsuperscript{143}Berle “For Whom Corporate Managers Are Trustees: A Note” (1932) 45 Harvard Law Review 1365 1367 – 1369 notes that
\begin{quote}
[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.
\end{quote}

Also see Chapman supra 213; Dawson supra 81; and Sealy Directors’ “Wider” Responsibilities 175.
\item \textsuperscript{144}See discussion infra Ch 8 (Beneficiary of the Duty) for more detail in this regard.
\item \textsuperscript{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 infra Ch 7 (Point in Time When the Duty Arises) for more detail in this regard.
\item \textsuperscript{146}According to MacIntosh supra 425 wealth maximisation is the traditional answer to the question of the function of corporate law. Also see Botha Duties to Bondholders 296; Pascoe & Anderson “Peeking under the veil: Creditor’s rights against directors behaving badly” (2002) 16:4 Commercial Law Quarterly 12 13.
\end{itemize}
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Conceptual Justification

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.147

It cannot be denied that companies need to take risks to prosper.148 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 [sic]
railways would not have been built and we would have had no Industrial Revolution, no
modern technology.149

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.150 In case of a
duty to creditors being triggered,151 directors should, as always, comply with their
fiduciary duties and the duty of care and skill152 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.

147 Chaver & Fried “Manager’s Fiduciary Duty Upon the Firm’s Insolvency: Accounting for Performance

148 Schwarz “Rethinking a Corporation’s Obligations to Creditors” (1996) 17 Cardozo Law Review 647
686.

149 Sealy Directors’ “Wider” Responsibilities 181.

150 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.

151 See infra Ch 7 (Point in Time When the Duty Arises) for more information on the circumstances that
could “trigger” a duty to creditors.

152 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.
All risk-taking should therefore not come under attack, but only irresponsible risk-taking.\textsuperscript{153} 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.\textsuperscript{154} Directors of a company experiencing distress should not engage in excessively risky transactions with what is in effect at that stage, creditors’ money.\textsuperscript{155} 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.\textsuperscript{156}

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.\textsuperscript{157}

\textbf{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

\begin{itemize}
  \item \textsuperscript{153} Keay \textit{Contractual Concerns} 683.
  \item \textsuperscript{154} Ibid.
  \item \textsuperscript{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 \textit{International Insolvency Review} 113 124 makes a similar point.
  \item \textsuperscript{156} See discussion \textit{infra} Ch 6 (Protection Afforded by the Duty of Care and Skill) for more detail in this regard.
  \item \textsuperscript{157} See Kraakman “Corporate Liability Strategies and the Costs of Legal Controls” (1984) 93 \textit{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 \textit{infra} Ch 9 (Relief from Liability) for further information regarding various such measures and their efficacy.
\end{itemize}
boards of companies.\textsuperscript{158} However, this argument functions on an empirical basis that is not well-established.\textsuperscript{159} 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”.\textsuperscript{160}

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.\textsuperscript{161}

2.6 EFFECT OF A DUTY TO CREDITORS ON LIMITED LIABILITY

Limited liability is considered as one of the cornerstones of modern company law.\textsuperscript{162} 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

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{158} Kennet “Liability of Directors to Third Persons” (1989) 63 \textit{Australian Law Journal} 502 504; Sealy Directors’ “Wider” Responsibilities 186.
\item \textsuperscript{160} \textit{Id} 451.
\item \textsuperscript{161} See discussion \textit{infra} Ch 9 (Relief from Liability) for more detail in this regard.
\item \textsuperscript{162} Easterbrook & Fischel \textit{supra} 40 – 62, as referred to by Booth “Limited Liability and the Efficient Allocation of Resources” (1994) 89 \textit{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.
\end{itemize}
\end{footnotesize}
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.\textsuperscript{163}

There are various counter arguments to this point. First, limited liability was initially enacted for the benefit of shareholders – not directors.\textsuperscript{164} This inference is supported by the fact that the initial legislation introducing limited liability in England, the \textit{Limited Liability Act 1855},\textsuperscript{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.\textsuperscript{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.\textsuperscript{167}

\begin{footnotes}
\item[163] Sealy \textit{Directors’ “Wider” Responsibilities} 181, in a paragraph titled “Limited Liability and Risk”.
\item[164] Nicholls “Liability of Corporate Officers and Directors to Third Parties” (2001) 35 \textit{Canadian Business Law Journal} 1 2 phrases it clearly:

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).

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”.

\item[165] 18 & 19 Vict, c 133 (hereinafter \textit{Limited Liability Act}).
\item[166] In terms of s 9 of the \textit{Limited Liability Act}.
\item[167] Cooke \textit{supra} 154 makes the following important observation with regard to s 9 of the \textit{Limited Liability Act}:
\end{footnotes}
Holding directors personally liable for failing properly to consider the interests of creditors under particular circumstances\(^{168}\) 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.\(^{169}\)

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).

\(^{168}\) 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.

\(^{169}\) 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-conferring 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

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

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

Also see Giugni & Ryan “Company Directors’ Spheres of Responsibility: Primary and Secondary Duties” 1988 \textit{New Zealand Law Journal} 437 439 \textit{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 \textit{supra} 513. Dabner “Directors’ Duties – The Schizoid Company” (1988) 6 \textit{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 \textit{supra} 530 (own emphasis).

\textsuperscript{173} Grundfest “The Limited Future of Unlimited Liability: A Capital Market Perspective” (1992) 102 \textit{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.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 support176 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.

debts. In this regard one must keep in mind, however, that this study does not propose a duty running directly in favour of creditors, but a reformulation of directors’ traditional duties to the company to encompass the interests of creditors. (See infra Ch 8 (Beneficiary of the Duty)) for more detail in this regard.) As a result directors would not incur liability for payment the company’s debts as such, but would incur normal liability resulting from a breach of their fiduciary duties or a breach of the duty of care. (See infra Ch 5 (Protection Afforded by Fiduciary Duties), as well as Ch 6 (Protection Afforded by the Duty of Care and Skill) for more detail on available remedies in case of a breach of these duties.) The “duty to creditors” would thus not infringe upon the separate legal entity principle.

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 supra par 2.5.3.

176 Branson supra 93; De Mott supra 88; Dine Corporate Groups 35.
Chapter 2                                                                                     Conceptual Justification

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

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
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

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

179 See eg Fourie “Die Plig van Direkteure Teenoor Maatskappyskuldeisers” 1992 SA Merc LJ 25 49 – 50, who is of the opinion that

a 424 in beginsel voldoende 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.\textsuperscript{180}

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,\textsuperscript{181} Australia,\textsuperscript{182} New Zealand\textsuperscript{183} and England,\textsuperscript{184} 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.\textsuperscript{185} 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.\textsuperscript{186}

For the sake of completeness reference is also made to typical insolvency remedies,\textsuperscript{187} as well as the “piercing of the veil” doctrine,\textsuperscript{188} 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.\textsuperscript{189}

\begin{footnotesize}
\begin{enumerate}
\item These provisions are formulated differently in various jurisdictions. See discussion \textit{infra} par 3.2.\textsuperscript{180}
\item \textit{Infra} par 3.2.1.\textsuperscript{181}
\item \textit{Infra} par 3.2.2.1.\textsuperscript{182}
\item \textit{Infra} par 3.2.2.2.\textsuperscript{183}
\item \textit{Infra} par 3.2.2.3.\textsuperscript{184}
\item \textit{Infra} par 3.2.2.4.\textsuperscript{185}
\item According to Wood “World Corporate Law – Mapping the Real Differences” (2003) 24 \textit{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”.\textsuperscript{186}
\item \textit{Infra} par 3.3. The inadequacy of these remedies in protecting creditors’ interests will also be referred to in subsequent discussions, where relevant.\textsuperscript{187}
\item \textit{Infra} par 3.4.\textsuperscript{188}
\item \textit{Infra} par 3.5.\textsuperscript{189}
\end{enumerate}
\end{footnotesize}
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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190 *Act 61 of 1973* (hereinafter South African *Companies Act*).

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 Maatskappyeereg* 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 *SA LJ* 162; Fourie “Dorklerk Investments (Pty) Ltd v Bhyat 1980 1 SA 443 (W): Roekelose of Bedrieglike Optrede – Artikel 424 van die Maatskappyyet 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 *SA LJ* 788; Luiz & Van der Linde “Trading in Insolvent Circumstances – Its Relevance to Sections 311 and 424 of the Companies
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*\(^{193}\) 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”.\(^{194}\)

In *Cronje v Stone*\(^{195}\) 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).\(^{196}\)

In yet another case, *Retail Management Services (Edms) Bpk v Schwartz*,\(^ {197}\) 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.\(^ {198}\) The same does not apply in respect of applications brought by the liquidator, however.\(^ {199}\)

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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.

\(^{199}\) *Ibid.*
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).

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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}

\subsection*{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

\begin{footnotesize}
\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} \textit{Id} 501.
\textsuperscript{206} Act 46 of 1926.
\textsuperscript{207} 1986 4 SA 459 (W).
\textsuperscript{208} \textit{Id} 462.
\textsuperscript{209} 1999 3 SA 480 (W).
\end{footnotesize}
was in a sound financial position and there was no necessity for it to be wound up or placed under judicial management.\footnote{Id 487.}

However, in \textit{L & P Plant Hire BK v Bosch},\footnote{2002 2 SA 662 (SCA).} a case dealing with the interpretation of section 64 of the \textit{Close Corporations Act}\footnote{Act 69 of 1984 (hereinafter \textit{Close Corporations Act}).} – 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.\footnote{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”.}

\subsection*{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 company in a manner that is “reckless”. The judiciary defined “recklessness” with reference to “gross negligence” on various occasions.\footnote{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).} In \textit{Mafikeng Mail (Pty) Ltd v Centner (No 2)}\footnote{1995 4 SA 607 (W).} 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.\footnote{Id 613.} The judiciary continued to
state that business conduct could be regarded as reckless if there is no plausible explanation for the conduct complained of.  

Judicial opinion thus seems settled that the term “reckless” in section 424 of the South African Companies Act denotes “gross negligence”.  

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”. 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.

The court also made use of a hybrid objective/subjective yardstick in determining whether directors acted with gross negligence in Philotex (Pty) Ltd v Snyman. The test is objective insofar as the conduct of the director is compared to that of a notional reasonable person, or even “reasonable businessman”, and subjective insofar as the notional person belongs to the same group of persons as the defendant. 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.

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217 Ibid.

218 Some uncertainty may be created by s 64 of the 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.

219 Ex parte Lebowa Development Corporation Ltd supra 111. This interpretation was repeated in Ozinsky v Lloyd 1992 3 SA 396 (C) 414.

220 According to the court in 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.

221 Supra.

222 Id 147.

223 Id 143; 148.
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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224 *Supra*.

225 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).

226 (1932) 2 Ch 71.

227 *Id* 77.

228 1933 Ch 786.

229 *Id* 790.

230 *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 \emph{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 \emph{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

\begin{itemize}
\item \textsuperscript{231} \emph{Id} 105.
\item \textsuperscript{232} \emph{Id} 106. Also see \emph{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.
\item \textsuperscript{233} \emph{Supra}.
\item \textsuperscript{234} \emph{Id} 103.
\item \textsuperscript{235} \emph{Supra}.
\end{itemize}
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{itemize}
\item \textsuperscript{236} \textit{Id} 606 – 607.
\item \textsuperscript{237} \textit{Supra}.
\item \textsuperscript{238} \textit{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 \textsuperscript{239} \textit{Supra}.
\item \textsuperscript{240} \textit{Id} 464.
\item \textsuperscript{241} \textit{Ibid}.
\item \textsuperscript{242} 1997 3 SA 470 (K).
\end{itemize}
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 \textit{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}

\textbf{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}

\textsuperscript{243} \textit{Id} 475. Also see \textit{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.

\textsuperscript{244} Brusser “Actions against Delinquent Directors” 1985 \textit{SA Company LJ} 33 43 (hereinafter Brusser \textit{Delinquent Directors}).

\textsuperscript{245} \textit{Supra}.

\textsuperscript{246} Havenga “Creditors, Directors and Personal Liability under Section 424 of the Companies Act” 1992 \textit{SA Merc LJ} 63 69.

\textsuperscript{247} \textit{Bowman v Sacks supra} 465; \textit{Howard v Herrigel} 1991 2 SA 660 (A) 672; \textit{Philotex (Pty) Ltd v Snyman supra} 142; \textit{Terblanche v Damji supra} 511.

\textsuperscript{248} \textit{Ibid}.

\textsuperscript{249} \textit{Bowman v Sacks supra} 465.
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

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. 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, but may even provide creditors with a remedy in instances where the company is financially sound and trading successfully. 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 *L & P Plant Hire BK v Bosch* 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

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251 See discussion *infra* Ch 6 (Protection Afforded by the Duty of Care and Skill) for more detail.

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 *infra* Ch 7 (Point in Time When the Duty Arises) for more detail.

253 As is seemingly indicated by the phrase “or otherwise”. The recent judgment in *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.

254 *Supra.*
company,\textsuperscript{255} and in case of a breach of the duty of care and skill liability is limited to the damages caused to the company.\textsuperscript{256}

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.\textsuperscript{257} 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.\textsuperscript{258} Measures that may provide such relief include section 248 of the South African \textit{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).\textsuperscript{259} 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.

\begin{itemize}
\item \textsuperscript{255} See \textit{infra} Ch 5 (Protection Afforded by Fiduciary Duties) par 5.4 for more detail.
\item \textsuperscript{256} See \textit{infra} Ch 6 (Protection Afforded by the Duty of Care and Skill) par 6.4 for more detail.
\item \textsuperscript{257} See sources referred to \textit{supra} Ch 2 (Conceptual Justification) par 2.5.4.
\item \textsuperscript{258} See discussion \textit{infra} Ch 9 (Relief from Liability) for further discussion.
\item \textsuperscript{259} De Koker \textit{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 \textit{Corporations Act} 2001 (hereinafter \textit{Australian Corporations Act}) or the proposed amendment of s 727(1) of the English \textit{Companies Act} 1985 (hereinafter \textit{English Companies Act}), namely that the requirement of “reasonableness” simply be removed. See \textit{infra} par 9.2.2.4.3 for more detail.
\end{itemize}
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.\(^\text{260}\) 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.\(^\text{261}\) 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.\(^\text{262}\) Members are afforded the

\(^{260}\) See discussion *infra* Ch 8 (Beneficiary of the Duty).

\(^{261}\) The Institute of Directors *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 *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).

\(^{262}\) In *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 *Ex parte Lebowa Development Corporation Ltd supra* 109, referred to with approval in *Kalinko v Nisbet supra* 774, the judiciary also acknowledged that this provision “supplements the common law remedies in certain circumstances: *it does not replace them*” (own emphasis). Even though these statements
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. The committee noted that there was a clear need for further reform of the insolvent trading provisions to address concerns associated with insolvent trading.263 The relevant parts of this provision read as follows:

(1) This section applies if:

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.


Chapter 3                                                                                    Alternative Remedies

(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; dependence 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.

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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}

\begin{flushright}
\textsuperscript{271} In terms of s 1317FA.
\textsuperscript{272} In terms of s 588J(1).
\end{flushright}


\textsuperscript{274} Morrison Australian Insolvent Trading Prohibition 156.
Chapter 3  Alternative Remedies

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

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

(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.
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).
Chapter 3  Alternative Remedies

(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. Section 214(2)(a) furthermore seems to indicate that the wrongful trading action is only triggered by formal winding-up.

Second, it must be noted that any proceedings against directors in terms of section 214 may only be instituted by the liquidator. Liquidators by and large will be reluctant to make use of the opportunity presented by section 214 – probably for fear of having to bear the costs of an unsuccessful action. 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. 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.

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).

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.

Chapter 3

Alternative Remedies

With regard to section 214 having been described as a “sharp” and “powerful” weapon against wayward directors, 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.

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

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, 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

\[302\] 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).
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.  

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.

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.\(^\text{309}\) 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”.\(^\text{310}\) 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.\(^\text{311}\)

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”.\(^\text{312}\)

### 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.\(^\text{313}\)

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\(^\text{309}\) S 238(a).

\(^\text{310}\) Own emphasis.

\(^\text{311}\) 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.

\(^\text{312}\) Ziegel *supra* 531.

\(^\text{313}\) 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.\(^{322}\)

### 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.\(^{323}\)

### 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*,\(^ {324}\) 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;\(^ {325}\) that there should be intention to defraud;\(^ {326}\) and that the fraud should have its effect.\(^ {327}\)

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,

\(^{322}\) S 29(1) of the South African Insolvency Act.

\(^{323}\) S 30(1) of the South African Insolvency Act.

\(^{324}\) 1938 SR 107.

\(^{325}\) This requirement indicates that a disposition, taking the form of payment of an existing debt, will not be covered by the *actio Pauliana*. The *actio Pauliana* does not, as a general rule, serve to protect creditors against preferences.

\(^{326}\) “Fraud” in this context does not carry its normal criminal law meaning, but is simply established with reference to whether a disposition was made by the debtor with the knowledge that he was insolvent. See *Scharff’s Trustee v Scharff* 1915 TPD 463 476; *Hockey v Rixom supra* 122.

\(^{327}\) *Id* 118.
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{footnotes}
\footnote{\textsuperscript{328} Fenhalls v Ebrahim \textit{supra} 723; \textit{Commissioner of Customs and Excise v Bank of Lisbon International Ltd} 1994 1 SA 205 (N) 210. See Boraine \textit{Die Leerstuk van Vernietigbare Regshandelinge in die Insolvensiereg} LLD UP (1995) 203 – 207 for more detail.}

\footnote{\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 \textit{supra}}. Boraine \textit{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 Thomas \& Boraine “Ownership of Money and the \textit{actio Pauliana}” 1994 \textit{THRHR} 678; 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.}

\footnote{\textsuperscript{330} Fisher “Preferences and Other Antecedent Transactions: Do Directors Owe a Duty to Creditors?” (1995) \textit{8 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{footnotes}
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.\textsuperscript{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.\textsuperscript{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 \textit{actio Pauliana}, namely that the person who receives from the debtor does not receive his own property, prevents the \textit{actio Pauliana} from being applied in a preference scenario.\textsuperscript{333} The \textit{actio Pauliana}

\begin{itemize}
  \item \textsuperscript{331} Fisher \textit{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.
  \item \textsuperscript{332} Keay “The Duty of Directors to Take Account of Creditors’ Interests: Has It Any Role to Play” 2002 \textit{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.
  \item \textsuperscript{333} Boraine \textit{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.
\end{itemize}
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.\(^{334}\) In such instances the extension of directors’ duties to include creditors’ interests may play an invaluable role in providing creditors with much needed protection.\(^{335}\)

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.\(^{336}\) A disposition *ex titulo lucrativo* may be set aside to the extent that the person who received the debtor’s property, was benefited thereby.\(^{337}\)

\(^{334}\) 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).

\(^{335}\) 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 51 – 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.

\(^{336}\) Boraine *supra* 222 and authority there referred to.

\(^{337}\) *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 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.

Chapter 3

Alternative Remedies

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”. In Botha v Van Niekerk 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 *unconscionable injustice* occurred.

The Appellate Division of the Supreme Court deviated from the previous approach in terms of which the separate identity of a company would only be disregarded under specific circumstances in *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* 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.

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.

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347 *Id* 201 (own emphasis).

348 1983 3 SA 513 (W).

349 *Id* 524 – 525.

350 Now known as the Supreme Court of Appeal.

351 Referred to as the “categorizing approach” by Domanski “Piercing the Corporate Veil – A New Direction?” 1986 *SALJ* 224.

352 1995 4 SA 790 (A).

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

354 This is a point raised by numerous commentators. See eg Carrol “Corporate Parents and Tort Liability” in Gillooly (ed) *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 *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 *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 *Corporate Veil*) (2001) 35 *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
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 \textit{Corporate Veil} 67.

\textsuperscript{356} Ibid.

\textsuperscript{357} Farrar \textit{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’ \textit{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 \textit{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 \textit{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 \textit{SA Merc LJ} 277 298.

\textsuperscript{358} Farrar \textit{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 \textit{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 \textit{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.\textsuperscript{359}

\textbf{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.\textsuperscript{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.\textsuperscript{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


[m]aking 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.

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

\textsuperscript{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.\textsuperscript{362}

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.\textsuperscript{363}

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.\textsuperscript{364}
\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.\textsuperscript{365}

\begin{footnotes}
\item[362] See supra par 3.3.4 for a detailed discussion.
\item[363] See supra par 3.4 for more detail.
\item[364] Keay supra 405 (own emphasis).
\item[365] See discussion infra Ch 4 – Ch 9.
\end{footnotes}
PART III

FRAMEWORK FOR A DUTY TO CREDITORS

Chapter 4: Judicial Framework .................................................................97

Chapter 5: Protection Afforded in terms of Fiduciary Duties.........................132

Chapter 6: Protection Afforded in terms of the Duty of Care and Skill .............189

Chapter 7: Point in Time When the Duty Arises ........................................248

Chapter 8: Beneficiary of the Duty ............................................................291

Chapter 9: Relief from Liability ...............................................................332
CHAPTER 4
JUDICIAL FRAMEWORK

SUMMARY

4.1 INTRODUCTION
4.2 TYPE OF DUTY
4.3 POINT IN TIME WHEN THE DUTY ARISES
4.4 BENEFICIARY OF THE DUTY
4.5 PROTECTED CREDITORS
4.6 POWER OF THE GENERAL MEETING TO RATIFY A BREACH OF THE DUTY
4.7 CONCLUSION

4.1 INTRODUCTION

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

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

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

97
duties to creditors were made, or in which decisions were based on the recognition of directors’ duties to creditors, in an attempt to form a clearer picture of the framework envisaged by the courts for such a duty.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

\(^{371}\) See infra Ch 7 (Point in Time When the Duty Arises) for more on this point.
directors’ duties, where the main aim of these duties is in fact to protect creditors’ interests; and the different classes of creditors that may be protected by such duty.\textsuperscript{372}

In this chapter the introductory discussion of these key issues is followed by an overview of the cases dealing with directors’ duties to creditors in various jurisdictions\textsuperscript{373} for the purpose of establishing how the courts dealt with key issues regarding directors’ duties to creditors. It is also important to compare the totality of the legal principles\textsuperscript{374} in respect of these jurisdictions to ensure that the basis of comparison is valid.\textsuperscript{375}

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

\textbf{4.2 \hspace{1em} TYPE OF DUTY}

\textbf{4.2.1 \hspace{1em} Introduction}

The cases that provided for an obligation on the part of directors to consider or protect the interests of creditors did so through reliance on existing company law principles pertaining to directors’ duties. Traditionally two types of duties are imposed on directors of companies, namely fiduciary duties\textsuperscript{376} and the duty to act with the necessary care.\textsuperscript{377} It

\textsuperscript{372} See \textit{infra} Ch 8 (Beneficiary of the Duty) for further discussion in this regard.

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

\textsuperscript{374} Specifically those pertaining to insolvency and share capital.

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

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

\textsuperscript{377} This duty may be referred to as the duty of care and skill; duty of care, skill and diligence, etc. For the sake of convenience it is referred to as “duty of care” in this section. A more detailed discussion of the various elements of this duty, especially with reference to the protection of the interests of corporate creditors, will follow later. See \textit{infra} Ch 6 (Protection Afforded by the Duty of Care and Skill).
is necessary to determine which one of these categories of duties, if not both, was used by the courts to hold directors liable, or relied upon by complainants in an attempt to hold directors liable for their failure to protect the interests of creditors.

### 4.2.2 Australia

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

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

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378 *Ring v Sutton* supra.

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

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

381 *Jeffree v NCSC* supra.

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

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

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

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

The majority of cases in New Zealand dealing with directors’ duties to creditors were thus instituted on the basis of a breach of fiduciary duties, or, at least, the codified version thereof.\(^ {388}\)

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

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

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

\(^{386}\) *David Neil and Co Ltd (in rec) v Neil* *supra*.

\(^{387}\) *Hilton International Ltd v Hilton* *supra*.

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

\(^{389}\) *Supra*. 

102
honestly, they were found to be negligent.\textsuperscript{390} This seems to indicate that the directors were held liable, not because they breached their fiduciary duties, but rather because they breached their duty of care.\textsuperscript{391}

4.2.4 England

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

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

In \textit{Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd},\textsuperscript{395} on the other hand, the action against the directors was founded on tort

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

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

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

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

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

\textsuperscript{395} \textit{Supra}. 
based on negligent decisions made by the plaintiff company’s directors. The action was thus clearly based on a breach of the duty of care. The court was very explicit, however, in denying the existence of a duty of care to creditors of the company and the action consequently failed.\footnote{Even though this particular action was based on an alleged breach of duty of care, Dillon LJ continued to state that directors owe neither a duty of care, nor fiduciary duties to creditors of a company (\textit{id} 585). This decision was distinguished from a later decision by the same judge in which he acknowledged a duty to creditors, namely \textit{Liquidator of West Mercia Safetywear Ltd v Dodd, supra}, on the basis that the company in \textit{Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd} was solvent at the time and the parties were acting in good faith – these being the reasons why it was held that directors were not under any obligation to creditors.}

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

\textbf{4.2.5 Canada}

The action against the directors in \textit{Peoples Department Stores Inc v Wise}\footnote{\textit{Supra}.} was based on section 122 of the Canadian Business Corporations Act.\footnote{\textit{Canadian Business Corporations Act}, RSC 1985, c C-44 (hereinafter \textit{CBCA}).} This provision places a duty on directors to “act honestly and in good faith with a view to the best interests of the corporation”\footnote{\textit{Id} s 122(1)(a).} and to “exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances”.\footnote{\textit{Id} s 122(1)(b).} Even though this statutory provision encompasses both the duty of care and fiduciary duties, the court found the directors liable in the end because “they failed to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances”,\footnote{\textit{Peoples Department Stores Inc (trustee of) v Wise supra} par 80.} or, in other words, because they did not comply with their duty of care.
In both *Canbook Distribution Corporation v Borins*\(^{402}\) and *Lakehead Newsprint (1990) Ltd v 893499 Ontario Ltd*\(^{403}\) actions against directors were based on breach of fiduciary duties for failing to consider creditors’ interests. While the action in *Lakehead Newsprint (1990) Ltd v 893499 Ontario Ltd* failed on the facts,\(^{404}\) the court in *Canbook Distribution Corporation v Borins* acknowledged that “Canadian law appears to be moving in the direction of recognizing such fiduciary duty”\(^{405}\).

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

### 4.2.6 United States of America

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

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\(^{402}\) (1999) 45 OR (3d) 565 (Ont SCJ).

\(^{403}\) [2001] OJ No 1 (Ont SCJ).

\(^{404}\) There was no pleading that the company was insolvent at the time of the impugned transaction, or that the impugned transaction rendered the company insolvent.

\(^{405}\) *Supra* par 16.

\(^{406}\) 2004 SCC 68.

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

\(^{408}\) *Id* par 57.

\(^{409}\) *Supra*. 
benefit, at the expense of the company who remained indebted to him. In all the cases discussed in this section, actions against directors were based on breach of typical fiduciary duties.\footnote{410} The extension of a fiduciary type of duty therefore seems to be supported in the United States of America as well.\footnote{411}

4.3 POINT IN TIME WHEN THE DUTY ARISES

4.3.1 Introduction

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

4.3.2 Australia

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

In terms of one viewpoint “the directors’ duty to a company as a whole extends \textit{in an insolvency context} to not prejudicing the interests of creditors”.\footnote{412}

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

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

\footnote{412} As formulated by Street CJ in \textit{Kinsela v Russell Kinsela Pty Ltd (in liq) supra} 732 – 733 (own emphasis).
In other decisions, however, impugned transactions were performed while the companies were still solvent. A second viewpoint thus seems to be that directors may incur liability for entering into transactions that are detrimental to creditors’ interests, even though the company was not actually insolvent at the time when these transactions were concluded.

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

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

414 Supra.

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

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

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

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

It is important, however, to take note of the warning issued by the court in *In re Lake Tekapo Motor Inn Ltd (in liq)*,422 namely that the mere fact that a company is insolvent when a particular transaction is entered into, does not automatically lead to liability on
the part of directors. Complaints by creditors in this regard will have to be supported by the facts and creditors will have to be able to show an intent to defraud, or reckless disregard of their position, before they will succeed with claims against directors.423

4.3.4 England

The courts in England seem to agree that a company must be experiencing some form of financial difficulty before a duty to creditors will be recognised. In In re Horsley & Weight Ltd424 the court expressly stated that, had the company been “doubtfully solvent” at the time of the grant complained of, the grant made by the directors would have been considered as “fraud on the creditors”.425 A similar viewpoint is reiterated in Winkworth v Edward Baron Development Co,426 where it was expressly stated that the breaches of duty would not have mattered, had the directors been able to maintain the solvency of the company. In Liquidator of West Mercia Safetywear v Dodd427 Dillon LJ, who expressed the view in Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd428 that directors do not owe duties to creditors, found that directors are in breach of their duties because they failed to consider the interests of the creditors. This distinction is made on the basis that the company in Liquidator of West Mercia Safetywear v Dodd429 was insolvent at the time directors performed the act complained of.

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

424 Supra.

425 Id 1056.

426 Supra 118.

427 Supra.

428 Supra.

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

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

### 4.3.5 Canada

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

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430 *Supra* 632.


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

4.3.6 United States of America

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

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

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

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

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

437 Harff v Kerkorian supra 222.

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

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

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

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

Uncertainty is created, however, by the court’s ambiguous statement in the unreported decision of Credit Lyonnais Bank Netherland, NV v Pathe Communications Corporation,\textsuperscript{446} namely that

\begin{quote}
[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to \textit{the corporate enterprise}.\textsuperscript{447}
\end{quote}

\textsuperscript{441} Supra 784.

\textsuperscript{442} Id 787.

\textsuperscript{443} Id 789.

\textsuperscript{444} Id 787.

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

\textsuperscript{446} Supra.

\textsuperscript{447} Id 1155 (own emphasis).
At first glance it is clear that the above statement contains two noteworthy phrases. In the first place, even though commentators discuss this case with reference to directors’ duties to creditors, no mention is in fact made of creditors’ interests in the body of the text. The focus is rather on the interests of the corporation itself, with the court placing directors under an obligation “to consider the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation’s long-term wealth creating capacity”.

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

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

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

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

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

451 Ibid.

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

453 Supra.
creditors’ interests, but have somebody or something else’s interests to consider, namely
the corporation’s community of interests.\textsuperscript{454}

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

4.4 \hspace{1cm} BENEFICIARY OF THE DUTY

4.4.1 Introduction

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

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

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

\textsuperscript{455} \textit{Supra}.

\textsuperscript{456} Nicholson \textit{supra} 592.

\textsuperscript{457} \textit{Percival v Wright} [1902] 2 Ch 421 424 – 425; \textit{In re Smith & Fawcett Ltd} [1942] Ch 304 306.
usually equated with the interests of the shareholders, are extended to creditors as one of the constituencies in the company. In terms of this method, the company thus remains the beneficiary of directors’ duties. The “interest” of the company is redefined, however, with reference to the interest of its creditors, rather than those of its members. Directors can therefore incur liability based on the fact they did not act *bona fide* in the best interests of a company, because they neglected to consider or protect creditors’ interests.

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

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

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

459 Hereinafter “indirect duty model”.

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

461 Hereinafter “direct duty method”.

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

4.4.2 Australia

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

4.4.3 New Zealand

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

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

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

465 In Re New World Alliance Pty Ltd (rec and mgr apptd); Sycotex Pty Ltd v Baseler supra 550 the court rejected the concept of creditors being direct beneficiaries of directors’ duties and limited the application of such a duty to a mere restriction on the right of shareholders to ratify breaches of the duty owed to the company. See also Spies v The Queen (2000) 173 ALR 529 555, where the court was very clear on the point that remarks suggesting that “directors owe an independent duty to, and enforceable by, the creditors by reason of their position as directors...are contrary to principle...and do not correctly state the law.” Some commentators, eg McConvill “Directors’ Duties to Creditors in Australia after Spies v The Queen” (2002) 20 Company & Securities Law Journal 45 – 6 are of the opinion, however, that the huge amount of interest created by this statement is misplaced, as it was only made obiter and was actually an attack of the majority of the court on the prosecution’s clear misuse of a criminal statutory provision. Cf Hargovan “Directors’ Duties in Australia after Spies v The Queen – Is the Development of an Independent Fiduciary Duty Dead or Alive?” (2003) 21 Company & Securities Law Journal 390 for a detailed analysis of the importance of this decision, namely that it provides a clear answer that “directors’ fiduciary duties are not owed directly to, and enforceable by, creditors at common law” (id 409), as well as the commentary thereon by various authors.
Chapter 4        Judicial Framework

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

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

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\(^{466}\) *Supra*.

\(^{467}\) *Id* 249 (own emphasis).

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

\(^{469}\) *Supra*.

\(^{470}\) *Id* 475 (own emphasis).
The fact that all the New Zealand cases discussed in this section were instituted by the liquidator on behalf of the company, along with the fact that there is no authoritative support for the general application of the direct duty method, justifies the conclusion that the indirect duty model is favoured in New Zealand.
4.4.4 England

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

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

The above statement seems to indicate some support for the direct duty method. In light of criticism levelled against this statement\textsuperscript{474} and the fact that it is contrary to all other cases in England on the same point, one feels compelled to agree with Farrar that these

\footnotesize
\begin{enumerate}
  \item In one of the first cases in England in which a duty to creditors was mooted, namely \textit{Lonrho Ltd v Shell Petroleum Co Ltd supra} 634 Lord Diplock, referring to the interests of the company, stated that the best interests of the company “are not necessarily those of the shareholders but may include those of the creditors”. This viewpoint was endorsed by an \textit{obiter} remark by Buckley LJ, delivering the primary judgment in \textit{Re Horsley & Weight Ltd supra} 1055, namely that it may be “somewhat loosely said that the directors owe an indirect duty to the creditors…but I would regard it as more accurate to say that the directors owe a duty \textit{to the company}” (own emphasis). In \textit{Yukong Line Ltd v Rendsburg Investments [1988] 2 BCLC 485} 503 Toulson J is also clear on the point that a director “does not owe a direct fiduciary duty towards an individual creditor, nor is an individual creditor entitled to sue for breach of the fiduciary duty owed by the director to the company”. Also see \textit{Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd supra}, where the court stated that directors must act in the best interests of the company, which includes considering the interests of the company’s creditors, should there be a possibility of imminent insolvency.
  \item \textit{Supra}.
  \item \textit{Id} 118 (own emphasis).
  \item See eg Sealy \textit{Directors’ Duties} 176 who is of the opinion that “if sentiments like this had prevailed over the past century and a half, the limited liability company would never have got off the ground”; and Farrar “The Responsibility of Directors and Shareholders for a Company’s Debts” (1989) 4 \textit{Canterbury Law Review} 12 14, who submitted that these remarks are “too widely stated”.
\end{enumerate}
obiter remarks should not be regarded as anything else, but a somewhat warbled version of the capital maintenance principles formulated in *Flitcroft’s Case*.\(^{475}\)

### 4.4.5 Canada

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

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

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

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

\(^{477}\) *Supra*.

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

\(^{479}\) *Supra* par 200.

\(^{480}\) Apart from an *obiter* statement in *Winkworth v Edward Baron Development Co Ltd supra* that seems to leave room for the application of the direct duty method, all the cases referred to by the court are in support of the indirect duty model.
Two subsequent decisions, \textit{Canbook Distribution Corporation v Borins}\footnote{Supra.} and \textit{Lakehead Newsprint (1990) Ltd v 893499 Ontario Ltd,}\footnote{Supra.} seem to indicate, however, that the courts favour the direct duty method. In \textit{Canbook Distribution Corporation v Borins}\footnote{Supra.} reference was made to the fact that a party may institute action against directors, “as a creditor...to whom the directors...owed a fiduciary duty”\footnote{Id par 18.} and in \textit{Lakehead Newsprint (1990) Ltd v 893499 Ontario Ltd}\footnote{Supra.} it was stated that the central theme in the cases on directors’ duties to creditors is that “directors may owe fiduciary duties to creditors”\footnote{Id par 33.}.

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

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

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

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

4.5 PROTECTED CREDITORS

4.5.1 Introduction

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

491 See eg Geyer v Ingersoll Publications Co supra.

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

493 The issue as to which creditors should be protected was only referred to by the courts in the context of present and future creditors of the company and are therefore only dealt with in that context in this specific chapter. Problems regarding a possible conflict of interests between different classes of creditors when discussing directors’ duties to creditors, eg secured and unsecured creditors, or the different rights of
Chapter 4        Judicial Framework

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

4.5.2 Australia

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

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

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

\(^{494}\) *Supra.*

\(^{495}\) *Id* 228.

\(^{496}\) *Supra.*

\(^{497}\) *Id* 132.

\(^{498}\) *Supra.*
4.5.3 New Zealand

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

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

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

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

[^499^]: Supra.

[^500^]: Supra.

[^501^]: Supra.

[^502^]: In re Avon Chambers supra 640.

[^503^]: Supra.
a company – the former not to be regarded as beneficiaries of a managerial duty, while the latter should be entitled to have their interests protected by directors.\footnote{Id 250. Cooke J summarised the position of future creditors as follows:}

### 4.5.4 England

An obiter remark in *Winkworth v Edward Baron Development Co Ltd*,\footnote{Supra.} namely that “a company owes a duty to its creditors, present and future”\footnote{Id 118 (own emphasis).} provides the only indication that English courts are willing to extend directors’ duties to consider creditors’ interests to future creditors as well. Whether this statement will carry much weight in providing authority for the viewpoint that directors’ duties to consider the interests of creditors include future creditors, is doubtful, because it was made obiter.

In *Brady v Brady*\footnote{Supra.} the judiciary furthermore seems to limit the duty of directors specifically to existing creditors, casting even more doubt on the probability of directors’ duties being extended to future creditors.\footnote{Id 632. The court noted that “it cannot therefore be necessarily fatal to the agreement that the individual parties to it may not...have had in mind specifically the interests of future creditors” and “there was no reason to suppose that the position of any present creditor was in the least affected” (own emphasis).}

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

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

505 *Supra.*

506 *Id* 118 (own emphasis).

507 *Supra.*

508 *Id* 632. The court noted that “it cannot therefore be necessarily fatal to the agreement that the individual parties to it may not...have had in mind specifically the interests of future creditors” and “there was no reason to suppose that the position of any present creditor was in the least affected” (own emphasis).
Chapter 4  Judicial Framework

4.5.5  Canada

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

4.5.6  United States of America

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

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

4.6.1  Introduction

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

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

\(^{510}\) Bamford v Bamford [1970] Ch 212. See infra Ch 8 (Beneficiary of the Duty) par 8.2.3 for more detail.
creditors. This question appears especially vexing when following the indirect duty model in extending directors’ duties to creditors.  

4.6.2 Australia

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

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

4.6.3 New Zealand

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

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

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

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

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

515 Supra.

516 Id 20.

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

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

### 4.6.4 England

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

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

\(^{518}\) *Supra*.  
\(^{519}\) *Id* 475.  
\(^{520}\) *Supra*.  
\(^{521}\) *Id* 1055 – 1056.
4.6.5 Canada

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

4.6.6 United States of America

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

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

4.7 CONCLUSION

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

Actions against directors for failing to consider creditors’ interests are most often based on breach of fiduciary type duties, rather than breach of the duty of care, although the latter was used in some instances.
Directors are placed under an obligation to consider the interests of creditors upon insolvency, or when the company is in the vicinity of insolvency. A duty to creditors is thus clearly linked to the financial situation of the company.

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

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

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

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

The above framework may seem deceptively simple. A closer look will reveal a number of problems inherent to the framework, however, and it leaves numerous practical questions unanswered.
It may be asked, for example, whether the conduct of directors in many of the cases mentioned in this section did not give rise to liability based on ordinary principles of fiduciary duties. The necessity of invoking creditors’ interests as a basis for inferring director liability is thus open to attack. An explanation for the courts opting for this route seems to be the fact that the shareholders ratified the alleged breaches of directors’ duties in many instances, in an attempt to prevent any action being taken against the directors. Rephrasing directors’ duties as being owed to creditors rather than shareholders, whether it be directly or indirectly, successfully deprives shareholders of the right to ratify these breaches of directors’ duties and thus opens the door for action being taken against the directors.

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

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

The circumstances that may give rise to a duty to creditors are also shrouded in uncertainty. It seems to be generally accepted that a duty to creditors is dependent on the company in question being in some form of financial difficulty. However, the court phrased this requirement in a number of ways. Directors may also be left in the unenviable position of having owed a duty to consider the interests of creditors at a particular point in time, without them having been aware of this at that particular moment. It is clearly unacceptable to burden directors with a duty that they only become aware of after the fact.
Enforceability of a duty to creditors is another critical issue. Drawing a distinction between a direct duty model and an indirect duty model offers superficial guidance only regarding the way in which a duty is to be enforced.

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

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522 Ch 5 – Ch 9.
CHAPTER 5
PROTECTION AFFORDED BY FIDUCIARY DUTIES

SUMMARY

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

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

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

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\(^{525}\) Farrar *supra* 377.
Chapter 5  Fiduciary Duties

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

Unfortunately legal principles with regard to the way in which directors should exercise their powers are considered as one of the most complex areas of company law.\textsuperscript{528} Despite the growth in the trust and confidence type fiduciary relationship\textsuperscript{529} and it having become a “standard wrong in commercial dealings”,\textsuperscript{530} it remains difficult to define the exact parameters of a fiduciary relationship with certainty.\textsuperscript{531}

\footnotesize{
\begin{itemize}
\item[\textsuperscript{526}] Cooper \textit{v} Luxor (Eastbourne) Ltd [1939] 4 All ER 411 (CA) 418 – 419. Larkin “The Fiduciary Duties of the Company Director (I)” 1979 \textit{SA Company LJ} E-1 agrees that the function of the fiduciary relationship is also to “safeguard [the company’s] creditors in view of the principle of limited liability”.
\item[\textsuperscript{527}] See discussion \textit{supra} Ch 4 (Judicial Framework) par 4.2.
\item[\textsuperscript{528}] Fourie \textit{Vertrouenspligte} 124. He also provides a list of factors that may have contributed towards the complexity of the law in this area (\textit{id} 119 – 120). Havenga “Directors’ Fiduciary Duties under Our Future Company Law Regime” (1997) \textit{SA Merc LJ} 310 311 regards a company directorship as “one of the most complex fiduciary offices”.
\item[\textsuperscript{529}] Glover \textit{Commercial Equity: Fiduciary Relationships} (1995) 8 distinguishes between three categories of fiduciary relationships, namely fiduciary relationships of trust and confidence; fiduciary relationships of influence; and fiduciary relationships of confidential information. The principle of trust as basis of directors’ fiduciary duties seems to be confirmed by the judiciary in Robinson \textit{v} Randfontein Estates Gold Mining Co Ltd 1921 AD 168 179, where it is stated that liability for a breach of fiduciary duties rests “upon the broad doctrine that a man, \textit{who stands in a position of trust} towards another, cannot in matters affected by that position, advance his own interests...at that other’s expense” (own emphasis). Naude \textit{Die Regsposisie van die Maatskappydirekteur met Besondere Verwysing na die Interne Maatskappyverband} (1970) (hereinafter Naude \textit{Regsposisie van die Maatskappydirekteur}) 108 – 109 also indicates that the figure of the company director was brought under the broad concept of \textit{trust} (“vertroue”). He warns, however, that the fiduciary relationship that a director has with the company of which he is a director is simply one of the categories of the broad \textit{genus} of relationships of trust and that it would be wrong to deduce that the position of the company director should be equated with that of a trustee on the basis that he holds a position of trust. The relationship of trust is furthermore based on the holding of the office of director and is not dependent on the director assuming certain responsibilities that are normally associated with a relationship of trust, eg when acting as representative of the company.
\item[\textsuperscript{530}] Glover \textit{supra} 17.
\item[\textsuperscript{531}] Glover \textit{supra} 17. Fourie \textit{Vertrouenspligte} 122 refers to the following statement by Shepherd in the preface to \textit{Law of Fiduciaries} (1981) in this regard:

The law of fiduciaries is the legal system’s attempt to recognize the more blatant abuses of the trust we place in each other. It is undoubtedly the most human area of the legal system, and as such the most undefinable.
\end{itemize}
}
Some form of theoretical structure for this relationship is, however, imperative to ensure that a fiduciary obligation is more than “merely descriptive” and is “sufficiently analytic” to permit the predictable application thereof to a variety of circumstances.\(^{532}\)

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

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

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

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

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\(^{534}\) \textit{Infra} par 5.2.

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

\(^{536}\) \textit{Infra} par 5.4.

\(^{537}\) \textit{Infra} par 5.5.
5.2 SOURCES AND FORMULATION

5.2.1 South Africa

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

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


539 Id par 10.10.

540 Pretorius; Delport; Havenga & Vermaas Hahlö’s South African Company Law through the Cases (1999) 279.

541 Naude Regposisie van die Maatskappydirekteur 111.

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

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

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

545 In terms of s 42(2)(a).
duty to avoid a conflict of interests.\textsuperscript{546} The duty to act in good faith is described as a duty to exercise powers in the interest and for the benefit of the close corporation;\textsuperscript{547} and the duty not to exceed those powers.\textsuperscript{548} The duty to avoid a conflict of interest entails, in particular, the duty not to derive any unwarranted personal benefit;\textsuperscript{549} the duty to notify other members of any interest in any contract of the close corporation;\textsuperscript{550} and the duty not to compete with the close corporation in its business activities.\textsuperscript{551}

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

5.2.2 Australia

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

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

(a) in good faith in the best interests of the corporation; and

(b) for a proper purpose.

Section 182(1) furthermore provides:

\textsuperscript{546} In terms of s 42(2)(b).

\textsuperscript{547} S 42(2)(a)(i).

\textsuperscript{548} S 42(2)(a)(ii).

\textsuperscript{549} S 42(2)(b)(i).

\textsuperscript{550} S 42(2)(b)(ii).

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

\textsuperscript{552} In terms of s 60(1A)(a).

\textsuperscript{553} In terms of s 60(1A)(b).

\textsuperscript{554} \textit{Corporations Act} 2001 (hereinafter Australian \textit{Corporations Act}).

136
Chapter 5  Fiduciary Duties

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

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

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

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

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

5.2.3 New Zealand

Section 131 of the New Zealand Companies Act\textsuperscript{555} also contains a statutory expression of directors’ fiduciary duties. In terms of this provision:

(1) [A] director of a company, when exercising powers or performing duties, must act in good faith and in what the director believes to be the best interests of the company.

(2) A director of a company, that is a wholly-owned subsidiary may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of that company’s holding company even though it may not be in the best interests of the company.

(3) A director of a company that is a subsidiary (but not a wholly-owned subsidiary) may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company and with the prior agreement of the shareholders (other than its holding company), act in a manner which he or she believes is in the best interests of that company’s holding company even though it may not be in the best interests of the company.

(4) A director of a company that is carrying out a joint venture between the shareholders may, when exercising powers or performing duties as a director in connection with the carrying out of the joint venture, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of the company.

\textsuperscript{555} Companies Act 1993 (hereinafter New Zealand Companies Act).
best interests of a shareholder or shareholders, even though it may not be in the best interests of the company.

5.2.4 England

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

Section B10 of the Company Law Reform Bill557 provides an indication, however, that a statutory formulation of directors’ duties is going to replace the existing common law principles.558 The general principles applicable to directors are set out in various provisions.

Section B2 reads as follows:

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


558 S B10(1) provides:

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

(a) act in accordance with the company’s constitution, and

(b) only exercise powers for the purposes for which they are conferred.\textsuperscript{559}

Section B3 reads as follows:

(1) As a director of a company you must act in the way you consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.

(2) Where or to the extent that the company is established for purposes other than the benefit of its members, your duty is to act in the way you consider, in good faith, would be most likely to achieve those purposes.

(3) In fulfilling the duty imposed by this section you must take account (where relevant and so far as reasonably practicable) of—

   (a) the likely consequences of any decision in both the long and the short term,

   (b) any need of the company—

       (i) to have regard to the interests of its employees,

       (ii) to foster its business relationships with suppliers, customers and others,

       (iii) to consider the impact of its operations on the community and the environment, and

       (iv) to maintain a reputation for high standards of business conduct, and

   (c) the need to act fairly as between members of the company who have different interests.

(4) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

Section B4 provides:

\textsuperscript{559} This provision can be equated with directors’ duty not to exceed their powers and to exercise powers for a proper purpose.
Chapter 5  Fiduciary Duties

(1) As a director of a company you must exercise independent judgment.

(2) This duty is not infringed by your acting –

(a) in accordance with an agreement duly entered into by the company that restricts the future exercise of discretion by its directors, or

(b) in a way authorised by the company’s constitution.

Section B6 stipulates:

(1) As a director of a company you must avoid a situation in which you have, or can have, a direct or indirect interest that conflicts, or possibly may conflict with the interests in the company.

(2) This applies in particular to the exploitation of any property, information or opportunity (and it is immaterial whether the company could take advantage of the property, information or opportunity).

(3) This duty is not infringed –

(a) if there is no real possibility of a conflict of interest;

(b) if the conflict of interest arises in relation to a proposed transaction or arrangement with the company (but see section B8 (duty to declare interest in proposed transaction with company));

(c) if the conflict of interest arises in relation to a transaction or arrangement duly entered into by the company;

(d) if authorisation has been given by the company in accordance with subsection (4).

(4) Authorisation by the company may be given –

(a) by the matter being proposed to the members of the company and authorised by them; or

(b) where the company is a private company and nothing in the company’s constitution invalidates such authorisation, by the matter being proposed to and authorised by the directors; or

(c) where the company is a public company and its constitution includes provision enabling the directors to authorise the matter, by the matter being proposed to and authorised by them in accordance with the constitution.

Section B7 reads as follows:
Chapter 5  Fiduciary Duties

(1) As a director of a company you must not accept a benefit from a third party conferred by reason of –
   (a) your being a director, or
   (b) your doing (or not doing) anything as director.

(2) A “third party” means a person other than the company, an associated company or a person acting on behalf of the company or an associated company.

(3) Benefits received by you from a person by whom your services (as a director or otherwise) are provided to the company are not regarded as conferred by a third party.

(4) This duty is not infringed –
   (a) if there is no real possibility of a conflict of interest;
   (b) if the matter has been proposed to the members of the company and authorised by them.

(5) Any reference in this section to a conflict of interest includes a conflict of interest and duty and a conflict of duties.

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

(1) As a director of a company you must declare the nature and extent of any interest, direct or indirect, you have in a proposed transaction or arrangement with the company.

(2) If an earlier declaration of interest proves to be, or becomes, inaccurate or incomplete (for instance, because of subsequent changes in the matters to which it relates) you must make a further declaration.

(3) Any declaration required by this section –
   (a) may be made to the other directors or to the members of the company, and
   (b) must be made before the company enters into the transaction or arrangement.

(4) You will be regarded as failing to comply with the duty imposed by this section if you fail to make a declaration, or fail to declare fully the nature and extent of your interest, because you are unaware of matters of which you ought reasonably to be aware.

(5) …
Chapter 5  
Fiduciary Duties

5.2.5 Canada

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

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

5.2.6 United States of America

Directors’ duties are partially codified in a large number of states in terms of provisions along the lines of section 8.30(a) of the 1984 Model Business Corporations Act.\(^\text{561}\) In terms of this provision:

A director shall discharge his duties as a director…

(1) in good faith;

(2) with the care an ordinary person in a like position would exercise under similar circumstances;

(3) in a manner he reasonably believes to be in the best interests of the corporation.

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

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

\(^{560}\) RSC 1985, c C-44 (hereinafter CBCA).

\(^{561}\) Hereinafter 1984 MBCA.


\(^{563}\) Clark Corporate Law (1986) 34.
prohibits self-dealing-type conduct, for example misappropriation of corporate opportunities and using corporate assets or information for personal gain.564

5.3 RELEVANT ELEMENTS

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

5.3.1.1 General

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

In Greenhalgh v Arderne Cinemas Ltd565 the court expressed the opinion that the phrase “‘bona fide for the benefit of the company as a whole’ means not two things but one thing”.566

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

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

564 Miller supra 1476; Millner supra 204.

565 [1951] 1 Ch 286.

566 Id 291.

567 S 42(2)(a) of the Close Corporations Act provides that members are required to act honestly in good faith. In a further subsection this duty is described to entail, amongst other things, a duty to exercise their powers in the interest and for the benefit of the close corporation (s 42(2)(a)(i)).
The two aspects will be discussed separately, however, to distinguish clearly between the problems of interpretation that exist in respect of each of them.

### 5.3.1.2 Requirement of Good Faith

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

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

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

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

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

569 Naude Regposisie van die Maatskappydirekteur 111 holds this viewpoint.


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

### 5.3.1.3 Defining the Interests of the Company

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

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

The fact that directors have to act in the best interests of the company does not, however, mean that they have to promote the welfare of the artificial entity, as it would be impossible to give a definite content of a duty framed in terms of benefiting the entity itself. Such a formulation will furthermore be unhelpful as it fails to identify the relevant constituencies and does no give any indication of the priority enjoined by them inter se.

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

573 Heath supra 379.

574 Supra par 5.2.

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


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

578 Parkinson supra 79.
It is suggested that a duty formulated for the benefit of the enterprise only becomes possible if the purpose of the enterprise is taken into consideration. This purpose can only be properly understood with reference to the enterprise serving human interests or objectives.\textsuperscript{579} Parkinson concludes that the “correct position is thus that the corporate entity is a vehicle for benefiting the interests of a specified group or groups”.\textsuperscript{580} 

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

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

\begin{footnotesize}
\textsuperscript{579} \textit{Id} 77.

\textsuperscript{580} \textit{Ibid.}

\textsuperscript{581} This viewpoint came across very clearly in Greenhalgh \textit{v} Arderne Cinemas Ltd \textit{supra} 291, where the court stated that

\begin{quote}
“the company as a whole”, does not…mean the company as a commercial entity, distinct from the corporators. It means \textit{the corporators as a general body} (own emphasis);
\end{quote}

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

\begin{quote}
so long as the company is solvent \textit{the shareholders are in substance the company} (own emphasis).
\end{quote}

\textsuperscript{582} The question is asked whether “members” refer to present members only, or whether the long-term interests of future members should also be considered. Commentators hold different viewpoints in this regard. Some, eg Farrar \textit{supra} 381, are of the opinion that the short-term interests of present members should be balanced against the long-term interests of future members, unless it is only the interests of the current shareholders that are relevant. Others, eg Parkinson \textit{supra} 80, regard it as “difficult…to see why the directors should have to take account of the interests of the as yet unidentifiable persons who might acquire shares in the company at some future date”.
\end{footnotesize}
Chapter 5  Fiduciary Duties

legislature in some jurisdictions seems inclined to stick to the traditional approach,\(^{583}\) this approach appears to be under attack by the judiciary\(^{584}\) and is also questioned by commentators.\(^{585}\)

A second problem relating to directors’ duty to act in the best interests of the company is whether compliance with this duty should be assessed in a subjective or an objective way. An objective approach regarding this duty suggests that directors must act in a way that they \textit{reasonably} believe to be in the best interests of the company.\(^{586}\)

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

\(^{584}\) See eg \textit{Fulham Football Club Ltd v Cabra Estates} [1992] BCC 863 876, where the court provides a clear indication of a general departure from the orthodox viewpoint through its statement that, even if the directors had acted improperly by fettering their discretion, it would have made no difference that the agreement into which the company had entered enjoyed the unanimous assent of the shareholders. The court based this argument on its view that the company is more than just the sum total of its members. Creditors, both present and potential, are interested, while section 309 of the Companies Act 1985 imposes a specific duty on directors to have regard to the company’s employees in general.

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

\(^{585}\) See eg Gower \textit{supra} 372 who states that even in these terms it might be thought to follow that, as the company nears insolvency, the interests of the members should be replaced by the interests of the creditors.

\(^{586}\) This is the viewpoint held by Farrar \textit{supra} 382 who states:

\begin{quote}
The proper approach is to consider whether an intelligent and honest man in the position of the director of the company concerned could, in the whole of the existing circumstances, have \textit{reasonably} believed that the transaction was for the benefit of the company (own emphasis).
\end{quote}
A subjective approach, on the other hand, merely requires directors to act in a way that they believe to be in the best interests of the company.\footnote{Gower *supra* 388 – 389 emphasises the subjectivity of this part of fiduciary duties which leads to the courts largely being excluded from second-guessing the decisions of directors as to where the best interests of the company lie. He states that it may be regarded as appropriate on the grounds that courts have little expertise in these matters, but notes on the downside that such a subjective approach would lead to this duty offering little protection for the interests that it is supposed to protect.} In light of the court’s pronouncement in *Re Smith & Fawcett Ltd*,\footnote{*Supra*.} namely that directors must act “bona fide in what they consider – not what a court may consider – is in the interests of the company”,\footnote{*Id* 306 (own emphasis).} one may conclude that the court favours a subjective approach. The court’s preference for a subjective approach is understandable in light of the fact that “judges are not obviously well qualified to make substantive evaluations of business policy”.\footnote{Parkinson *supra* 94.}

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

A more preferable approach is that adopted in *Lyford v Commonwealth Bank of Australia*,\footnote{*(1995) 130 ALR 267.*} a case specifically dealing with the extension of directors’ duties to include creditors’ interests. The court summarised its approach as follows:

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

\footnote{\footnotemark[587] \footnotemark[588] \footnotemark[589] \footnotemark[590] \footnotemark[591] \footnotemark[592]}
state of mind of the directors so as to show whether they were honestly acting in
discharge of their powers in the interests of the company.\footnote{593}{Id 284.}

The court thus seems to recognise the subjective approach through its reference to the
state of mind of the directors and their motives and intentions. This must, however,
be objectively determined in light of “all the materials that genuinely throw light upon
the question of the state of mind of the directors”.\footnote{594}{Ibid.} The mere fact that directors
subjectively believed something to be in the best interests of the company does not
automatically infer compliance with their fiduciary duties – surrounding
circumstances must have warranted this subjective belief.\footnote{595}{The suggestion of Parkinson supra 96 that an aid to discovering intention, namely that “what no reasonable board could have believed to be beneficial to the company, the actual board could not have believed either”, or put differently, that “where the means adopted could not on any reasonable view lead to the end of benefiting the company, the directors could not have been motivated by a desire to achieve that end”, is in line with the approach followed by the court.} In this case the court thus
seems to favour a hybrid subjective-objective approach.

A decision by directors may therefore be open to attack if no reasonable man will
regard it to be \textit{bona fide} in the best interests of the company.\footnote{596}{Farrar supra 381, with reference to \textit{In re Smith & Fawcett Ltd} [1942] Ch 304; and \textit{Heron International Ltd v Lord Grade} [1983] BCLC 244.} It must be conceded,
however, that the courts rarely interfere\footnote{597}{Worthington “Directors’ Duties, Creditors’ Rights and Shareholder Intervention” (1991) 18 \textit{Melbourne University Law Review} 121 132 suggests that the duty to act in good faith in the best interests of the company still only requires loyalty from directors and does not impose an objective standard of behaviour.} and one is inclined to agree that the “overall emphasis on a subjective test can be criticised as entrenching management to an
unacceptable degree”.\footnote{598}{Farrar supra 381.}

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

\begin{footnotesize}
\begin{enumerate}
\item[593] Id 284.
\item[594] Ibid.
\item[595] The suggestion of Parkinson supra 96 that an aid to discovering intention, namely that “what no reasonable board could have believed to be beneficial to the company, the actual board could not have believed either”, or put differently, that “where the means adopted could not on any reasonable view lead to the end of benefiting the company, the directors could not have been motivated by a desire to achieve that end”, is in line with the approach followed by the court.
\item[596] Farrar supra 381, with reference to \textit{In re Smith & Fawcett Ltd} [1942] Ch 304; and \textit{Heron International Ltd v Lord Grade} [1983] BCLC 244.
\item[597] Worthington “Directors’ Duties, Creditors’ Rights and Shareholder Intervention” (1991) 18 \textit{Melbourne University Law Review} 121 132 suggests that the duty to act in good faith in the best interests of the company still only requires loyalty from directors and does not impose an objective standard of behaviour.
\item[598] Farrar supra 381.
\end{enumerate}
\end{footnotesize}
company”⁵⁹⁹ indicating a clear preference for a subjective yardstick. Section B3(1) of the English *Company Law Reform Bill* also appears to entrench the subjective test, in that it states that as a director you are required to “act in the way *you* consider, in good faith, would be most likely to promote the success of the company”⁶⁰⁰.

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

⁶⁰⁰ Own emphasis.
5.3.2 Maintaining an Unfettered Discretion

5.3.2.1 General

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

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

5.3.2.2 Nominee Directors

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

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

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

\(^{603}\) 1965 4 SA 651 (W).

\(^{604}\) *Id* 651. Even though this decision refers expressly to the possibility that a shareholder could appoint nominees, Redmond “Problems for Insiders” in Gillooly (ed) *The Law Relating to Corporate Groups* (1993) 209 213 indicates that it is equally possible for creditors, debenture holders, a participant in a corporate joint venture, or even a group of employees, to contractually obtain the right to appoint a representative to the board of directors. According to Redmond *supra* 214 directors appointed to the boards of subsidiary companies could, however, be regarded as the principal class of nominee director. Also see Boros “The Duties of Nominee and Multiple Directors (I)” (1989) 10 *The Company Lawyer* 211 for a discussion of the difference between nominees other than those of controlling shareholders (*id* 216) and nominees of controlling shareholders (*id* 217); as well as Du Plessis “Nominee Directors Versus Puppet, Dummy and Stooge Directors: Reflections on these Directors and Their Nominators or Appointors” 1995 *TSAR* 310 316 (hereinafter Du Plessis *Nominee Directors*).
These shareholders will clearly expect the director so appointed to serve as their spokesman on the board and to protect their interests in the company.\textsuperscript{605}

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

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

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

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

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

\textsuperscript{607} 1980 4 \textit{SA} 156 (W).

\textsuperscript{608} As is suggested by Du Plessis \textit{Nominee Directors} 312.

\textsuperscript{609} \textit{Fisheries Development Corporation of SA Ltd v Jorgensen supra} 163 (own emphasis).
The traditional approach to the duty, in terms of which a director is under an obligation to act in the best interests of the subsidiary exclusively when exercising his management powers in that company, seems to be followed in South Africa, England, Canada and the United States of America.

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

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

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

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

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

Enriquez “Honor Thy Shareholder at All Costs? Towards a Better Understanding of the Fiduciary Duties of Directors of Wholly-owned Subsidiaries” (2003) 32 *Southwestern University Law Review* 97 98 refers to *First American Corporation v Al-Nahyan* 17 F Supp 2d 10 (DDC 1998) to indicate that subsidiary companies in the USA are generally regarded as entities that are separate from their holding companies. In this case directors of a wholly-owned subsidiary concluded a transaction that was to the detriment of the subsidiary, but favourable to the holding company. They were accused of having breached their fiduciary duties. In their defence they raised the argument that the only fiduciary duty
This particular issue received considerable attention from numerous commentators and the question is often asked whether this principle is as easy to apply in practice as it is to formulate in theory, as it represents a “stark divergence between regulatory philosophy and commercial reality”.

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

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


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

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

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

Chapter 5  Fiduciary Duties

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

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

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

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617 S 187 of the Australian *Corporations Act*.
618 S 187(a).
619 S 187(b).
620 S 187(c).
621 Ss 131(2) and (3) of the New Zealand *Companies Act*.
622 S 131(2).
623 S 131(3).
5.3.3 Avoiding a Conflict of Interests

5.3.3.1 General

The duty of directors to avoid a conflict of interests entails that directors should not exploit assets or opportunities\(^{624}\) of the company for their own benefit.\(^{625}\) This principle has a twofold practical effect. The first is that directors are in general not entitled to any benefit deriving from them holding the office of director in a company, beyond what the company is willing to pay them.\(^{626}\) The second is that they cannot, in general, conclude valid contracts with the company.\(^{627}\)

Case law on directors’ duties to creditors indicate that creditors are particularly vulnerable to a breach of this particular arm of directors’ fiduciary duties.\(^{628}\)

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

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

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

And later on:

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

\(^{626}\) See discussion *infra* par 5.3.3.2 for further detail.

\(^{627}\) See discussion *infra* par 5.3.3.3 for further detail.

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

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

5.3.3.3 Contracts with the Company

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

The application of this rule may, however, be avoided in terms of the company’s constitution.\(^{634}\) A provision in the articles of association permitting contracts between

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

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

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

\(^{632}\) Aberdeen Railway Co v Blaikie Bros (1854) 1 Macq 461.

\(^{633}\) Transvaal Lands Co v New Belgium (Transvaal) Land and Development Co [1914] 2 Ch 488 CA; Movitex Ltd v Butfield [1988] BCLC 104.
the director and the company will therefore cause these contracts to be valid. On the same basis an ex post facto approval of such a contract by a fully informed general meeting will ensure that a contract between the director and the company is valid.635

5.4  CONSEQUENCES OF BREACH OF DUTY

5.4.1 General

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

5.4.2 Setting Aside of Transaction

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

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

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

636 See infra par 5.4.2 for further discussion.

637 See infra par 5.4.3 for more detail.

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

639 See infra par 5.4.4 for more information.


641 According to Pennington supra 724, with reference to Charterbridge Corporation Ltd v Lloyds Bank Ltd supra; and Rolled Steel Products (Holdings) Ltd v British Steel Corporation [1986] Ch 246, the company will not always be able to set the transaction aside. This will, eg, be the case where the third party gave valuable consideration without being aware that the directors misused their powers.
Some regard these transactions as “void”, but the majority of opinion hold the view that they are in fact “voidable”. 642

5.4.3 Civil Personal Liability

5.4.3.1 Extent of Personal Liability

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

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

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

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

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

645 In terms of s 1317H(2) the profits made by a director as a result of a particular contravention are included when determining the damage suffered by a corporation for the purposes of making a compensation order. It is thus clear that damage for the purpose of a compensation order is not necessarily equal to profit and may very well exceed the profit that the director made.
However, many commentators are opposed to directors being subject to liability for damages for a breach of fiduciary duties. The reasons advanced for their opposition is that holding directors liable for an account of profits, as well as compensation for the loss arising out of the same breach of duty, will be an “overkill”; 646 that it runs the risk of “mismatching” duty and remedy; 647 and that it carries the danger that the “notion of fiduciary relationship may shrink in order to avoid the imposition of draconian remedies”. 648

5.4.3.2 Basis of Personal Liability

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

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

646 Sealy Directors’ Duties 81.


648 Ibid.

649 As in Australia, New Zealand and Canada.

650 This was made clear in Robinson v Randfontein Estates Gold Mining Co Ltd supra 199 by Innes CJ, who expressly stated that the claim is not one for damages. Nor is it an action on either an oral or a written contract. The fiduciary relationship on which it depends may rest upon an implied mandate; but the suit is not one upon contract. It asks neither for contractual performance nor for damages (own emphasis).

Solomon JA also left no doubt that

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

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

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

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652 Du Plessis *Aanspreeklikheidsgrondslag* 31.

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

654 *Id* 23 – 28.

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

656 *Id* 37.

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

5.4.3.3.1 Defining “Director”

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

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

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

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

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

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

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

\(^{660}\) Du Plessis Term Director 153 – 154.

\(^{661}\) See Du Plessis Term Director 156 – 158 and authority there referred to for more detail.

\(^{662}\) S 1(1).

\(^{663}\) In terms of s 9 of the Australian Corporations Act.
The New Zealand *Companies Act* contains quite an extensive definition of “director”. A director is defined as “any person occupying the position of director of the company by whatever name called”. 664 Also included in the definition are other persons, for the specific purpose of particular provisions of the New Zealand *Companies Act*. For the particular purpose of the provisions dealing with directors’ duties, these would include a person “in accordance with whose directions or instructions a person referred to in paragraph (a)...may be required or is accustomed to act”, 665 a person “in accordance with whose directions or instructions the board of the company may be required or is accustomed to act”, 666 as well as a person “who exercise or who is entitled to exercise or who controls or who is entitled to control the exercise of powers which, apart from the constitution of the company, would fall to be exercised by the board”. 667 It continues to provide that a director is also a person “to whom a power or duty of the board has been directly delegated by the board with that person’s consent or acquiescence, or who exercises the power or duty with the consent or acquiescence of the board”. 668

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

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664 S 126(1)(a).
665 S 126(1)(b)(i).
666 S 126(1)(b)(ii).
667 S 126(1)(b)(iii).
668 S 126(1)(c).
670 In terms of s 741(1).
671 In terms of s 741(2).
otherwise than only because “the directors act on advice given by him in a professional capacity”. 672

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

Problems in identifying the directors that may incur liability for a breach of fiduciary duties may occur in respect of de facto directors; non-executive directors; so-called “puppet”, “dummy”, or “stooge” directors 674 and “shadow” directors.

5.4.3.3.2 De Facto Directors

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

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

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

673 In terms of s 2(1) of the CBCA.

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

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

676 Naude Regsposie van die Maatskappydirekteur 69. Meskin, Kunst, Galgut, Delport & Vorster Henochsberg on the Companies Act (1994 – ) (hereinafter Henochsberg) 8(1) use the term “pretended directors” in respect of these directors and suggest that they are not to be regarded as directors for purposes of the South African Companies Act and that the term de facto director should be reserved for directors who have been appointed, but in whose appointment there is some irregularity. The possibility of treating those who act as directors without any form of appointment as de facto directors for the purpose of common law principles, specifically directors’ duties, is, however, not expressly excluded.
This submission is in line with the approach adopted by the judiciary, as indicated by the following statement in *Cyberscene Ltd v i-Kiosk Internet and Information (Pty) Ltd*:

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

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

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

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

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677 *Supra*.

678 *Id* 814 (own emphasis).

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

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

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

682 Havenga *Fiduciary Duties* 309.

683 *Supra*. 

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5.4.3.3.3 Non-executive Directors

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

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

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

(i) is not involved in the day to day management of the business and has not in the last three years been employment (sic) as an executive manager or executive director of the issuer or its group;

(ii) is not or does not represent a shareholder with the ability to control or significantly influence management or the board;

(iii) is not a member of the immediate family of an individual mentioned in (ii);

(iv) is not a professional advisor to the issuer or its group, except as a director;

(v) is not a significant supplier to, or customer of the issuer or its group;

(vi) has no significant contractual relationship with the issuer or its group; and

(vii) has no business or other relationship that could be seen to materially interfere with the director’s capacity to act independently.

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

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

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

and a “non-executive director” as

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

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

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

5.4.3.3.4 Puppet, Dummy or Stooge Directors and Shadow Directors

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

688 Id 678.

689 578 (own emphasis).

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

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

692 Supra.

693 Id 651 – 652.

694 Id 652.

695 Id 651.
In *S v De Jager*696 it was held that the appointment of puppet directors was a “sham”697 and that the court could disregard it. The previous directors who resigned and appointed the puppets, still controlled the company and occupied the position of directors and as such could still be defined as the directors of the company.698 This decision seems to offer judicial support for the recognition of “shadow directors” in South African law.699 Judicial recognition of this concept is limited, however, to persons previously appointed to the office of director.

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

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

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696 *Supra.*
697 *Id* 623.
699 “Shadow directors” are statutorily defined in Australia, New Zealand and England as persons in accordance with whose directions or wishes directors are accustomed to act.
700 Naude *Regsposisie van die Maatskappydirekteur* 107. He argues against referring to the “puppeteers” as directors, as this would lead to a situation where they would be in a position to attend board meetings and be entitled to directors’ remuneration.
701 Statutory recognition is afforded to the concept of shadow directors in terms of s 219(4)(a) of the South African *Companies Act*. In terms of this provision an officer of a company will include “any person in accordance with whose directions or instructions the directors of the company have been accustomed to act”. This definition only applies for the purposes of subsection 1(b)(ii) of the same provision, however, dealing with the disqualification of persons from being directors where the Master has made a report upon the winding-up of a company that such directors or officers, in his opinion,
A further question in this regard is whether it is possible to institute action against the puppet directors. Since they were clearly appointed to the office of director and are in fact *de jure* directors, there is no reason why they should not incur liability for a breach of fiduciary duties.\(^{702}\)

### 5.4.4 Pecuniary Penalty Orders

The Australian *Corporations Act* provides for civil penalties in case of contravention of certain provisions.\(^{703}\) Included in these provisions\(^{704}\) are those that contain a statutory statement of what may typically be regarded as fiduciary duties.\(^{705}\)

The relevance of these provisions being termed “civil penalty provisions” is that a court may make a declaration of contravention in case of a person having contravened one of these provisions.\(^{706}\) Once such a declaration has been made the *Australian* have committed fraud in relation to the company. It does, however, indicate statutory recognition of the concept of a “shadow director”, which may play an important role in persuading the judiciary to accept a similar definition in cases on directors’ duties.

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

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

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

\(^{704}\) In terms of s 1317E(1)(a).

\(^{705}\) Ss 181; 182 and 183. See *supra* par 5.2.2 for more detail on these provisions.

\(^{706}\) In terms of s 1317E(1).
\textit{Securities and Investments Commission}\textsuperscript{707} may seek a pecuniary penalty order,\textsuperscript{708} in terms of which a court may order a person to pay the Commonwealth a penalty of up to A$ 200 000,\textsuperscript{709} provided that:

(a) a declaration of contravention by the person has been made under section 1317E; and

(aa) the contravention is of a corporation/scheme civil penalty provision; and

(b) the contravention:

(i) materially prejudices the interests of the corporation or scheme, or its members; or

(ii) materially prejudices the corporation’s ability to pay its creditors; or

(iii) is serious.

\section*{5.5 APPLICATION TO A DUTY TO CREDITORS}

\subsection*{5.5.1 Sources}

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

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

\textsuperscript{707} Hereinafter ASIC.

\textsuperscript{708} In terms of s 1317G.

\textsuperscript{709} S 1317G(1).

\textsuperscript{710} Heath supra 377.
enable them to act in accordance with the law and with as little expense and delay in obtaining legal advice as possible.\textsuperscript{711}

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

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

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

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

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

\textsuperscript{714} Ibid.

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

\textsuperscript{716} Clarke supra 607 agrees that the law is in a continuous state of development and that “every statute, code or even restatement is by its very nature dated. It is corseted by lines of thinking current when it was stitched together”. Santow “Codification of Directors’ Duties” (1999) 73 Australian Law Journal 336 347 believes that continuous changing societal expectations and the occurrence of unforeseen
duties are capable of being developed by the courts in order to keep up with the continuously evolving needs that these principles have to fulfil,\textsuperscript{717} this is indeed a serious concern.

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

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

### 5.5.2 Formulation

A broad distinction between directors’ fiduciary duty to act in good faith in the best interests of the company on the one hand and their fiduciary duty to exercise their situations are arguments against the displacement of a general law by statute. He accordingly feels that the important elements in modulating a general duty of care are “best left to evolve by judicial interpretation in accordance with community expectation”.

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

\textsuperscript{718} De Mott “Beyond Metaphor: An Analysis of Fiduciary Obligation” 1988 Duke Law Journal 879 923 – 924 rightly notes:

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

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

\textsuperscript{719} If it is decided that a statutory statement of directors’ fiduciary duties is necessary, it is submitted that such a statement should follow the model presented in terms of s 42 of the Close Corporations Act, namely that it should operate “[w]ithout prejudice to the generality of the expression ‘fiduciary relationship’” (s 42(2)).
powers for a proper purpose is accepted in jurisdictions such as Australia. A similar distinction is not drawn clearly in South African law.

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

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

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

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

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

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

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

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

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

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

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

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

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

\textsuperscript{725} According to Worthington \textit{supra} 121, the extension of directors’ fiduciary duties to include creditors’ interests is most often achieved by a “manipulation of the concept of ‘interests of the company’”.

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

\textsuperscript{727} See discussion \textit{infra} Ch 8 (Beneficiary of the Duty) for particulars on how the beneficiary of the duty to creditors should be defined.
One may broadly distinguish between two possibilities in this regard. First, the duty to creditors can be construed broadly, in which case directors are required to take positive steps to maximize creditors’ interests once the company becomes insolvent. A narrow view of the duty, however, entails that directors are only expected to treat creditors equally and not to use corporate assets to prefer themselves or shareholders.

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


729 Ibid.

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

731 That is, circumstances with regard to the company’s financial position, which is not always easy to determine. The issue here relates to the fact that directors’ duties to consider the interests of creditors become pertinent only upon the company experiencing financial or economic distress. See infra Ch 7 (Point in Time When the Duty Arises) for more detail.
It may rightly be asked, however, whether defining the “interests of the company” with reference to the interests of its creditors will serve any purpose whatsoever, if such a step will have no impact on what is expected of directors in terms of their fiduciary duties. The importance of redefining the interests of the company becomes clearer in regard to directors’ duty to maintain an unfettered discretion and their duty to avoid a conflict of interests. Redefining the interests of the company with reference to the interests of the creditors also facilitates the enforcement of extended fiduciary duties by creditors.

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

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

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732 See discussion infra par 5.5.3.2 and par 5.5.3.3.

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

734 It must be kept in mind that USA directors are subject to fiduciary duties, which are divided into the duty of loyalty (which closely resembles what we know as fiduciary duties) and the duty of care (see discussion supra par 5.2.6). This explains why Millner supra 210 – 214 suggests that a duty to minimise loss upon insolvency could fall under “fiduciary duties”. See infra Ch 6 (Protection Afforded by the Duty of Care and Skill) for further discussion on how the duty of care and skill could serve to protect the interests of corporate creditors.
Chapter 5  Fiduciary Duties

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

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

5.5.3.2 Maintaining an Unfettered Discretion

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

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

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

735 Parkinson supra 96.

736 As was for example done by the Australian judiciary in Teck Corporation Ltd v Millar supra; and Lyford v Commonwealth Bank of Australia supra.
membe r. In the case of a wholly-owned subsidiary, where membership of the company comprises only the holding company and other wholly-owned subsidiaries, it is clear that no action will be taken against directors who breached the fiduciary duties that they owe to the subsidiary.\footnote{Gouvin \textit{supra} 303 – 304 recognizes this problem.}

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

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

One is furthermore inclined to agree with a large number of commentators that the practical reality of the situation faced by nominee directors of subsidiaries should not be ignored and that they should be provided with some leeway in this respect. Depending on the courts to provide such guidelines does not seem to be the answer as “the degree to which the courts are prepared both to identify and to distinguish the interests of so-called group companies is very much a matter of conjecture”.\footnote{Finn \textit{supra} 52.}

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

\footnotetext[37]{Gouvin \textit{supra} 303 – 304 recognizes this problem.}
\footnotetext[38]{Finn \textit{supra} 52.}
Chapter 5  
Fiduciary Duties

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

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

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

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

739 As is done in terms of s 131(3) of the New Zealand Companies Act.
740 S 131(3) of the New Zealand Companies Act contains such a requirement.
741 Gouvin supra 324 – 337 identifies and analyses four approaches that may be followed in response to the dilemma faced by directors of subsidiary companies, namely the ad hoc approach; the contractarian approach; the modification of the horizontal conflict approach; and an approach based on agency law. According to him the first three are problematic and the answer to the dilemma faced by nominee directors lies in the agency approach.
Chapter 5  
Fiduciary Duties

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

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

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

742 Gouvin supra 332.

743 The concept of “shadow director” is provided for by s 9 of the Australian Corporations Act; s 126(1)(b) of the New Zealand Companies Act; as well as s 741(2) of the English Companies Act. See supra par 5.4.3.1 for more detail.

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

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

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

In order to ensure that corporate creditors’ interests are adequately protected in terms of an extension of this duty, it is once again submitted that corporate interests should be defined with reference to those of the creditors of the company, once the company is experiencing financial difficulty.\(^{746}\) In this regard one would hope that the view expressed in *Winkworth v Edward Baron Development Co Ltd*,\(^{747}\) namely that [a] duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors\(^{748}\) will gain some acceptance.

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

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

\(^{747}\)*[1987]* 1 All ER 114.

\(^{748}\)*Id* 118.
5.5.4 Consequences of Breach

5.5.4.1 Remedy

5.5.4.1.1 Personal Liability

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

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

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

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

750 Supra par 5.4.3.1.
5.5.4.1.2 Pecuniary Penalty Order

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

5.5.4.2 Basis of Liability

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

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

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751 S 1317G(1)(b)(ii).
752 S 1317G(2).
753 Arguments against this suggestion, eg the fact that it is not supported by a number of subsequent cases, as well as the fact that it leads to uncertainty as to how a company should go about setting aside a transaction that resulted from an improper exercise of powers where the only available remedy is damages, remain valid, but are not relevant for the purposes of this discussion.
754 A factor that immediately jumps to mind in this regard is that a successful claimant in case of a breach of the duty of care and skill will be awarded damages. It was already indicated (*supra* par 5.4.1) that the remedy sought in case of a breach of fiduciary duties is not necessarily damages, indicating a crucial difference between these two types of duties.
755 Havenga *Breach of Fiduciary Duties: Liability* 371.
Apart from the conceptual differences that exist between these categories of duties, it is also possible that a removal of the distinction between them may result in fiduciary duties, which are generally regarded as more onerous than the duty of care and skill, becoming less onerous. This result is clearly unacceptable, as it would diminish the protection available to creditors in terms of directors’ fiduciary duties.

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

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

5.5.4.3 Defendant

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

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756 Id 370 – 371 and authority there referred to.

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

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

759 Id 374 and preceding arguments.
extent that they were previously appointed as directors of the company and may consequently incur liability for a breach of fiduciary duties.

It also seems possible to hold persons in control of the company, but who were never appointed as directors, liable for a breach of common law fiduciary duties. This may be in terms of an implied mandate given by the company,\footnote{As suggested by Naude \textit{Regsposisie van die Maatskappydirekteur} 107.} or on the basis that they are recognised as “shadow directors”. Since the concept of “shadow directors” gained some statutory recognition,\footnote{In terms of s 219(4)(a) of the South African \textit{Companies Act}, as discussed \textit{supra} \textit{par} 5.4.3.3.4.} the judiciary may possibly apply this definition and hold such persons liable for a breach of the fiduciary duties that they owed to the company as \textit{directors}.

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

5.6 CONCLUSION

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

This statement must be qualified, however, as it seems that particular fiduciary duties are more capable of providing protection for creditors’ interests than others. In this regard a distinction is drawn between directors’ duty to act in good faith in the best interests of the company and their duty to exercise powers for a proper purpose. It is submitted that creditors may benefit from an extension of directors’ duty to act in good faith in the best interests of the company, resulting in specific duties such as a
duty to maintain an unfettered discretion and a duty to avoid a conflict of interests, but not necessarily from a duty to act for proper purposes.

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

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

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

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

762 In terms of s 187(c) of the Australian Corporations Act.
This will make it easier to extend directors’ duties to act in good faith in the best interests of the company; to maintain an unfettered discretion and to avoid a conflict of interests to creditors and will furthermore facilitate enforcement of fiduciary duties by creditors.

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

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

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

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

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

765 See infra Ch 6 (Protection Afforded by the Duty of Care and Skill) for further discussion.
penalty orders seem to offer limited protection as a deterrent measure, as any monies recovered thereby will not be for the benefit of creditors.

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

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

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

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

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

766 As discussed *supra* par 5.4.3.2.

767 *Infra* Ch 6 (Protection Afforded by the Duty of Care and Skill).
CHAPTER 6
PROTECTION AFFORDED BY THE DUTY OF CARE AND SKILL

SUMMARY

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

6.1 INTRODUCTION

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

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

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

\textsuperscript{770} Finch “Company Directors: Who Cares About Skill and Care?” (1992) 55 \textit{Modern Law Review} 179 189 agrees that “[c]reditors no less than shareholders have certain interests in non-negligent direction, notably a concern that incompetence does not prejudice the company’s ability to repay”. See also
Unfortunately this duty has been largely neglected and has played a very subsidiary role to fiduciary duties for a long time. The courts also display a very indulgent attitude towards directors insofar as compliance with their duty of care and skill is concerned and impose a very lax standard in determining compliance with the duty of care and skill. These facts compel one to question the effectiveness of the duty of care and skill as a measure to protect the interests of corporate creditors.

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

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


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

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

773 Trebilcock supra 18 emphasises that:

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

774 Infra par 6.2.

775 Infra par 6.3. These aspects include the way in which the elements of “care”, “skill” and “diligence” relate to each other; the required standard; the distinction between executive and non-executive directors; and the reliance of directors on others.
The general principles as discussed above are analysed with the view to determine how they can be applied effectively to a duty to creditors. In areas where shortcomings were identified, some suggestions are offered as to how the current formulation of the duty of care and skill may be adapted to improve the protection afforded to creditors\(^{777}\) in terms thereof.\(^{778}\)

**6.2 SOURCES AND FORMULATION**

**6.2.1 South Africa**

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

In *Fisheries Development Corporation of SA Ltd v Jorgensen*\(^ {780}\) Margo J rightly noted that there is a dearth of cases on the topic of directors’ duty of care and skill.\(^ {781}\) South African courts and commentators thus tend to turn to English cases for some guidance on the content of this particular duty. A very important case in this regard\(^ {782}\) is that of *In re City Equitable Fire Insurance Co Ltd*,\(^ {783}\) where the court laid down a number of principles in respect of directors’ duty of care and skill.\(^ {784}\)

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\(^{776}\) *Infra* par 6.4.

\(^{777}\) A more effective duty of care and skill would obviously benefit shareholders as well.

\(^{778}\) *Infra* par 6.5.

\(^{779}\) Naude *supra* 313.

\(^{780}\) 1980 4 SA 156 (W).

\(^{781}\) *Id* 165 – 166.

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

\(^{783}\) [1925] 1 Ch 407. According to Davies *Gower & Davies’ Principles of Modern Company Law* (2003) (hereinafter Gower) 433 a stream of nineteenth century cases culminated in this decision, which renders it of particular importance. It is also regarded by Butcher *Directors’ Duties: A New Millennium, A New Approach?* (2000) 41 as the *locus classicus* concerning the standard of care and
Chapter 6

Duty of Care and Skill

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

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

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

\begin{footnotesize}
\begin{enumerate}
\item These principles are listed \textit{infra} par 6.2.4.
\item \textit{Id} 165.
\item \textit{Ibid}.
\item \textit{Ibid}.
\item \textit{Id} 166.
\end{enumerate}
\end{footnotesize}
Chapter 6  
Duty of Care and Skill

The corresponding duty of members of a close corporation, and of directors of banks, is provided for by statute.\footnote{In terms of the \textit{Close Corporations Act} 69 of 1984 (hereinafter \textit{Close Corporations Act}) and \textit{Banks Act} 94 of 1990 (hereinafter \textit{Banks Act}) respectively.} Although not specifically applicable to directors of companies, these provisions provide valuable insight into how the duty of care and skill is viewed by the legislature and serve as an indication as to how this duty may develop in future.

In terms of section 43(1) of the \textit{Close Corporations Act} 
\begin{quote}
A member of a close corporation shall be liable to the corporation for loss caused by his failure in the carrying on of the business of the corporation to act with the degree of care and skill that may reasonably be expected from a person of his knowledge and experience.
\end{quote}

Section 60(1A) of The \textit{Banks Act} places directors of banks\footnote{This duty applies to directors, chief executive officers and executive officers of banks.} under a statutory obligation to 
\begin{quote}
(c) possess and maintain the knowledge and skill that may reasonably be expected of a person holding a similar appointment and carrying out similar functions as are carried out by the director, chief executive officer or executive officer of that bank; and
\end{quote}
\begin{quote}
(d) exercise such care in the carrying out of his or her functions in relation to that bank as may reasonably be expected of a diligent person who holds the same appointment under similar circumstances, and who possesses both the knowledge and skill mentioned in paragraph (c) and any such additional knowledge and skill as the director, chief executive officer or executive officer in question may have.
\end{quote}

It became apparent in other jurisdictions that the statutory formulation of director liability for wrongful or insolvent trading influenced the way in which the judiciary regarded directors’ duty of care and skill.\footnote{In England the judiciary adopted the test contained in s 214(4) of the \textit{Insolvency Act} 1986 dealing with directors’ liability for wrongful trading as an accurate exposition of the common law in two cases, namely \textit{Norman v Theodore Goddard} [1991] BCLC 1028 (CLD) and \textit{In re D’Jan of London Ltd} [1994] BCLC 561 (Ch). According to Havenga supra 31 a deviation from the traditional approach regarding} Should the South African judiciary
proceed in a similar manner, cases dealing with director liability for reckless or fraudulent trading\textsuperscript{793} may also indicate how directors’ common law duty of care and skill will be viewed in future. Principles enunciated in these cases, specifically pertaining to the conduct required of directors, are therefore referred to where relevant.\textsuperscript{794}

6.2.2 Australia

In terms of section 180(1) of the Australian \textit{Corporations Act},\textsuperscript{795} directors have a statutory duty to

\begin{itemize}
\item exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they
\item were a director...of a corporation in the corporation’s circumstances; and
\item occupied the office held by, and had the same responsibilities within the corporation as the director...
\end{itemize}

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

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

\textsuperscript{793} In terms of s 424(1) of the South African \textit{Companies Act}.

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

\begin{itemize}
\item Although the focus there was upon the duty owed to the company, whereas here one is concerned with alleged recklessness \textit{vis-à-vis} creditors, much of what was said there is applicable to the instant matter…
\end{itemize}

\textsuperscript{795} \textit{Corporations Act} 2001 (hereinafter Australian \textit{Corporations Act}).

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

\begin{itemize}
\item Sections 180 to 184:...
\end{itemize}
In addition, the way in which Australian directors’ liability for a breach of their duty of care is viewed by the judiciary, may be influenced by the fact that the Australian Corporations Act provides for the application of a business judgment rule. The potential effect of this provision is addressed in more detail below.

### 6.2.3 New Zealand

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

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

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

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

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

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

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

(a) make the judgment in good faith for a proper purpose; and

(b) do not have a material personal interest in the subject matter of the judgment; and

(c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and

(d) rationally believe that the judgment is in the best interest of the corporation.

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

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

Infra Ch 9 (Relief from Liability) par 9.2.3.2.

1993 Companies Act (hereinafter New Zealand Companies Act).
the same circumstances taking into account, but without limitation, -
(a) The nature of the company; and
(b) The nature of the decision; and
(c) The position of the director and the nature of the responsibilities undertaken
by him or her.

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

6.2.4 England

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

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

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

801 *Supra*.

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

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

804 *In re City Equitable Fire Insurance Co Ltd supra* 429. See also *In re Montrotier Asphalte Company
(*Perry’s Case*) (1876) 34 LT 716, referred to by Trebilcock *supra* 505, where it was held that a
director’s “business or pleasure may call him elsewhere and it would be a most unheard of thing to say
director may assume, in the absence of grounds for suspicion, that duties that may properly be left to some other official are performed honestly by that person.\footnote{In re City Equitable Fire Insurance Co Ltd supra 429.}

Whether these principles still present the legal position with regard to directors’ duty of care and skill is questionable,\footnote{Gower 432 observes, with some degree of relief it would seem, that the law relating to directors’ duty of care and skill is “at last beginning to undergo a profound change”. Loose, Griffiths & Impey The Company Director: Powers, Duties and Liabilities (2000) 151 are also of the opinion that although these standards have been applied until comparatively recently, “there are good reasons for believing that they no longer represent the law”.} as courts in England nowadays are more inclined to impose a higher standard on directors in terms of their duty of care and skill.

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

In two later cases the distinction between a subjective duty of skill and an objective duty of diligence was dropped, with the court expressing the view that both of these duties should be judged objectively.\footnote{See Norman v Theodore Goddard supra and Re D’Jan of London Ltd supra. The courts’ change of approach may be attributed to various factors. See Gower 433. These include guidelines provided by the statutory formulation of directors’ liability in case of wrongful trading; the emphasis put upon the importance of the role of the non-executive director in reports such as the \textit{Cadbury Report} (Report of the Committee on the Financial Aspects of Corporate Governance, chaired by sir Adrian Cadbury The Report of the Committee on the Financial Aspects of Corporate Governance Gee and Co Ltd, London, 1992) and \textit{Greenbury Report} (Report of a Study Group on Directors’ Remuneration, under chairmanship of sir Richard Greenbury Directors’ Remuneration Gee Publishing Ltd, London, 1995) and the public attitudes to corporate governance. In Bishopsgate Investment Management Ltd v Maxwell (No 2) [1994] 1 All ER 261 264 the court acknowledged, with reference to directors' participation in the management of the company, that the law “may be evolving in response to changes in public attitudes to corporate governance”.

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

\footnote{Gower 432 observes, with some degree of relief it would seem, that the law relating to directors’ duty of care and skill is “at last beginning to undergo a profound change”. Loose, Griffiths & Impey The Company Director: Powers, Duties and Liabilities (2000) 151 are also of the opinion that although these standards have been applied until comparatively recently, “there are good reasons for believing that they no longer represent the law”.}
Section B5 of the White Paper on “Company Law Reform” published in March 2005\(^8\) furthermore suggests that directors’ duty of care and skill is to be codified as follows:

1. As a director of a company you must exercise reasonable care, skill and diligence.

2. This means the care, skill and diligence that would be exercised by a reasonably diligent person with –
   
   a. the knowledge, skill and experience that may reasonably be expected of a director in your position; and

   b. any additional knowledge, skill or experience that you in fact have.

\(^8\) Available at www.dti.gov.uk/cld/review.htm, hereinafter referred to as the English Company Law Reform Bill.
Chapter 6  
Duty of Care and Skill

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

6.2.5 Canada

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

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

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

(a) …

(b) he must, in the exercise of his powers, take such steps…as he believes will achieve a reasonable balance between –

(i) reducing the risk that the company will be unable to pay its debts as they fall due; and

(ii) promoting the success of the company for the benefit of its members as a whole.

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

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

(a) …

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

\textsuperscript{811} Secretary for Trade and Industry Modernising Company Law (Cm 5553-I) par 3.11.
regard to this duty are very similar. Section 122(1)(b) of the *Canada Business Corporations Act* is illustrative of these provisions and reads as follows:

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

### 6.2.6 United States of America

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

A director shall discharge his duties as a director…

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

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

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

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

814 Sarra & Davis *supra* 32.

815 Hereinafter *MBCA*.

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

817 Balotti & Hinsey “Director Care, Conduct, and Liability: The Modern Business Corporation Act Solution” (2000) 56 *The Business Lawyer* 35 36 describe the business judgment rule as “the familiar and longstanding doctrine that serves as the common law’s principal guidepost on issues relating to director conduct and liability” (own emphasis). The fact that requirements in respect of director conduct are separated from issues of liability for non-compliance with these requirements, is clearly illustrated by the 1999 amendments to the *Model Business Corporations Act* which distinguishes between “Standards for Conduct of Directors” (s 8.30) and “Standards of Liability for Directors” (s 8.31).
directors are expected to comply with a duty of care, only the principles embodied in the business judgment rule indicate whether a director should be held liable for non-compliance with this particular duty.818

6.3 RELEVANT ASPECTS

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

6.3.1.1 Duty of Care

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

6.3.1.2 Duty of Skill

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

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818 See infra Ch 9 (Relief from Liability) par 9.2.3.1 for more detail on the business judgment rule.
820 Finch supra 189; McLennan supra 95.
821 In terms of s 218(1) of the South African Companies Act certain categories of persons are expressly disqualified from holding the office of company director, eg minors; persons under legal disability; unrehabilitated insolvents; and dishonest persons. Apart from these limited statutory exclusions from the office of director, any person may be appointed as a company director. The viewpoint that a director is not required to have any particular skills could not be more clearly expressed than it was by Neville J in In re Brazilian Rubber Plantations & Estates Ltd supra 437:

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

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

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

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

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

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

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

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

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

825 In terms of par 2.3 of Ch 4 of Section 1 of King II.
the financial, industrial and social milieu in which the company operates”. In terms of paragraph 2.6 of Chapter 4 of Section 1 of King II, another such development is that directors of banks are required to “possess and maintain the knowledge and skill that may reasonably be expected of a person holding a similar appointment and carrying out similar functions as are carried out by the director”.

6.3.1.3 Duty of Diligence

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

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

6.3.2 Required Standard

6.3.2.1 South Africa

A director is required to exercise the care that can reasonably be expected of a person with his or her specific knowledge and experience. Although a measure of objectivity is provided for in that a director must at least display the degree of care that could reasonably be expected from somebody like himself, indicating that irrational behaviour in light of the particular knowledge and experience of the director is unacceptable, the standard laid down in Fisheries Development Corporation of SA Ltd v Jorgensen supra 166 (own emphasis).

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826 In terms of par 2.6 of Ch 4 of Section 1 of King II.
827 In terms of s 60(1A)(c) of the Banks Act.
828 These are Australia, New Zealand and Canada.
829 Supra.
830 Supra 429.
831 In terms of par 2.11 of Ch 4 of Section 1 of King II.
832 Fisheries Development Corporation of SA Ltd v Jorgensen supra 166 (own emphasis).
Chapter 6                                                          Duty of Care and Skill

_Ltd v Jorgensen_\(^{833}\) seems to indicate the application of a subjective yardstick. The perception of subjectivity inherent to this duty is furthermore enforced by the fact that the extent of a director’s duty of care and skill is dependent on the nature of the company’s business and on any particular obligations assumed by the director.\(^{834}\)

The judiciary introduced an objective/subjective yardstick when assessing director liability for reckless trading in terms of section 424(1) of the South African _Companies Act_. In _Philotex (Pty) Ltd v Snyman; Braitem (Pty) Ltd v Snyman_\(^{835}\) the court declared:

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

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

> The enquiry will therefore be: what would the reasonable businessman having that additional knowledge, or having ready access to that knowledge, have done in the circumstances?\(^{837}\)

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

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\(^{833}\) _Supra_.

\(^{834}\) _Fisheries Development Corporation of SA Ltd v Jorgensen supra_ 165; with reference to _In re City Equitable Fire Insurance Co supra_ and _Wolpert v Uitzigt Properties (Pty) Ltd_ 1961 2 SA 257 (W).

\(^{835}\) _Supra_.

\(^{836}\) _Id_ 143; with reference to _S v Van As_ 1976 2 SA 921 (A).

\(^{837}\) _Id_ 149.
director...may have”, indicating a definite departure from an exclusively subjective approach to the duty of care and skill.

6.3.2.2 Australia

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

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

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

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838 Own emphasis.
839 S 180(1)(a) of the Australian Corporations Act.
840 Ibid.
841 S 180(1)(b) of the Australian Corporations Act.
842 Ibid.
843 In Deputy Commissioner of Taxation v Clark supra par 93 the court stated:

Until a decade or two ago, the standard of skill and the standard of care of directors were each to be determined by what could reasonably be expected from a person with the knowledge and experience of the director concerned...Over a period of time that standard of care and skill came to be regarded as too low. By 1992 it had become clear that directors were expected to be proactive. This was reflected in both amendment of the statutory duty and in the parallel development of the common law duty (own emphasis).
care and diligence. A landmark judgment in this respect is *AWA Ltd v Daniels* and on appeal *Daniels v Anderson*, where the court stated:

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

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

### 6.3.2.3 New Zealand

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

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

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

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

848 S 137.
“reasonable person”,\textsuperscript{849} or even a “reasonably prudent person”\textsuperscript{850} or “ordinarily prudent person”.\textsuperscript{851} The term “reasonable director” is, however, not defined.\textsuperscript{852}

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

This statutory formulation of the standard of care expected of directors seems to be in line with common law principles\textsuperscript{854} as expressed in \textit{Grayburn v Laing},\textsuperscript{855} namely that:

Something more than mere carelessness will be necessary before liability can arise.

The standard of care which is imposed is to be assessed in relation to the particular responsibilities of the director concerned towards the company, the nature of the company and the nature of the directorship.\textsuperscript{856}

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

\textsuperscript{849} As in Australia (s 180(1) of the Australian \textit{Corporations Act}).

\textsuperscript{850} As in Canada (s 122(1)(b) of the \textit{CBCA}).

\textsuperscript{851} As in the USA (s 8.30(a) of the \textit{MBCA}).

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

\textsuperscript{853} S 137 (own emphasis).

\textsuperscript{854} According to Jones \textit{supra} 120.

\textsuperscript{855} [1991] 1 NZLR 482.

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

\textsuperscript{857} Jones \textit{supra} 120.
furthermore required to display the skill of a reasonable director in the same circumstances, indicating a subjective element to this particular element of the duty.

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

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

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

858 S 137 (own emphasis).
859 As proposed in In re City Equitable Fire Insurance Co Ltd supra 429.
860 (1990) 5 NZCLC 66, 384, as referred to by Jones supra 121.
861 In terms of the common law proposition put forward by Romer J in In re City Equitable Fire Insurance Co Ltd supra 429 a director is not expected to give continuous attention to the affairs of his or her company. The duties are of an intermittent nature to be performed at periodical board meetings – a director is not bound to attend all board meetings.
862 Jones supra 121.
863 Id 122.
864 (1992) 6 NZCLC 68,040, as referred to by Jones supra 122.
If need be I would support those who question whether a person who accepts appointment of the directorate of a publicly listed company should now be exempt from any obligation to keep himself reasonably informed about its financial state...

6.3.2.4 England

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

6.3.2.5 Canada

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

\textsuperscript{865} S B5(1).

\textsuperscript{866} S B5(2)(a).

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

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

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

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

### 6.3.2.6 United States of America

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

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\(^{870}\) *Supra*.

\(^{871}\) *Id* par 156.

\(^{872}\) *Ibid*.

\(^{873}\) *Id* par 157.

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

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

\(^{876}\) Balotti & Hinsey *supra* 51.
Chapter 6
Duty of Care and Skill

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

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

6.3.3 Distinction Between Executive and Non-Executive Directors

6.3.3.1 South Africa

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

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

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

880 Fisheries Development Corporation of SA Ltd v Jorgensen supra 165G, with reference to In re City Equitable Fire Insurance Co supra and Wolpert v Uitzigt Properties (Pty) Ltd supra 267.
actively involved in the management of the company’s affairs, and the non-executive
director.\textsuperscript{881}

In \textit{Fisheries Development Corporation Ltd v Jorgensen}\textsuperscript{882} the court made the
following telling statement with regard to the non-executive director:

\begin{quote}
[The non-executive director] is not bound to give continuous attention to the affairs of
his company. His duties are of an intermittent nature to be performed at periodical
board meetings, and at any other meetings which may require his attention. He is not,
however, bound to attend all such meetings, though he ought to whenever he is
reasonably able to do so.\textsuperscript{883}
\end{quote}

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

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

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

\textsuperscript{882} \textit{Supra}.

\textsuperscript{883} \textit{Id} 165.

\textsuperscript{884} In terms of s 424(1) of the \textit{Companies Act} 61 of 1973 (hereinafter South African \textit{Companies Act}).

\textsuperscript{885} See examples referred to \textit{supra} par 6.2.1.

\textsuperscript{886} 1991 2 SA 660 (A).

\textsuperscript{887} 1985 3 SA 597 (T).

\textsuperscript{888} \textit{Supra} 674.

\textsuperscript{889} S 424(1).
personal liability by refraining from participating actively in the management of the company’s affairs.

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

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

6.3.3.2 Australia

The statutory formulation of directors’ duty to act with care and diligence does not necessarily indicate that the position of executive directors is different from that of non-executive directors. The fact that the degree of care and diligence required from a director is determined, amongst other things, by the office held by him or her and the responsibilities of that particular director\(^ {893}\) does, however, lead one to conclude that the scope of directors’ duty of care and diligence is influenced by whether they hold the office of executive or non-executive director.

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

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890 *Supra.*

891 *Id* 678.

892 *Supra.*

893 S 180(1)(b) of the Australian *Corporations Act.*
The degree of skill required of an *executive director* is measured objectively. In contrast...*non-executive directors* are not bound to give continuous attention to the affairs of the corporation. $^{894}$

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

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

In deciding whether or not she had “good reason” for not taking part in the management of the company, $^{898}$ thus relieving her from statutory liability in terms of

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

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

$^{896}$ *Supra*.

$^{897}$ *Id* par 10.

$^{898}$ With reference to the statutory defence provided by s 588FGB of the *Corporations Act*. Although this case to a large extent dealt with directors’ statutory duties and defences provided by s 588G, the
Section 588FGA of the Australian Corporations Act, the court per Spigelman CJ made the following statement:

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

\textbf{6.3.3.3 New Zealand}

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

\textbf{6.3.3.4 England}

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

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

\textsuperscript{899} \textit{Id} par 167. This statement was confirmed by Hodgson JA par 174 who said:

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

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

\textsuperscript{900} S 137(c) (own emphasis).
principles of company law, it will be of little relevance whether he was an executive or non-executive director.\(^901\) One could therefore say that the days of the old-school non-executive director who “lent his name, sometimes his presence, and perhaps his connection, to the board” are over.\(^902\)

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

**6.3.3.5 Canada**

The Canadian legislature does not distinguish between executive and non-executive directors insofar as their statutory duty of care, diligence and skill is concerned. The \textit{CBCA}\(^1\) does specify, however, that every director is subject to a duty of care, diligence and skill that a “reasonably prudent person would exercise in comparable circumstances”.\(^905\) “Comparable circumstances” may refer to the particular circumstances in which the director finds himself, which include the nature of the office held by him and the extent of the duties assumed by him.

**6.3.3.6 United States of America**

Once again a clear statutory distinction is not drawn between the position of executive and non-executive director in terms of statutory provisions. Reference made to the care exercised by a person in a “like position” under “similar circumstances” in section 8.30(a)(2) of the \textit{MBCA}\(^2\) may lead one to conclude that the particular position

\(^{901}\) \textit{Dorchester Finance Co Ltd v Stebbings} \textit{supra} 505.

\(^{902}\) \textit{Loose, Griffiths & Impey} \textit{supra} 151. Cases pertaining to the disqualification of non-executive directors, \textit{eg} \textit{In re Continental Assurance Co of London plc} [1996] BCC 888 and \textit{In re Park House Properties Ltd} [1998] BCC 847, as referred to by \textit{Arsalidou} \textit{supra} 110, indicate that the courts are taking a firmer stance against inactive non-executive directors.

\(^{903}\) \textit{Id} 156.

\(^{904}\) \textit{Id} 155.

\(^{905}\) S 122(1)(b) (own emphasis).
assumed by a director will play a role in establishing whether he complied with his
duty of care.

The American judiciary furthermore distinguishes between the decision-making role
and the overseeing role of directors. In respect of the first, the business judgment rule
defines the content of the duty of care. In respect of the latter, however, the business
judgment rule is not applicable. This distinction may, to a large extent, influence the
manner in which the potential liability for breach of duty of care of executive and
non-executive directors is assessed. Non-executive directors are traditionally less
involved in active decision-making and more in an overseeing context. This may
result in the business judgment rule not being applicable in many instances when
determining the liability of non-executive directors for a breach of the duty of care.906

6.3.4 Reliance on Others

6.3.4.1 South Africa

Directors may, in the absence of reasonable grounds for suspicion, assume that duties
that may properly be left to some other official are performed honestly.907 They are
also entitled to rely on information and advice from management in the absence of
reasons for questioning such information and advice.908 This does not mean that
directors are entitled to rely on such information blindly – they are still expected to
exercise their own judgment, having given the relevant advice or information due
consideration.909

6.3.4.2 Australia

Directors are afforded statutory room to rely on others in discharging their
management functions, by way of a rebuttable presumption. In terms section 189(a)
of the Australian Corporations Act a director’s reliance on information or advice from
particular persons is taken to be reasonable, unless the contrary is proved.

906 See discussion infra Ch 9 (Relief from Liability) par 9.2.3 for more detail on the business judgment
rule.

907 Fisheries Development Corporation of SA Ltd v Jorgensen supra 166; Triptomania Twee (Pty) Ltd
v Connolly 2003 3 SA 558 (C) 563, with reference to In re City Equitable Fire Insurance Co [1925] Ch 407 429 and

908 Ibid.

909 Ibid.
A director is, however, not entitled to rely on the advice or opinions of others blindly. The reliance must have been in good faith, having made an independent assessment of the information or advice and taking into account the director’s knowledge of the corporation and the complexity of the structure and operations of the corporation.  

Should a particular director be a specialist in a particular field, one may assume that the other directors, taking into account their knowledge, or more particularly, lack thereof relating to this matter, are entitled to rely on the opinion of the expert director.

The persons who can be relied on in terms of section 189(a) are an employee of the corporation, reasonably believed to be reliable and competent; a professional adviser regarding matters reasonably believed to fall within that person’s professional or expert competence; another director or officer regarding matters within that person’s authority; or a committee of directors on which the director did not serve in relation to matters within the committee’s authority.

6.3.4.3 New Zealand

The New Zealand legislature made express provision for the common law proposition that a director is entitled to rely on information supplied by others in the New Zealand Companies Act. In terms of this provision a director is entitled to rely on the reports,
statements and information of professionals, experts and employees, provided that
the director acts in good faith, makes proper inquiry when appropriate, and has no
knowledge that the reliance is unwarranted.

Jones’s analysis of this provision indicates that the ability to rely on others may
decrease directors’ potential liability in case of a breach of the duty of care. It may,
on the other hand, at least be seen to place a limited duty of inquiry on directors.
The statutory formulation does not, however, contain a more onerous duty than the
common-law principles stated in *In re City Equitable Fire Insurance Co Ltd.*

6.3.4.4 England

The English judiciary stated that a director can neither be expected to watch the
subordinate officers of the corporation, nor to verify the calculation of the auditor
himself, as the business of life cannot go on if the directors cannot trust those who are
put in a position of trust for the express purpose of attending to the details of
management. A director who is deceived by his own officers will thus not incur
liability based on negligence.

This entitlement is, however, qualified by duties to supervise and inquire into the
conduct of the company’s affairs. Reliance on or delegation to others will also not
exonerate directors from liability if such reliance was on or if such delegation was to
obviously incompetent or unsuitable persons. Blind reliance on information

916 S 138(1).
917 S 138(2).
918 Jones *supra* 128.
919 *Ibid*.
920 *Supra*.
921 Jones *supra* 128.
922 *Dovey v Corey supra* 486.
923 Loose, Griffiths & Impey *supra* 157.
924 *Id* 156.
provided by and opinions of others may thus result in a breach of the duty of
diligence, making a director vulnerable to liability on the basis of such a breach.

6.3.4.5 Canada

Canadian directors are statutorily permitted to rely on information provided by others
in terms of the *CBCA*, provided that they acted in good faith. In terms of the
relevant provision, directors who relied on financial statements of the corporation
represented to them by an officer of the corporation; or on a written report of an
auditor of the corporation fairly to reflect the financial condition of the corporation;
or on the report of a person whose profession lends credibility to statements, will
not be held liable for decisions made on the basis of that information.

Powers of directors may furthermore be delegated to officers, but directors must
exercise due care in selecting competent officers.

6.3.4.6 United States of America

Directors are fully protected if they rely in good faith on reports made by officers.
For a report to qualify as such, however, it must, at a minimum, be pertinent to the
subject matter upon which a board is called to act. Directors are furthermore not
protected in cases of blind reliance on such reports.

The above principles gained statutory recognition in the 1999 revised version of the*
MBCA*. In terms of the revised section 8.30 directors “who [do] not have knowledge
that makes reliance unwarranted” may rely on certain categories of persons. These
include “officers or employees of the corporation whom the director reasonably

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925 S 123(5).
926 S 123(5)(a).
927 S 123(5)(b).
928 *R v Bata Industries Ltd* (1992) 9 OR (3d) 329 (Ont Crt (Prov Div)).
929 *Smith v Van Gorkom* 488 A2d 858 (Del 1985).
930 Ibid.
931 Ibid.
932 S 8.30(c).
believes to be reliable and competent”; 933 “legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise”; 934 and a committee of the board of directors of which the director is not a member. 935 A director is not entitled to rely on these persons blindly and must be able to indicate that he reasonably believed that the particular person or committee merits confidence. 936

6.4 CONSEQUENCES OF BREACH

6.4.1 South Africa

A director who is in breach of his duty of care and skill to the company may be held personally liable for the damages suffered by the company as a result of the breach. 937 Such liability is based in delict, 938 which entails that a successful plaintiff must be able to prove that the director in question committed a wrongful act that caused damages to the plaintiff and that the director acted intentionally or negligently. 939

6.4.2 Australia

Directors have a statutory duty to act with care and diligence in terms of section 180(1) of the Australian Corporations Act, which is regarded as a so-called “civil penalty provision”. 940

Directors who fail to comply with their duty of care and diligence may incur statutory liability to the corporation. Section 1317H of the Australian Corporations Act

933 S 8.30(e)(1).
934 S 8.30(e)(2).
935 S 8.30(e)(3).
936 S 8.30(e)(1) – (3).
937 Lagunas Nitrate Co v Lagunas Syndicate supra 435; In re Brazilian Rubber Plantations and Estates Ltd supra 437; In re City Equitable Fire Insurance Co Ltd supra 428 – 429; Ex parte Stubbs: In re Wit Extensions Ltd 1982 1 SA 526 (W) 532; Du Plessis v Phelps 1995 4 SA 165 (C) 170.
938 Ex parte Stubbs: In re Wit Extensions Ltd supra 532; Du Plessis v Phelps supra 170.
939 Neethling, Potgieter & Visser Law of Delict (2001) 4 indicate that all of the elements of a delict, namely an act, wrongfulness, fault, harm and causation, must be present. If any of these elements is missing, no delict was committed and there is no liability.
940 S 1317E(1)(a).
specifically provides that a court may order a person to compensate the corporation if the person has contravened a civil penalty provision and damage resulted from the contravention. “Damage” includes “profits made by any person resulting from the contravention or the offence”.

The further importance of the fact that section 180(1) is a civil penalty provision is that a court must, once it is satisfied that a person has contravened a civil penalty provision, make a declaration of contravention. Once such a declaration has been made by the court, the Australian Securities and Investments Commission is free to seek a pecuniary penalty order in terms of which the delinquent party may be ordered to pay a pecuniary penalty of up to A$200,000. Although a pecuniary penalty order may be granted by the court where a contravention “materially prejudices the corporation’s ability to pay its creditors”, creditors do not stand to benefit directly from the order, as the penalty is a civil debt payable to ASIC. One may argue, however, that creditors benefit indirectly from the statutory provision for pecuniary penalty orders for a breach of the duty of care and diligence, as it may encourage directors to comply with these duties in managing the affairs of the company.

Section 1324 of the Australian Corporations Act furthermore provides for injunctive relief. This provision makes it possible for ASIC or a person whose interests have been affected, to apply for an injunction where somebody is engaged in, or planning, a contravention of the Australian Corporations Act. It is also possible to obtain an

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941 Subs (1)(a).
942 Subs (1)(b).
943 S 1317H(2).
944 S 1317E(1).
945 Hereinafter ASIC.
946 S 1317G.
947 S 1317G(1)(b)(ii).
948 S 1317G(2).
949 S 1324(1).
injunction where a person refuses or is failing to do something that is required in terms of the Australian *Corporations Act*. The fact that injunctive relief may be obtained by “a person whose interests have been affected” leaves the door open for creditors to apply for this type of relief. Subsection 10 furthermore empowers the court to order a person do pay damages, in stead of or in addition to the grant of the injunction.

6.4.3 New Zealand
Directors failing to comply with their duty of care, diligence and skill may be held liable on a statutory basis and will have to compensate the company for the damages that their conduct caused.

6.4.4 England
Director liability for failing to comply with their duty of care and skill seems to be based on common-law principles of negligence. The remedy envisaged in case of a breach of the duty is payment of damages to the company.

6.4.5 Canada
In Canada director liability for a breach of this particular duty is also based on statute and the relief is mainly compensatory in nature.

6.4.6 United States of America
Section 8.30, describing standards of conduct required of directors, is not the operative test for determining whether a director is liable for damages for failing to exercise reasonable care. The proper test for determining director liability is the business judgment rule. This is made very clear by the 1999 amendments to the *MBCA*. In terms of these amendments a distinction is drawn between standards of conduct and standards of liability, the latter essentially codifying the business judgment rule.

950 S 1324(2).
951 S 8.30.
952 S 8.31.
953 Balotti & Hinsey *supra* 56 are of the opinion that this framework “reflects the substantive core of the business judgment rule”.

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In determining whether the common law business judgment rule is applicable, it is important to distinguish between directors’ duty of care in a decision-making context, and the duty of care in a non-decision making or oversight context. In the first instance the business judgment rule will apply to alter and to limit the duty, while the business judgment rule will enjoy no application in the latter instance.

In respect of the duty of care in a decision-making context, the business judgment rule provides that a director acting in good faith and with due care in the process of decision making will not be found liable, even though the decision itself might not be one that the ordinarily prudent person would have made. The duty of care in a decision-making context could thus be seen as process due care alone.

This is clearly illustrated by the well-known case of Smith v Van Gorkom in which the directors were held liable because they did not follow the appropriate process by not taking adequate steps to become informed about the proposed merger. Whether the steps taken were adequate will be measured against principles of gross negligence.

When, on the other hand, directors are not required to make a business decision or where they are required to do so, but fail to make the decision, the business judgment rule will not apply.

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954 Hansen supra 1356.
955 Ibid.
956 Ibid. The business judgment rule therefore comprises both a procedural and a substantive element. According to Balotti & Hinsey supra 37 the procedural element “establishes a presumption that the directors ‘acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company’”, while the substantive element “prevents judicial review of the merits of the decision and protects the decision from challenge”.
957 Hansen supra 1356.
958 Supra.
960 Ie in a non-decision making or oversight context.
961 Hansen supra 1359.
Chapter 6

Duty of Care and Skill

Section 8.31 of the 1999 revised MBCA, dealing with the standards of liability, describes procedural steps to be followed for specified aspects of director conduct that will be actionable. The majority of these aspects are related to what is traditionally referred to as a breach of directors’ fiduciary duties. Important for the purposes of this chapter, however, is section 8.31(a)(2)(iv). In terms of this provision conduct involving a sustained failure by the director to devote attention to the oversight function, or a specific failure to devote timely attention to a demonstrable need for inquiry when particular facts and circumstances of significant concern materialise, will be actionable.

In those states where the amended MBCA was accepted and introduced into legislation, director liability for failing to comply with required standards are therefore determined in accordance with section 8.31. In other states the common law business judgment rule still seems to be the only available device to determine whether directors may in fact be held liable for failing to comply with the required standards.

In terms of the 1999 revision of the MBCA a person who seeks to hold a director liable for failing to act with the necessary care, will furthermore be required to prove two facts. The first of these is that the corporation or its shareholders suffered harm measurable in monetary damages. The plaintiff must secondly also be able to show that the harm suffered was proximately caused by the challenged conduct.

An action for damages against directors is, however, not the only remedy available under circumstances where a director is suspected of breaching his duty of care and the corporation may also apply for injunctive relief.

962 Balotti & Hinsey supra 56.
963 S 8.31(b)(1).
964 See Radin “The Director’s Duty of Care Three Years After Smith v Van Gorkom” (1988) 39 The Hastings Law Journal 707 728 – 744 for a detailed discussion of cases in which the court found a lack of due care and was willing to provide injunctive relief. These include EAC Industries Inc v Frantz Manufacturing Co 11 Del J Corp L 608 (Del Ch); Sealy Mattress Co of New Jersey, Inc v Sealy, Inc.
6.5 APPLICATION TO A DUTY TO CREDITORS

6.5.1 Sources

Directors’ duty to act with care and skill forms part of their common-law duties in South Africa. One may probably argue that this fact contributes to the lack of protection afforded in terms of such a duty, in that the party or parties to be protected by it are rarely certain of what exactly can be expected of directors in terms of this duty. This may result in hesitancy to commence with action against directors on what might constitute conduct in breach of this duty.

The obvious solution to this shortcoming is a codification or partial codification of directors’ duty of care and skill, as is the case in Australia, New Zealand, Canada and the majority of states in the United States of America.

The point was already made in a previous chapter that one must carefully consider arguments in favour of and against a codification of directors’ duties before taking such a step. The conclusion was reached that a codification of fiduciary duties will be undesirable, since the judiciary seems to be quite capable to develop this area of the law in order to ensure that fiduciary duties remain relevant in the modern corporation. An exhaustive codification of fiduciary duties will hinder this ongoing process.

Unfortunately the same cannot be said in respect of directors’ duty of care and skill where common-law principles have remained stagnant. In respect of directors’ duty of care and skill codification may provide the opportunity for following the modern trend of a more onerous and clearer duty of care and skill, without having to wait for a

[1987 Transfer Binder] Fed Sec L Rep (CCH), 93 331 (Del Ch July 20, 1987); Hanson Trust PLC v ML SCM Acquisition, Inc 781 F 2d 264 (2d Cir 1986); Edelman v Fruehauf Corp 798 F 2d 882 (6th Cir 1986); Buckhorn, Inc v Ropak Corp 656 F Supp 209 (SD Ohio).

965 As is the position in England and particular states in the USA.

966 And as is proposed for England in terms of the English Company Law Amendment Bill.

967 See discussion supra Ch 5 (Protection Afforded by Fiduciary Duties) par 5.5.1 and sources there referred to.
case dealing with this topic to come before a court whose judgment might or might not provide for progress in this area of the law.

One may also argue that a codification of the duty of care and skill is not totally foreign to South African law, in light of section 43(1) of the Close Corporations Act which provides for a codification of the duty of care and skill owed by the members of a close corporation, as well as section 60(1A)(c) and section 60(1A)(d) of the Banks Act, in terms of which the duty of care and skill of directors of banks is codified.

Apart from the proponents and opponents of codification, there are those who believe that codification will have no effect whatsoever. Rogers CJ, in delivering judgment in AWA Ltd v Daniels, seems to be of the opinion that there is no distinction between standards of care owed under common law and those owed under statute and stated that “[t]he legal label may change but the contents of the bottle will remain the same.”

968 Since a close corporation does not have directors but is managed by its members, members are subject to duties similar to the common-law duties of directors of a company, in their management of the close corporation.

969 S 43(1) provides:

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

This statutory definition of the duty of care and skill is identical to one of the principles enunciated by the court in Fisheries Development Corporation of South Africa Ltd v Jorgensen supra 166, but is less exhaustive than the explanation of the duty of care and skill provided by the court. It cannot therefore really be said to clarify the duty of care, and whether it may indeed be regarded as a proper “codification” is debatable.

970 See eg Sealy “Directors’ Duties in the New Millennium” (2000) 21 The Company Lawyer 64 who doubts whether a statutory statement of directors’ duties “will make any difference of substance to the law that we know”.

971 Supra.

972 Id 873. A contrary view is expressed by Ipp J in Vrisakis v Australian Securities Commission supra 428, according to whom there are differences, eg damages that have to be proved for common law liability, whereas s 229(2) of the Companies Code, 1981 and s 232(3) of the Corporations Law,
Even if the above were true, a codification of directors’ duties may still be advantageous in that it will increase directors’ potential liability through no other factor than “expectation”. Beneficiaries who are more aware of duties incumbent on directors will have greater expectations than before. This will not necessarily result in a greater number of actions against directors, but may improve directors’ standard of conduct where their increased knowledge of their duties and of the higher expectations of beneficiaries of the duties can serve as an incentive to take steps to mitigate adverse consequences arising from non-compliance with their duties. Codification may thus serve “to ensure that there are not too many bad directors”.

6.5.2 Formulation
The comparative study indicated that the duty of care and skill is not formulated in a universal way. In some jurisdictions it is simply referred to as a duty of care; in others as a duty of care and skill; a duty of care and diligence; or a duty of care, diligence and skill. The question may be asked as to which of these elements may serve to protect creditors’ interests, and whether the content of the duty will change, depending on whether it is a duty for the benefit of shareholders, or of creditors.

973 Jones supra 123.
974 Ibid.
976 As in the USA.
977 As in South Africa and England.
978 As in the statutory statement of the duty in Australia. Some voiced criticism against this formulation, as it dispensed with the element of skill and thus places a less onerous duty on directors than the common-law duty of care, skill and diligence.
979 As in New Zealand and Canada.
Chapter 6

Duty of Care and Skill

It is firstly submitted that creditors may benefit from directors having a duty to act with the necessary care in managing the affairs of the company. This is also the only element of the duty that is universal to all the jurisdictions discussed and it is therefore obvious that it must form part of any formulation of this particular duty of directors.

Directors who act with care, but who are not properly qualified and who do not possess the necessary skills for the position, may still cause a lot of damage. It is therefore secondly submitted that the duty of skill should also be provided for in a formulation of directors’ duty of care and skill.

It is furthermore submitted that these two elements of the duty of care be kept separate,\(^{980}\) in order to avoid any confusion that may result from an intermingling of the requirements of each.

It is also clear that directors must be diligent in the performance of their duties. The duty of diligence may be said to be subsumed by the duty of care, however, which makes an express duty of diligence as part of directors’ duty of care seem unnecessary.\(^ {981}\)

### 6.5.3 Relevant Aspects

#### 6.5.3.1 Required Standard

In the immediately preceding discussion it was suggested that a formulation of directors’ duty of care should contain express reference to the elements of care and skill. The degree of care required from directors and the amount of skill that a director should possess will, however, greatly influence the protection that is afforded to creditors in terms of such a duty.

### 6.5.3.1.1 Duty of Care

\(^{980}\) As was done in the Banks Act. S 60(1A)(c) provides for directors’ duty of skill and s 60(1A)(d) for the duty of care.

\(^{981}\) The duty of diligence is provided for in the Banks Act in the subsection dealing with the duty of care, in that a director is required to display what may reasonably be expected of a diligent person.
As was mentioned already, according to the decision in *Fisheries Development Corporation Ltd v Jorgensen* a largely subjective yardstick is proposed to determine whether a director acted in breach of his duty to act with care. This approach may be criticised for numerous reasons.

In general it may be criticised for being outdated. A subjective yardstick does not relate to the backdrop of the modern commercial world in which directors are “appointed to their positions and paid large...sums of money for the expertise which they assert they can bring to the business”. These principles were also formulated primarily with reference to non-executive directors, or as some would have it “part-time officers, adornments to the corporate Christmas tree” – a perception of directors that is clearly not in line with the role and function of the executive director in the modern corporation.

A purely subjective yardstick is furthermore clearly not in line with developments in other jurisdictions, as well as locally. One must recognise the fact that the jurisdictions discussed in this contribution are all, some to a greater degree than others, moving in the direction of a minimum objective standard when judging director conduct. In South Africa corporate governance guidelines in terms of *King II*, as well as the judiciary’s approach to the interpretation of section 424(1) of the

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982 Supra 166.


984 Gower 433. Also see Farrar & Hannigan *Farrar’s Company Law* (1998) (hereinafter Farrar) 392 who refer to the emphasis placed on corporate governance today, as well as an increasing number of disqualifications in England on grounds of unfitness, which encompasses both incompetence and negligence.

985 Farrar 391.

986 Gower 433 observes that this particular proposition by Romer J in *In re City Equitable Fire Insurance Co Ltd supra* seems to have been formulated with non-executive rather than executive directors in mind.

987 In par 2.3 of Chapter 4 entitled “Role of the Executive and Non-executive Director” of Section 1 of *King II*, it is proposed that executive as well as non-executive directors must “in line with modern trends worldwide, not only exhibit the degree of skill and care as may be reasonably expected from persons of their skill and experience...but must also exercise both the care and skill any reasonable
South African *Companies Act,*\(^{988}\) have opened the door for a more objective standard.\(^{989}\)

With specific regard to the position of corporate creditors, the subjective yardstick may be faulted for being based on the notion of the supremacy of shareholder rights, as well as their perceived role in exercising control over directors. The courts justified their leniency towards directors’ with regard to compliance with their duty of care and skill on the basis that it was shareholders who elected the directors and that they had to live with their decision if they decided to appoint incompetent amateurs. It was also the shareholders who could rectify the situation by removing the directors from office.\(^{990}\)

The reasoning that shareholders appointed the directors and should not bother the courts if the consequences of appointing foolish and incompetent directors are visited upon them is clearly unfair towards corporate creditors. Creditors will have to suffer the consequences of havoc wreaked by foolish and incompetent directors along with shareholders, without having any say in their appointment in the first place.

This basis also presupposes active shareholders. It must be noted, however, that the modern shareholder, be it an individual or an institutional shareholder, is well-known for his apathy and remains largely uninterested in exercising the rights and enforcing the remedies showered upon him.\(^{991}\)

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\(^{988}\) In *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman supra* 143 149 the judiciary made it clear that the alleged “recklessness” of a director for the purposes of this provision should be assessed by using the objective measuring stick of the reasonable person. Subjective elements, such as the fact that the directors are qualified auditors, may play a role in increasing the standard expected of a director.

\(^{989}\) *King II* par 2.3.

\(^{990}\) Farrar 393; Gower 433.

\(^{991}\) See *supra* Ch 2 (Conceptual Justification) par 2.4.5 for more detail.
Even authors who make a strong case in favour of a subjective standard, concede that objectivity is important when creditors’ interests become the focus point.\textsuperscript{992}

A strong case can thus be made for the application of an objective yardstick as a minimum requirement for director conduct. Care must be taken, however, to define the objective yardstick in such a way that it does not infringe upon directors’ risk-taking ability unnecessarily.\textsuperscript{993} It may also prove problematic to define an objective yardstick that will apply to all directors of all companies.\textsuperscript{994}

It is submitted that the above concerns may be addressed through the taking into account of subjective factors in determining directors’ liability for a breach of their duty of care and skill.\textsuperscript{995}

A further question in respect of the standard of care expected of directors, and one that is particularly pertinent for the purposes of this study, is whether the degree of care expected of directors will vary depending on whether the duty is aimed at protecting the interests of shareholders or those of creditors. In practical terms this question addresses the issue of whether directors are to be confronted with two separate duties of care – one that is applicable when the duty is aimed at protection of shareholders’ interests and one that is applicable when the duty is aimed at the protection of creditors’ interests.

\textsuperscript{992} Riley \textit{supra} 700.

\textsuperscript{993} Finch \textit{supra} 202.

\textsuperscript{994} Finch \textit{supra} 203; Trebilcock \textit{supra} 509 – 511.

\textsuperscript{995} This is the approach followed in the statutory statement of the duty of care of directors of banks. S 60(1A)(d) of the \textit{Banks Act} provides that directors are required to exercise the care that may reasonably be expected from a diligent person, indicating an objective yardstick. Subjective factors that are to be considered, however, are the appointment of this person; the particular circumstances; as well as any additional knowledge and skill in addition to the minimum standard required in terms of statute. The statutory statements of the duty in both Australia, in terms of s 180(1) of the Australian \textit{Corporations Act}, and New Zealand, in terms of s 137 of the New Zealand \textit{Companies Act}, enumerate a number of subjective factors that should be considered when assessing director conduct and may serve as valuable guidelines in this regard. For various formulations of the yardstick see Finch \textit{supra} 203 who, apart from her own suggestion, lists those of Romer J in \textit{In re City Equitable Fire Insurance Co Ltd supra}; Trebilcock \textit{supra} 511; and Mackenzie “A Company Director’s Obligations of Care and Skill” 1982 \textit{Journal of Business Law} 460 475 – 476.
This question has to be addressed in the context of directors’ risk-taking ability. It is critical not to lose sight of the fact that corporate growth is achieved by exposing the assets of a corporation to risks. Directors who are forced to be too careful as a result of the sword of personal liability created by a very onerous duty of care constantly hanging over their heads, will be hindered in this task. An attempt must therefore be made at balancing creditors’ aversion to risk and the economic necessity of allowing directors to take risks.

This balance may be achieved by a duty of care formulated in such a way that it is clear that directors’ conduct should be assessed in light of the particular circumstances under which they have to operate. In case of a company that is in a precarious financial position, cognisance should be taken of the fact that directors are taking business risks with what is in effect creditors’ money. Where shareholders’ equity is already extinguished, or on the point of being extinguished, directors should refrain from engaging in very high risk activities in a desperate attempt to save the company. These shareholders, who have already lost everything, clearly will be in favour of directors engaging in such desperate measures, as they have nothing to lose in case of failure, but everything to gain in case of success. Creditors have a lot to lose in case of failure, however, and nothing to gain in case of success.

It is therefore submitted that directors’ ability to take business risks should be curtailed by the fact that a company is not financially sound, providing protection for the interests of creditors who would have become the beneficiaries of directors’ duties upon the company experiencing financial difficulty. This may be achieved through the inclusion of subjective considerations in the formulation of the duty of care once again, which will obviate the need for the formulation of a separate duty of care to creditors.

6.5.3.1.2 Duty of Skill

It was suggested already that the notion that directors are not required to possess any degree of skill or particular knowledge is outdated in light of the position of the

996 See discussion *infra* Ch 7 (Point in Time When the Duty Arises) for more detail on circumstances that would “trigger” the duty to creditors.
director in the modern company. The fact that creditors are exposed to foolish appointments made by shareholders, was also explained. Continued acceptance of the idea that directors do not need any particular skills or knowledge may thus cause immeasurable harm to creditors who did not have the opportunity to protect their interests through the appointment of skillful directors.

It is therefore submitted that directors should possess at least a certain minimum level of knowledge and experience. A problematic aspect in this regard is to determine an acceptable level of skill or knowledge, especially in light of the variety of companies that may have diverse needs.

An acceptable solution may be the formulation of a duty of skill in line with section 60(1A)(c) of the *Banks Act*, in terms of which directors of banks are required to possess and maintain the knowledge and skill that may reasonably be expected of a person holding a similar appointment and carrying out similar functions as the director in question. This formulation, while laying down that a reasonable level of knowledge and experience is required, accepts that the level will differ from director to director, thus allowing for some flexibility.

**6.5.3.2 Distinction Between Executive and Non-executive Directors**

It is accepted in most jurisdictions that the role, position or function of a director should be taken into consideration when determining compliance with his duty of care and skill. To a limited extent the fact that a person is an executive or a non-executive director may be pertinent in determining liability for a breach of the duty of care and skill. It should not lead to a categorisation of duties on the basis of a person holding either the office of executive director or non-executive director.

997 See discussion *supra* par 6.3.1.2.

998 *Supra* par 6.5.3.1.1.

999 See discussion *supra* par 6.2.2 – par 6.2.6.
One is thus inclined to agree with Goldstone J in *Howard v Herrigel* \(^{1000}\) that the distinction between executive and non-executive directors is not particularly helpful in demarcating directors’ duties. \(^{1001}\) This approach is supported as it helps to remove the perception that non-executive directors will not incur liability for breaching their duty of care and skill even if they failed to act in any meaningful way whatsoever. Clinging steadfastly to a distinction between duties based on the mere fact that a director occupied the office of executive or non-executive director may well result in creditors being deprived of a remedy against inert non-executive directors.

It is thus submitted that the distinction drawn between these two categories of directors in terms of *King II* should be regarded as no more than a corporate governance guideline aimed at creating independence of opinion at board level. It should in no way be a conclusive factor in determining the liability of a particular director for breaching his or her duty of care and skill.

### 6.5.3.3 Reliance on Others

One has to agree that commercial reality dictates that directors should be able to delegate to and rely on others if a company is to function properly. \(^{1002}\) Reliance on the opinion of experts is in fact required by *King II* in some instances \(^{1003}\) and is allowed in all the jurisdictions referred to in this study.

Directors should, however, not be able to escape liability for failure to comply with their duty of care by abdicating any of their responsibilities. \(^{1004}\)

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\(^{1000}\) *Supra* 678.

\(^{1001}\) According to Cilliers & Benade *Corporate Law* (2000) par 10.10 n 21 the unique position of non-executive directors should be taken into consideration when determining the extent of their potential liability for a breach of their duties. This discussion is not aimed at denying that principle. The point advanced here is simply that a strict categorisation of duties and potential liability should not take place merely on the holding of the office of executive or non-executive director.

\(^{1002}\) Comerford & Law *supra* 104.

\(^{1003}\) See par 2.3 of Ch 4 of Section 1 in terms of which directors are required to rely on expert advice where necessary and par 2.14 of the same chapter, in terms of which directors must “if in doubt about any aspect of their duties, obtain independent professional advice at the earliest opportunity”.

\(^{1004}\) Baxt *supra* 150 warns against this possibility, as indicated by the title of his contribution.
The issue that needs to be addressed, therefore, is the extent to which directors are entitled to rely on the opinion of or information provided by others and on whom they should be entitled to rely.

In this regard it is submitted that director conduct in this respect should be informed by their general duty of care. Directors who rely on others have to ensure that they act with the necessary care when placing their trust in the opinion of others.

A provision similar to the rebuttable presumption provided for by section 189 of the Australian Corporations Act would seems unnecessary. In terms of general rules of evidence, a person who alleges misconduct carries the burden of proof in respect thereof. This entails that a person alleging unreasonable reliance has to prove this fact. It is therefore submitted that such a provision should not be incorporated in our legislation as it is strictly speaking not necessary.

It also does not seem advisable to include a closed list of persons on whom directors are entitled to rely in a statutory statement of the duty of care and skill as in Australia, New Zealand and Canada. The requirement that directors must act with the necessary care when relying on others is sufficient to ensure that directors are held liable if they delegate to or rely on incompetent persons, or blindly rely on the advice of others.

6.5.4 Consequences of Breach

6.5.4.1 Basis of Liability

1005 Comerford and Law supra 118 provide a set of guidelines to assess whether directors may be held liable for relying on others. Reliance or delegation must, in the first place, be reasonable. In order to determine whether reliance or delegation was reasonable under particular circumstances, a number of factors should be considered, eg the function that has been delegated. A second crucial factor is whether directors were or should have been “put on inquiry”. A director must thirdly subjectively believe in the ability of the person to whom a function was delegated, or on whose opinion was relied. This person must fourthly objectively be capable of performing the function delegated to him. The nature of the transaction is fifthly an element that should be considered. Transactions containing a greater element of risk would be expected to be carried out by the directors themselves, or would require them to take further steps to justify reliance. In the sixth place, mere passive reliance would not exonerate a director from liability. A director would still be required to take certain steps, the extent of which would depend on the circumstances of each case. A last factor that would play a role is the position held by the director.
Chapter 6  Duty of Care and Skill

An action against a director for breach of his duty of care and skill is based in delict. Before a plaintiff can succeed with a claim for damages based in delict, he must prove all the elements of a delict. 1006

In order to be successful with an action based on delict, the plaintiff must prove an act or omission on the part of the directors. 1007 The particular act or omission must furthermore have caused prejudice in a wrongful manner. 1008 Wrongfulness is determined with regard to two questions, namely whether a legally recognised individual interest has been infringed and whether such prejudice occurred in a legally reprehensible or unreasonable manner. 1009 The plaintiff also has to prove that there was intent or negligence on the part of the director who committed the wrongful act or omission. 1010 In order to be successful the plaintiff must also convince the court that he suffered damage, 1011 and that the damage was caused by the wrongful conduct of the directors. 1012

Creditors must therefore prove all of the above elements in order to be successful with a claim for damages against directors for breach of their duty of care and skill. It should not be too difficult to prove the requirements of conduct, damage and fault. The wrongfulness of the act will depend on whether an “individual interest” has been infringed and whether prejudice occurred in a “legally reprehensible manner”.

Since it is suggested that a duty to creditors is mediated through the company, 1013 creditors will not have to show that it was their individual interests that were

1006 Neethling, Potgieter & Visser supra 4 emphasise that there is “no question of a delict and consequently, no liability” if any of these elements is missing.

1007 Neethling, Potgieter & Visser supra 27.

1008 Id 35.

1009 Ibid.

1010 Neethling, Potgieter & Visser supra 119.

1011 Id 211.

1012 Id 173.

1013 See discussion infra Ch 8 (Beneficiary of the Duty) par 8.5.
prejudiced. In order to prove wrongfulness, creditors who suffered as a result of directors breaching the duty of care and skill to the company will have to prove that the company’s interest, defined with reference to the interests of company creditors, has been infringed.

Secondly, creditors will have to show that the prejudice occurred in a “legally reprehensible manner”. The general norm to assess whether infringement was indeed unlawful, is the *boni mores* or legal convictions of the community.\(^{1014}\) The application of this norm entails the *ex post facto* balancing of the interests which the defendant promoted by his act, and those which he infringed.\(^{1015}\) Factors which will influence the balancing process include the nature and extent of the harm; the costs and effort of steps which could have been taken to prevent the loss; the degree of probability of the success of preventative measures; the nature of the relationship between the parties; knowledge on the part of the defendant that his conduct would cause harm; economic considerations, and so forth.\(^{1016}\)

The requirement of wrongfulness may facilitate the extension of directors’ duties to creditors, because the *boni mores* involve the balancing of interests promoted by the defendant against those interests which he infringed. An instance where the balancing test may be used extremely well is, for example, in case of a director who did not comply with his duty of care to the company for failing to consider the interests of creditors, by engaging in extremely risky activities while the company was in a precarious financial position in order to benefit shareholders. The interests of the creditors should be balanced against those of the creditors to establish whether his conduct was reasonable. The way in which the *boni mores* test is applied thus makes the delictual requirement of wrongfulness extremely suitable for extending directors’

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\(^{1014}\) Neethling, Potgieter & Visser *supra* 37 – 38 n 17.

\(^{1015}\) Neethling, Potgieter & Visser 39, with reference to *Coronation Brick (Pty) Ltd v Strachan Construction Co (Pty) Ltd* 1982 4 SA 371 (D) 384.

\(^{1016}\) Neethling, Potgieter & Visser *supra* 40.
duties to creditors, provided that the interests of the company is defined with reference to the interests of creditors.\textsuperscript{1017}

The objective factors to be considered in order to determine reasonableness, for example the cost and effort of steps to prevent the loss; the probability of these being successful; knowledge on the part of the director that his conduct would have caused harm and so forth, also fit well into the context of determining whether a director acted unreasonably towards creditors and should incur liability as a result.

In the case of a director accused of being in breach of the duty of care and skill, the requirement of causation may present a problem, however.\textsuperscript{1018} A codification of directors’ duties, as suggested previously,\textsuperscript{1019} may go some way towards addressing this problem, as director liability for a breach of the duty of care and skill will be based on a statutory provision that does away with the causation requirement.\textsuperscript{1020}

\textbf{6.5.4.2 Suitability of Remedy}

Judicial reluctance to apply an objective standard of reasonable care may be seen as partially resulting from the severity of the available sanctions.\textsuperscript{1021} Remedies that serve as “realistic alternatives to the all-or-nothing approach of current compensatory remedies”, such as injunctive relief, may address this problem.\textsuperscript{1022}

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\textsuperscript{1017} It was already suggested that the interests of the company should be defined in this way upon the duty to creditors being triggered. See discussion \textit{supra} Ch 5 (Protection Afforded by Fiduciary Duties) par 5.5.3.1.

\textsuperscript{1018} \textit{International Shipping Co (Pty) Ltd v Bentley} 1990 1 SA 680 (A), a case dealing with an auditor’s delictual liability toward creditors of a company, provide a good exposition of the requirements of a successful delictual action and is indicative of how the requirement of causation could jeopardise the successful outcome of a case based on the \textit{actio legis Aquiliae}.

\textsuperscript{1019} See discussion \textit{supra} par 6.5.1.

\textsuperscript{1020} Similar to the way in which s 424(1) of the South African \textit{Companies Act} provides for personal liability of directors and others for payment of company debts, without making a causal link between director conduct and their liability a requirement. See discussion \textit{supra} Ch 3 (Evaluation of Alternative Remedies) par 3.2.1 for a more detailed discussion of s 424(1).


\textsuperscript{1022} \textit{Ibid}. 
South African company law does not provide for the same type of injunctive relief as that provided for by section 1324 of the Australian Corporations Act. This is probably because a director in breach of the duty of care and skill will incur delictual liability, and a delictual action requires damages to be proved.

A remedy similar to section 1324 of the Australian Corporations Act may prove valuable in that creditors may prevent directors from continuing to manage a struggling company in a negligent manner, or from taking extremely high risks in a desperate attempt to rescue the company, thus protecting their own interests. The availability of such a remedy in case of a breach of the duty of care and skill is, however, dependent on statutory intervention.

6.5.4.3 Inadequate Information

A practical problem is that directors’ breaches of the duty of care and skill are often discovered when it is too late.\textsuperscript{1023} The first clear sign that the directors have been incompetent will more often than not be the failure of the company.\textsuperscript{1024} It is suggested by some that more emphasis on the principle of disclosure may go some way towards addressing this problem.\textsuperscript{1025}

Creditors’ inability to take preventative action is not the only consequence of a lack of information. They may, in addition, find it difficult to establish that a company’s failure is due to negligence by its directors after the fact. Should creditors be afforded some way of approaching the court in case of a breach of an enhanced duty of care

\textsuperscript{1023} Trebilcock \textit{supra} 512.

\textsuperscript{1024} \textit{Ibid}. Also see Rider \textit{supra} 286 who makes the same observation.

\textsuperscript{1025} Trebilcock \textit{supra} 513. Bidin “Corporate Law, Directors’ Duties and Creditor Protection” (1998) 19 \textit{The Company Lawyer} 188 191 also identifies creditors’ inability to acquire and utilise information from the company as a major hurdle in creditor protection. She conceded that they are entitled to ordinary information from the Registrar of Companies, but found this to be inadequate, as important information relating to possible insolvency is normally obtained at a very late stage. This will make it impossible for creditors to make an effort at taking action to prevent directorial failures or negligent behaviour.
and skill, protection afforded in terms of such a duty may prove to be largely illusory if creditors are not able to discharge their onus of proof.

An important aid in addressing these concerns is the *Promotion of Access to Information Act*. PAIA was enacted for the purpose of giving effect to the constitutional right of access to information by providing for access to information held by the state or another person, where this information is required for the exercise and protection of any rights. The right to access to information is subject to “justifiable limitation, including, but not limited to, limitations aimed at the reasonable protection of privacy, commercial confidentiality and effective, efficient and good governance”.

In terms of PAIA a requester has a right to be given access to any record of a private body if that record is required for the exercise or protection of rights. This provision thus creates the possibility that a creditor of a company will have the right to approach the company for any information, as long as the creditor is able to prove that he requires this information for the exercise or protection of a right.

This provision was interpreted in relation to the right of a shareholder to have access to books of record of a private company in *Davis v Clutchco (Pty) Ltd*. In this case the respondent justified his refusal to comply with the applicant’s request on various grounds. Relevant for the purposes of this study is the fact that the respondent

1026 See infra Ch 8 (Beneficiary of the Duty) par 8.5.3 for further discussion on this point.
1027 Radin *supra* 728 admits that a plaintiff may “have an extremely difficult time obtaining evidence that would prove his allegations…”.
1028 Act 2 of 2002 (hereinafter PAIA).
1030 S 9(a)(i).
1031 S 9(a)(ii).
1032 S 9(b)(i).
1033 S 50(1).
1034 2004 1 SA 75 (C).
Chapter 6  Duty of Care and Skill

averred that the applicant has no “right” as a shareholder to inspect the books of record of the company, as no such right was accorded to shareholders in terms of the Companies Act, at common law or in the respondent’s articles of association.

The court held that a shareholder such as the applicant must be permitted to “obtain access to information in the books of account to safeguard his investment in the company or to ensure that he has knowledge of the value of his shares”\(^{1035}\) and that he has established that the records requested by him are “reasonably required…to verify his concerns about financial mismanagement and take any resultant steps and to protect his investment in the company”\(^{1036}\).

Although this judgment was delivered in respect of the rights of a shareholder requiring particular information, the court’s emphasis on the applicant’s constitutional right to access to information where his interests are not adequately protected in terms of company law, may justify the conclusion that creditors will be afforded the same protection. Creditors, no less than shareholders, should be entitled to safeguard their investments in the company, to verify their concerns about financial mismanagement and to take any resultant steps.

The court’s partial justification of the shareholder’s entitlement to this information on the fact that the South African Companies Act does not provide “an equivalent process to safeguard his proprietary interest in the company”\(^{1037}\) may present a problem to creditors. In terms of traditional company law dogma, shareholders, and not creditors, are regarded as the “owners” of the company, which led to them being afforded numerous rights in respect of control of management, the institution of actions on behalf of the company, and so forth. Should this principle be accepted as correct, creditors will not be entitled to the same rights as shareholders in terms of \(PAIA\).

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\(^{1035}\) Id 86 (own emphasis).

\(^{1036}\) Ibid (own emphasis).

\(^{1037}\) Ibid.
Chapter 6

Duty of Care and Skill

This principle was criticised from a conceptual point of view, however.\textsuperscript{1038} It is furthermore asserted that creditors replace shareholders as primary corporate constituents\textsuperscript{1039} where the duty to creditors is triggered.\textsuperscript{1040} Should this viewpoint be accepted, creditors should be able to access the protection afforded in terms of \textit{PAIA}.\textsuperscript{1041}

The provision of adequate information may also go some way towards enabling creditors to establish whether particular conduct of directors led to the demise of the company and to ascertain when the duty to consider their interests was triggered. This may aid them in discharging their onus of proof.

\textbf{6.5.4.4 Judicial Reluctance}

A last factor that may impede a successful action against negligent directors by creditors, is the judicial reluctance to impose liability on directors who seemingly failed to act with the necessary care and skill. This reluctance may be attributed to a number of factors.

The courts firstly have some difficulty in demarcating directors’ duty of care and skill. Unlike the legal principles of directors’ fiduciary duties, which to a large extent can be based on existing principles derived from other fiduciary relationships,\textsuperscript{1042} no

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\textsuperscript{1038} See discussion \textit{supra} Ch 2 (Conceptual Justification) par 2.4.2 for more detail.
\textsuperscript{1039} See discussion \textit{infra} Ch 8 (Beneficiary of the Duty) par 8.5.
\textsuperscript{1040} See discussion \textit{infra} Ch 7 (Pont in Time When the Duty Arises) for more detail on the circumstances that may give rise to a duty to creditors.
\textsuperscript{1041} The decision of the court \textit{a quo} was, however, subsequently reversed in March 2005 by the Supreme Court of Appeal in \textit{Clutchco} \textit{(Pty) Ltd v Davis} 2005 3 SA 486 (SCA). The Supreme Court of Appeal made reference to measures of the South African \textit{Companies Act} and common law aimed at the protection of shareholders and came to the conclusion that “[t]he machinery established by legislation and the common law for the protection of shareholders is in my opinion not lightly to be disregarded” (\textit{id} par 17). The court decided that the respondent failed to lay a substantial foundation for his case and thus failed to show that the access which he sought was required for the exercise or protection of the rights which he asserted (\textit{id} par 18). It cannot be said with certainty whether creditors will succeed where a shareholder failed. It should be noted, however, that the court reached its decision in light of the plethora of measures in terms of legislation and common law aimed at the protection of shareholders. It is submitted that creditors are not afforded equal protection by the law and should therefore have a better chance with obtaining information in terms of \textit{PAIA}. Only time will tell, however, whether this will indeed be the case.
\textsuperscript{1042} Eg the fiduciary relationship that comes into existence in case of a trust or agency.
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principles existed that could serve as guidelines for the way in which directors’ duty of care and skill should be approached.\textsuperscript{1043}

Reluctance also stem from the fact that directors’ functions entail exposing the assets of the company to calculated economic risks, the prudence of which courts are traditionally loath to judge upon.\textsuperscript{1044}

The courts also held the belief that the appointment of directors was a matter for the shareholders, as was the level of a director’s performance thereafter.\textsuperscript{1045} The courts may even have been hampered by a sense of commercial inadequacy when pronouncing on directors’ business decisions.\textsuperscript{1046}

These factors lead some to note somewhat cynically that it is certainly doubtful “whether any system which would assign a substantial role to the courts could be seriously considered” as “[n]othing in their past record in this field suggests either a capacity or a willingness to discharge such a role”.\textsuperscript{1047}

\textsuperscript{1043} Naude \textit{supra} 154.


\textsuperscript{1045} This sentiment dates back as far as 1812 with the court making its perceived role very clear in Carlen \textit{v} Drury (1812) 1 V & B 154 158, namely that “[t]his Court is not to be required on every Occasion to take the Management of every Playhouse and Brewhouse in the Kingdom”. It is also confirmed in Turquand \textit{v} Marshall \textit{supra} 386 that as long as directors remained within the ambit of their powers, however ridiculous and absurd their conduct might seem, it was the misfortune of the company that they had chosen such foolish directors. No mention is made of the fact that creditors also have to bear the consequences of the shareholders’ appointment. See also Shuttleworth \textit{v} Cox Brothers & Co (Maidenhead) Ltd \textit{supra} 23 – 24 where the court confirmed that “[i]t is not the business of the court to manage the affairs of the company. That is for the shareholders and directors”.

\textsuperscript{1046} Butcher \textit{supra} 37. An illustrative statement in this regard was made by Scrutton LJ in Shuttleworth \textit{v} Cox Brothers & Co (Maidenhead) Ltd \textit{supra} 23 – 24, namely that “I should be sorry to see the court go beyond this and take upon itself the management of concerns which others may understand far better than the court does”.

\textsuperscript{1047} Trebilcock \textit{supra} 515.
Authors in other jurisdictions observed a change in judicial attitude in this regard, however. The dearth of South African cases dealing with directors’ liability for a breach of the duty care and skill makes it difficult to assess whether the same can be said in respect of the local judiciary. The approach of the court in respect of directors’ statutory liability for reckless trading does cast a ray of hope, however, that the courts are assuming a more active role in judging director conduct. A codification of the duty of care and skill as suggested above, providing clearer guidelines in terms of what is expected of directors, as well as guidelines provided in terms of King II, may further advance the courts’ ability and willingness to pronounce on director conduct.

6.6 CONCLUSION

One would think that creditors stand to benefit greatly from an extension of the duty of care and skill to protect their interests. The general discussion on the duty of care and skill revealed numerous shortcomings with regard to the content of the duty of care and skill, as well as the enforcement of the duty, however, that seem to detract from the protection afforded to the interests of creditors by this duty.

With regard to the content of the duty, criticism is levied against the yardstick used to measure directors’ compliance with this duty; the distinction between what is expected of executive and non-executive directors; and the possibility that directors may rely on others to such an extent that they evade their obligations in terms of this duty. Some suggestions were made regarding these problem areas, with the view of increasing the protection that may be afforded in terms of the duty of care and skill.

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1048 See eg Butcher supra 65.

1049 In terms of s 424(1) of the South African Companies Act. See eg the case of Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman supra.

1050 Supra par 6.5.1.

1051 These general shortcomings would obviously also detract from the protection that is offered for the interests of shareholders in terms of the duty of care and skill.
In respect of the yardstick applicable to the duty of care, it is submitted that adherence to a subjective yardstick is outdated and not in line with developments in other jurisdictions, or even developments in other areas of South African law. It is therefore proposed that directors’ conduct should be assessed in an objective manner, namely the care that may reasonably be expected of a director, in order to determine whether they acted with the necessary care in managing the affairs of the company.

It is furthermore submitted that the notion that directors need not have any particular skills, knowledge or experience is not in line with the position of the director in the modern company. The legal principles with regard to the duty of skill should thus be phrased in such a way that it is clear that directors should possess and maintain an acceptable level of skill that is necessary for them to properly fulfil their managerial duties.

Furthermore, inert non-executive directors should not be allowed to escape liability merely because they hold the office of non-executive rather than executive director. Neither should directors be able to evade their obligations or liability in respect of a duty of care and skill by pleading reliance on others. While it is accepted that directors should be able to rely on and delegate to others, it is submitted that the extent of reasonable reliance should be informed by their duty of care, in order to prevent directors from abdicating all responsibility or placing too much faith in incompetent persons.

Insofar as the enforcement of the duty of care and skill is concerned, a number of hurdles were identified that may impede a successful action by creditors. These include the delictual basis of liability in case of a breach of the duty; the fact that the available remedy is limited to damages; a lack of information; and judicial reluctance to pronounce on directors’ business decisions.

It was submitted that a codification of the duty of care and skill may to a large extent address the majority, if not all, of the problems that were identified with regard to the content of the duty, as well as the enforcement of the duty.
With specific reference to the enforcement of the duty of care and skill, it is suggested that a statutory basis for an action will remove the problem that creditors must be able to prove all the elements of delict in order to succeed with an action against negligent directors. Alternative remedies, such as injunctive relief, may also be provided for in terms of statute. Clearer guidelines and a wider variety of remedies may also go some way towards removing some of the reluctance on the part of the judiciary to pronounce on directors’ business decisions. *PALA* may go some way towards addressing the problem of inadequate information available to creditors, provided that creditors are seen as parties who are able to make use of the protection afforded in terms of this Act.

A statutory provision that is properly phrased may, apart from addressing concerns pertaining to the enforcement of a duty of care and skill, also address the problems that were highlighted in respect of the content of this duty.

Care must be taken, however, that a statutory statement of directors’ duty of care and skill is formulated in such a way that it is relevant to a variety of companies functioning with diverse directors under different circumstances. This aim may be achieved by providing for subjective factors that may be taken into consideration when applying an objective yardstick. Examples of subjective considerations are the particular appointment assumed by the director, the functions of the director, as well as the circumstances under which the director is to fulfil his managerial duties.

The inclusion of subjective factors in a codified version of directors’ duty of care and skill may also play a valuable role in that the particular financial circumstances of the company will dictate the degree of risk that directors are permitted to expose corporate assets to, thus obviating the need for a separate duty of care formulated specifically with creditors’ interests in mind.

It is also submitted that a statutory statement should be formulated in such a way that a clear distinction is drawn between directors’ duty of care and their duty of skill, as these are clearly two very different duties with different requirements. A formulation in terms of which these duties are seen as a single concept may intermingle different requirements and confuse the issue.
Sections 60(1A)(c) and 60(1A)(d) of the Banks Act provide a good example of how a duty of care and a duty of skill of company directors may be formulated. A clear distinction is drawn between the duty of care and the duty of skill, objective yardsticks are provided for and the consideration of subjective factors is permitted.

It is therefore submitted that creditors should be entitled to the benefits of a duty of care and skill, be it indirectly through improved managerial competence as a result of higher standards, or directly through a suitable remedy in case of a breach of the duty, especially in light of the fact that alternative remedies are not adequate. Should the legislature decide against the codification of the duty of care and skill, the delictual element of wrongfulness seems to be able to facilitate the extension of directors’ duty of care and skill to creditors.

The benefits rendered by the duty of care and skill in its current guise are seen to be largely illusory, however, and problem areas as identified should be addressed in order to ensure that creditors gain meaningful protection for their interests in this way. It is also submitted that the opportunity of enjoying direct benefits, such a duty should become available to creditors through the inclusion of subjective elements that are to be considered in assessing director compliance with the duty of care, specifically the financial state of the company in question. The duty of care to creditors is thus not seen as a continuous duty, but one that is triggered by the company in question being in financial or economical difficulty. More detail on this particular aspect will be provided in the next chapter.

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1052 With specific reference to s 424(1) of the South African Companies Act. Reasons why this provision is deemed inadequate for the protection of creditors’ interests were discussed in detail supra Ch 3 (Evaluation of Alternative Remedies) par 3.2.1.6.

1053 Infra Ch 7 (Point in Time When the Duty Arises).
CHAPTER 7
POINT IN TIME WHEN THE DUTY ARISES

SUMMARY

7.1 INTRODUCTION
7.2 DEFINING THE TRIGGERS
7.3 FACTORS INFLUENCING PREFERENCE FOR A TRIGGER
7.4 PRACTICAL APPLICATION OF THE TRIGGERS
7.5 CONCLUSION

7.1 INTRODUCTION

Directors’ duty to creditors hinges on the application of some sort of “trigger”. In terms of this construction of the duty, the duty to creditors is not a continuous one, but comes into operation at the occurrence of a specific event or situation related to the company in question being in financial or economic distress.1054

Cases dealing with directors’ duties to creditors indicate that the courts distinguish three broad categories of triggers in respect of the ailing company. These are the fact that the company was insolvent when the impugned transaction took place;1055 the fact that the company in question was neither clearly solvent, nor clearly insolvent, but verging on the

1054 The majority of cases in which directors’ duties to creditors are discussed, seem to indicate that the existence of a duty to creditors is dependent on the company experiencing distress. See discussion supra Ch 4 (Judicial Framework) par 4.3. In a relatively small number of cases, however, eg Ring v Sutton (1980) 5 ACLR 546; Jeffree v NCSC (1989) 15 ACLR 217; In re Day-Nite Carriers Ltd [1975] 1 NZLR 172; In re Avon Chambers Ltd [1978] 2 NZLR 638, the courts went further and recognised a duty to creditors despite the fact that the company was fully solvent at the time of the impugned transaction.

brink of insolvency at the time of the impugned transaction;\textsuperscript{1056} and that a particular course of conduct rendered the company insolvent.\textsuperscript{1057}

Providing clear guidelines regarding the event or situation that will trigger the duty is of great importance for directors and creditors alike. Directors, on the one hand, naturally wish to know to whom they owe their duties in order to prevent liability for non-compliance therewith, while creditors, on the other hand, are anxious to know whether they are entitled to remedies resulting from a breach of directors’ duties.

The question that needs to be answered is therefore which of the categories mentioned above, or combination of them, will be most suitable to indicate that directors are under an obligation to consider creditors’ interests.

Before an answer is given to the above question, it is first of all important to determine how each of the various categories of triggers should be construed. This discussion therefore commences with an attempt at defining the categories of triggers applied by the courts,\textsuperscript{1058} upon which the main arguments that may influence the choice of a trigger are highlighted.\textsuperscript{1059}

\textsuperscript{1056} This trigger was phrased in a number of ways by the courts, eg the fact that the company is near insolvency \textit{(In re New World Alliance Pty Ltd supra 550)}; that solvency is doubtful \textit{(Nicholson v Permakraft [1985] 1 NZLR 242 249; In re Horsley & Weight Ltd [1982] 3 All ER 1045 1056)}; that the company is operating in the vicinity of insolvency \textit{(Credit Lyonnais Bank Netherland NV v Pathe Communications Corporation No 12150, 1991 WL 277613 (Del Ch Dec 30, 1991), reprinted in (1992) 17 Delaware Journal of Corporate Law 1099 1155)}; that there is a real risk of insolvency \textit{(Grove v Flavel (1986) 43 SASR 410 421)}; a threat of insolvency \textit{(Equiticorp Finance Ltd (in liq) v BNZ supra 982)}; or simply that its financial position is precarious or that it is experiencing financial difficulties \textit{(Australian Growth Resources Corporation Pty Ltd v van Reesema (1988) 13 ACLR 261 268 – 271; Chew v The Queen (1991) 4 WAR 395 450; Equitycorp Industries Group Ltd v Attorney-General [1988] 2 NZLR 481 549)}.

\textsuperscript{1057} \textit{Peoples Department Stores (trustee of) Inc v Wise [1998] QJ No 3571 (QSC (Bankruptcy and Insolvency Division)) par 202}.

\textsuperscript{1058} \textit{Infra par 7.2}.

\textsuperscript{1059} \textit{Infra par 7.3}.
Another aspect that needs to be addressed is the *practical effect* that the advent of a trigger may have on directors’ common-law duties. Some regard it as a clear indication that a switch took place from directors having to consider shareholders’ interests in discharging their duties to the company, to having to consider the interests of creditors in discharging their duties to the company. Others, however, provide for the possibility of a dual duty under certain circumstances, with the effect of the trigger being that directors will be under obligation to shareholders and creditors simultaneously, and in varying degrees depending on the exact financial position of the company in question. This aspect is analysed in more detail below.\footnote{1060}{See *infra* par 7.4.}

### 7.2 DEFINING THE TRIGGERS

#### 7.2.1 Insolvency

##### 7.2.1.1 General

Insolvency is normally determined with reference to two possible tests, namely the inability of a company to pay its debts as they become due,\footnote{1061}{Also referred to as “commercial insolvency”; “cash flow insolvency”; or the “equitable insolvency test”.} or the fact that a company has an excess of liabilities over assets.\footnote{1062}{Also referred to as “factual insolvency”; “balance sheet insolvency”; or the “bankruptcy test”.} It has to be established which of these two tests could best be applied to determine directors’ common law liability to creditors for failing to consider their interests, or perhaps even whether both are or neither is suited for this purpose.

Event though there are no judicial guidelines in South Africa as to what is to be understood by “insolvency” specifically in the context of directors’ duties to creditors, there are various sources that the South African judiciary may look to for guidelines in this regard.
Chapter 7

Point in Time When the Duty Arises

The first of these is the opinion of courts in other jurisdictions as to what is to be understood by “insolvency” for the purpose of establishing whether creditors can hold directors liable for failing to take their interests into consideration.

Cases dealing with the interpretation of the statutory provision concerning directors’ statutory personal liability for reckless or fraudulent trading\textsuperscript{1063} may also provide helpful insights as to how the South African judiciary may view “insolvency” for purposes of determining whether directors may incur common liability for failing to consider creditors’ interests.\textsuperscript{1064}

A last possible source of guidelines with regard to the meaning of insolvency are provisions of the South African \textit{Companies Act}, other than section 424(1), specifically aimed at the protection of creditors.\textsuperscript{1065}

\textbf{7.2.1.2 Definition of Insolvency in Cases dealing with Directors’ Duties to Creditors}

\textbf{7.2.1.2.1 Australia}

In Australian cases on the subject, the court determined insolvency with reference to the ability of a company to pay its debts as they become due.\textsuperscript{1066} The Australian judiciary

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\textsuperscript{1063} S 424(1) of the \textit{Companies Act} 61 of 1973 (hereinafter South African \textit{Companies Act}).
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\textsuperscript{1064} In many instances where the court was involved in an interpretation of this particular provision, even though it was sometimes not directly applicable, the question regarding the solvency of the particular company played an important role and pronouncements were made as to what is to be understood by “insolvency”. There are also South African decisions concerning the interpretation of s 344(f) and s 345 of the South African \textit{Companies Act} pertaining to the winding-up of an insolvent company. See Cilliers & Benade \textit{Corporate Law} (2000) par 27.36 – 27.39 and authority there referred to regarding the interpretation of these provisions. This study is not concerned with an acceptable definition of insolvency for the purpose of obtaining a winding-up order, however, but solely for the purpose of determining whether directors are personally liable to creditors. In this regard the courts’ interpretation of “insolvency” for the purposes of determining s 424(1) statutory personal liability thus seems to be a more suitable guideline.
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\textsuperscript{1065} Eg statutory provisions negating the application of common law principles of capital maintenance, ie ss 85-88; 90 of the South African \textit{Companies Act}. Seeing that these common law principles were formulated for the purpose of protecting creditors (see Trevor v Whitworth (1887) 12 App Cas 409 423 – 424), statutory provisions to the effect that they seldom apply contain some other form of creditor protection. See discussion infra par 7.2.1.4.
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also indicated that a company’s balance sheet position, namely whether there is a surplus of assets over liabilities, is not decisive of solvency, thereby enforcing the perception that commercial solvency is paramount when determining whether directors owed duties to creditors under particular circumstances.

7.2.1.2.2 New Zealand

The New Zealand judiciary applied two yardsticks to determine insolvency in cases dealing with directors’ duties to creditors: firstly, the balance sheet test, namely whether the company’s liabilities exceeded its assets and secondly, the criterion of whether the company is able to pay its debts as they become due. The courts are not unanimous, however, as to whether balance sheet solvency is decisive, or whether the two tests should be used together.

7.2.1.2.3 England

The English judiciary’s uncertainty as to which criteria should be used to establish insolvency became obvious from statements made in Brady v Brady. The court first stated that the companies in question were “solvent and possessed of a very comfortable

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1068 This is in line with the definition of insolvency for the purposes of determining whether directors are statutorily liable for insolvent trading in terms of s 588G of the Australian Corporations Act 2001 (hereinafter Australian Corporations Act). Insolvency is defined in terms of s 95A of the Australian Corporations Act, which provides that a company is insolvent if it is unable to pay all its debts, as and when they become due for payment. See supra Ch 3 (Evaluation of Alternative Remedies) par 3.2.2.1 for further discussion of the statutory personal liability of directors for payment of company debts in Australia.

1069 The judgment in In re Lake Tekapo Motor Inn Ltd (in liq) (1987) 3 NZCLC 100,156 100,166; as well as the judgments of Richardson J and of Somers J in Nicholson v Permakraft (NZ) Ltd supra 255 – 256 seem to show support for the viewpoint that balance sheet solvency is decisive. Support for the viewpoint that these two tests should be used in conjunction can be inferred, however, from the judgment of Cooke J in Nicholson v Permakraft (NZ) Ltd supra 249, which was referred to with approval in David Neil and Co Ltd (in rec) v Neil (1986) 3 NZCLC 99,658 99,671; and from the judgment in Hilton International Ltd v Hilton [1989] 1 NZLR 442 475. The New Zealand statutory insolvent trading provisions, s 135 and s 136 of the Companies Act 1993, do not provide any clear guidance in this respect either, as both are applicable at all times and not only when the company is insolvent. See Goddard “Directors’ Liability for Trading While Insolvent: A Critical Review of the New Zealand Regime” in Ramsay Company Directors’ Liability for Insolvent Trading (2000) 186. Statutory guidelines as to the meaning of insolvency, being unnecessary, are therefore not provided. See supra Ch 3 (Evaluation of Alternative Remedies) par 3.2.2.2 for further discussion of directors’ statutory liability for insolvent trading in New Zealand.

1070 [1988] 2 All ER 617.
surplus of assets over liabilities”, thereby indicating that solvency refers to something else than an excess of assets over liabilities. The most obvious possibility that suggests itself is the ability of a company to pay its debts as they become due. Later on, however, the court remarked that the “companies were solvent and able to pay their debts as they fell due without the aid of assets being transferred”, creating the impression that “solvency” does not refer to the ability of a company to pay its debts as they fall due.

7.2.1.2.4 United States of America

The Delaware court expressly addressed the question of what is to be understood by “insolvency” in *Geyer v Ingersoll Publications Co.* The court decided that a duty to creditors arises when the company is “insolvent in fact”. Insolvency in fact is defined with reference to the ability of a company to discharge its debts promptly and to the fact that the company should have an excess of assets over liabilities. The court was very

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1071 Id 630 (own emphasis).

1072 Id 632 (own emphasis).

1073 The statutory English insolvent trading provision (or wrongful trading provision, as it is termed), s 214 of the *Insolvency Act* 1986, provides that directors may incur liability if the company has gone into insolvent liquidation and it appears that the company continued trading after a point in time before the commencement of the winding-up when the director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. Insolvent liquidation for the purposes of s 214 is defined in s 214(6) with reference to the balance sheet test of insolvency, namely whether the company has an excess of liabilities over assets. See *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.2.2.3 for more detail on directors’ statutory personal liability in England. This guideline only provides a definition of insolvency for the purposes of insolvent winding-up, but does not appear especially helpful in providing a definition of insolvency for determining whether a shift in directors’ duties occurred as a result of the insolvency of the company. Cooke and Hicks “Wrongful Trading – Predicting Insolvency” 1993 *Journal of Business Law* 338 furthermore indicate that there is some difficulty in identifying the statutory point in time beyond which trading should not continue, which is the actual point in time that may prove helpful in determining whether a shift in directors’ common-law duties took place.

1074 621 A 2d 784 (Del Ch 1992).

1075 Id 787.

1076 Id 789. The term “insolvency” is not defined under the *Delaware General Corporation Law* Del Code Ann tit 8 (1991) specifically, though various definitions can be found in other legislation. The various statutory definitions of insolvency, each applicable under very specific delineated circumstances, do, however, not provide much assistance in establishing a general guideline on what is to be understood by insolvency for the purpose of determining whether a shift in directors’ duties occurred.
clear on the point that it is not the institution of formal statutory proceedings that triggers the duty.1077

7.2.1.3 Definition of Insolvency in Context of Application of Section 424(1)

7.2.1.3.1 Commercial or Factual Insolvency?

The South African judiciary hold conflicting viewpoints on the meaning of insolvency for the purpose of determining whether directors may be held personally liable for payment of company debts in terms of this provision.1078

In terms of the first viewpoint, solvency should not simply be defined with reference to a company’s ability to discharge its current liabilities, but should be defined in terms of the balance sheet of a company, namely whether there is an excess of assets over liabilities.1079 Acceptance of this viewpoint may create havoc as there are apparently many South African companies functioning quite successfully despite being factually insolvent, because they are primarily funded by loan capital from members.1080

In terms of the second viewpoint notice is taken of this commercial reality, and insolvency, for the purpose of determining directors’ liability for insolvent trading, is

1077 Id 787.
1078 It should be noted that none of the decisions discussed in this section specifically dealt with the question of whether directors incurred liability in terms of s 424(1). In all the cases mentioned the court had to decide whether a compromise between the company and its creditors in terms of s 311 should be sanctioned by it. The court felt that the possible liability of directors in terms of s 424(1) was a factor on which creditors should receive full information, in order to enable them to assess the merits of the proposal in terms of s 311 and alternatives thereto. The meaning of s 424(1) was thus considered in this specific context only insofar as the cases mentioned in this section are concerned.
1079 This viewpoint was reiterated in a number of cases, all of which were decided by Stegmann J, namely Ex parte Lebowa Development Corporation Ltd 1989 3 SA 71 (T) 95 – 97; Ex parte De Villiers: In re MSL Publications (Pty) Ltd (in liq) 1990 4 SA 59 (W) 86; Ex parte De Villiers: In re Carbon Developments (Pty) Ltd (in liq) 1992 2 SA 95 (W) 115.
1080 According to McLennan “Abuse of Limited Liability, Insider Debts and Subordination Agreements” 1993 SALJ 686 689 it is a “notorious fact” that smaller companies, mostly private companies, are financed almost exclusively by loans and that the share capital is often a purely nominal amount. This practice was denounced by Stegman J in Ex parte Lebowa Development Corporation supra 114, who described it as a “social evil”.
defined with reference to the inability of a company to pay its debts as they become due and payable.\textsuperscript{1081}

The second definition of insolvency was finally endorsed by the Supreme Court of Appeal\textsuperscript{1082} in \textit{Ex parte De Villiers: In re Carbon Developments (Pty) Ltd (in liq)},\textsuperscript{1083} the court being very clear on the point that “the mere carrying on of business by directors does not constitute an implied representation to those with whom they do business that the assets of their company exceed its liabilities” and that it in fact constitutes “no more than that the company will be able to pay its debts when they fall due”.\textsuperscript{1084}

This difference of opinion may rightly be attributed to the age-old problem of conflict between theory-based legal principles and the realities of the market place.\textsuperscript{1085} The former approach, although attractive from a moral and legal theoretical perspective, may upset accepted commercial practices.\textsuperscript{1086} The Appellate Division’s preference for the second approach, as indicated by \textit{Ex parte De Villiers: In re Carbon Developments (Pty) Ltd (in liq)},\textsuperscript{1087} is based on its acceptance of the existing commercial practice and concern for detrimental consequences that may result from interference.\textsuperscript{1088}

\textsuperscript{1081} \textit{Ex parte Strydom: In re Central Plumbing Works (Natal) (Pty) Ltd; Ex parte Spendiff: In re Candida Footwear Manufacturers (Pty) Ltd; Ex parte Spendiff: In re Jerseytex (Pty) Ltd 1988 1 SA 616 (D) 623; Cooper v A & G Fashions (Pty) Ltd; Ex parte Millman 1991 4 SA 204 (C) 207.}

\textsuperscript{1082} Or the Appellate Division of the Supreme Court as it was known at the time of the judgment.

\textsuperscript{1083} 1993 1 SA 493 (A).

\textsuperscript{1084} \textit{Id} 504 E. This decision was followed in other cases. See eg \textit{Ozinsky v Lloyd 1995 2 SA 915 (A) 919; Lordan v Dusky Dawn Investments (Pty) Ltd (in liq) 1998 4 SA 519 (SE) 526.}

\textsuperscript{1085} As noted by De Koker \textit{Die Roekelose en Bedrieglike Dryf van Besigheid in die Suid-Afrikaanse Maatskappyreg} LLD UOVS (1996) 59.

\textsuperscript{1086} De Koker \textit{supra} 60.

\textsuperscript{1087} \textit{Supra.}

\textsuperscript{1088} De Koker \textit{supra} 60.
Chapter 7

Point in Time When the Duty Arises

This does not mean, however, that the potential danger for creditors created by this practice, as identified by proponents of the former approach, is non-existent or unimportant. Some mechanism should therefore be put in place to improve protection of creditors’ interests under such circumstances. Debt subordination may play a valuable role in this regard.

7.2.1.3.2 Debt Subordination

The fact that a company is funded by loan capital from insiders, resulting in its factual insolvency, should not present serious problems while it is operating successfully and is able to discharge its debts as they become due. It does, however, become problematic should the company ever be wound-up because of its inability to pay its debts. Insider-creditors will then compete with external creditors for limited funds. This situation may be prevented by insider-creditors agreeing to defer their claims under such circumstances in terms of a debt subordination agreement, also known as back ranking of debts.

Subordination of insider debt may thus be seen as a way to reconcile the objectives of the two approaches mentioned above. Companies will still be permitted to trade while factually insolvent because of primarily being funded by insider loans, while creditors will be protected to an extent in that external creditors will not have to compete with insider creditors for limited funds should a company that is funded in this way become insolvent.

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1089 Ibid.


1091 Supra par 7.2.1.3.1.
However, South African law does not currently provide for the obligatory subordination of debt in any way. Subordination of debt will thus only occur if a specific agreement to that effect is concluded.\textsuperscript{1092}

It may be asked whether subordination of debt should not automatically take place in companies that are under-capitalised; and how automatic subordination would impact on insolvency as a trigger for a duty to creditors.

In the United States of America, where the doctrine of equitable subordination is formally recognised, the automatic subordination of debts in under-capitalised companies was rejected.\textsuperscript{1093} Subordination of debt is thus subject to the courts’ discretion in bankruptcy proceedings to order that the claims of certain creditors not be paid until all or some of the other creditors are completely paid.\textsuperscript{1094}

The fact that automatic subordination is rejected in a jurisdiction where subordination is formally recognised and applied, does make one weary of blindly suggesting that the South African legislature should provide for automatic subordination in companies that are under-capitalized. In light of the fact that creditors of under-capitalized companies are extremely vulnerable, and that arguments against automatic subordination were not all that convincing,\textsuperscript{1095} it is submitted, however, that automatic subordination of insider

\textsuperscript{1092} Subordination agreements are not regulated in terms of South African law in any way either. This issue needs to be addressed. See McLennan \textit{supra} 705 – 710 regarding proposals for reform in this regard.

\textsuperscript{1093} See Clark \textit{Corporate Law} (1986) 69 – 71 for reasons why the automatic subordination of debt in companies that are inadequately capitalized was rejected in the USA, as well as his reasons for not regarding these arguments as convincing. He concludes, however, that a conservative approach to subordination is defensible for the reason that the benefits to be expected from automatic subordination are conjectural and that automatic subordination would imperfectly implement the principles behind fraudulent conveyance law, as it may lead to inadequate correction or overcorrection of transactions that are unfair.

\textsuperscript{1094} Ie equitable subordination rather than automatic subordination.

\textsuperscript{1095} Clark \textit{supra} 69 – 71.
loans in companies that are primarily funded by such loans, should be regulated statutorily if the company is wound up due to its inability to pay its debts.\textsuperscript{1096}

A second question that needs to be answered in respect of debt subordination – whether it be equitable or automatic subordination – is the extent to which insider debts should be subordinated.\textsuperscript{1097}

In this regard a distinction can be made drawn “full” or “blanket subordination”, in terms of which all insider debts are subordinated to outsider debts, or “constructive distribution”, in terms of which creditors are only compensated for the portion of loss in the value of their claims against the company proximately caused by under-capitalization.\textsuperscript{1098} The latter may prove to be too difficult to achieve in most cases, which would mean that one is in effect forced to use blanket subordination.\textsuperscript{1099}

\textbf{7.2.1.4 Definition of Insolvency in Other Statutory Measures Aimed at the Protection of Creditors}

Another possibility is that the South African judiciary, if confronted with a case dealing with directors’ duties to creditors, may rely on statutory measures aimed at the protection of creditors when defining insolvency as a trigger for the duty to creditors.

The statutory protection mechanisms referred to entail that a company may not acquire its own shares;\textsuperscript{1100} provide financial assistance for the acquisition of its own shares;\textsuperscript{1101} make

\begin{flushleft}
\begin{enumerate}
\item A potential negative consequence of statutory subordination of insider loans on insolvent winding-up is that the position of insider creditors is seen to resemble that of shareholders so closely that the distinction is disregarded for tax purposes, resulting in interest on these loans not to be deductible. One can only hope that the suggested measure for protection of creditors’ interests will not be dealt such a blow.
\item Clark supra 68 distinguishes between two possibilities, namely full or blanket subordination, or constructive distribution, in terms of which creditors are only compensated for the portion of the loss in value of their claim against the company proximately caused by under-capitalization.
\item Ibid.
\item Ibid.
\item S 85 of the South African \textit{Companies Act}.
\end{enumerate}
\end{flushleft}
payments to its members, or acquire shares in its holding company, unless it complies with what is commonly referred to as the solvency criterion and the liquidity criterion. In terms of these criteria a company is only allowed to engage in the above type of activities if there are reasonable grounds for believing that the company is, or would after the transaction be, able to pay its debts as they become due in the ordinary course of business and if the consolidated assets of the company fairly valued would after the payment exceed the consolidated liabilities of the company.

Should the above criteria be accepted as guidelines, it may very well mean that directors will only be exempt from having to consider creditors’ interests in discharging their duties to the company if the company is able to maintain both factual and commercial solvency.

### 7.2.1.5 Suggested Definition of Insolvency

#### 7.2.1.5.1 Balance Sheet and/or Commercial Insolvency?

Decisions in which insolvency was recognised as a trigger for the duty revealed that the courts, even in the same jurisdiction, are not always unanimous regarding the test to be applied for determining insolvency. The Australian judiciary is the most consistent in this respect, indicating a preference for commercial insolvency. The reason for this, however, may lie in the fact that this reasoning is in line with the statutory definition of insolvency in that jurisdiction. Courts in other jurisdictions were not so consistent in their preference of a particular test. The impression created by decisions in other

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1101 S 38(2)(d) of the South African *Companies Act*.

1102 S 90 of the South African *Companies Act*.

1103 S 89 of the South African *Companies Act*.

1104 See Cilliers & Benade *supra* par 20.09.

1105 S 85(4)(a); s 90(2)(a) of the South African *Companies Act*.

1106 S 85(4)(b); s 90(2)(b) of the South African *Companies Act*.

1107 S 95A of the Australian *Corporations Act* provides that a company is insolvent if it is unable to pay all its debts, as and when they become due for payment.
Chapter 7  

Point in Time When the Duty Arises

jurisdictions is that both factual and commercial insolvency are deemed to put creditors’ interests at risk.

In a South African context, it is submitted that either balance sheet insolvency or commercial insolvency should indicate that directors are under obligation to consider the interests of creditors in discharging their duties to the company. Two reasons may be advanced for this submission.

The first is that statutory measures in South African company law specifically aimed at the protection of creditors require a company to comply with both the solvency and liquidity criterion before it may engage in particular actions. This seems to indicate that the advent of both factual and commercial insolvency is regarded as placing creditors at risk.

The second is that one test should not be preferred to another on the basis that it is perceived to be clearer or less problematic, as both tests for insolvency have their own particular problems.

In case of the balance sheet test for insolvency, for example, one is confronted with difficulties such as the lack of clarity regarding the appropriate method of valuing corporate assets and liabilities. Uncertainty also exists as to how companies that are

1108 Authors hold differing viewpoints as to which test should be applicable. Keay “The Director’s Duty to Take Into Account the Interests of Company Creditors: When Is It Triggered?” (2001) 25 Melbourne University Law Review 315 (hereinafter Keay Directors’ Duty to Creditors: Trigger) 324 proposes that the cash-flow test for insolvency be applied in Australia, as this definition is statutorily endorsed in terms of s 95A(1) of the Australian Corporations Act. For support that either test could be applicable, see Millner “What Does it Mean for Directors of Financially Troubled Corporations to Have Fiduciary Duties to Creditors?” (2000) 9 Journal of Bankruptcy Law and Practice 201 219, who emphasises that insolvency in both the balance sheet and equity sense (ie commercial insolvency) has the effect that creditors are at risk of non-payment; as well as Riley “Directors’ Duties and the Interests of Creditors” (1989) 10 The Company Lawyer 87 89.

1109 S 85(4), 90 and 38(2)(d) of the South African Companies Act; see discussion supra par 7.2.1.4.

1110 Rao, Sokolow & White “Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially Distressed Firm” (1996) 22 The Journal of Corporation Law 63 identify the
factually insolvent because they are primarily funded by loan capital should be treated. Apart from these difficulties, balance sheet insolvency may be difficult to establish if there was a failure to keep proper financial records.\footnote{A provision similar to s 588E(4) of the Australian \textit{Corporations Act}, in terms of which a company is presumed to be insolvent if it has failed to keep financial records (s 588E(4)(a)), or if it has failed to retain financial records for a seven year period (s 588E(4)(b)), may go some way towards addressing this problem.}

Criticism has also been levied at the commercial insolvency test for being vague\footnote{Milman “Test of Commercial Solvency Rejected” (1983) 4 \textit{The Company Lawyer} 231 232; Stilson “Re-examining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors’ Duties to Creditors” (1995) 20 \textit{Delaware Journal of Corporate Law} 1 113.} and for being imprecise insofar as it is used to establish whether a company is insolvent on any particular day.\footnote{Riley \textit{supra} 88. This point of criticism is equally applicable to balance sheet insolvency, as it is possible for companies to fluctuate from being solvent to being insolvent and back again from day to day.}

\subsection*{7.2.1.5.2 Objective Test}

Establishing the liability of directors of insolvent companies for failing to consider the interests of creditors may be complicated if knowledge of insolvency on the part of the directors is required. The introduction of any notion of knowledge as an absolute requirement may have the effect that “the duty may well be tantamount to useless on many occasions”.\footnote{Keay \textit{Directors’ Duty to Creditors: Trigger} 325.} A possible solution is that an objective element should be introduced, namely \textit{ought} the director to have known that the company was insolvent.\footnote{\textit{Ibid}. The introduction of an objective element is also advocated by authors such as McDonnell “\textit{Geyer v Ingersoll Publications Co: Insolvency Shifts Directors’ Burden from Shareholders to Creditors}” (1994) 19 \textit{Delaware Journal of Corporate Law} 177 208; Ziegel “Directors’ Fiduciary Obligation to Creditors: A Re-examination” 334 335 in Queen’s Annual Business Law Symposium 1995 \textit{Corporate Restructurings and Insolvencies: Issues and Perspectives} (1996); and Cohen “Directors’ Negligence Liability to Creditors: A Comparative and Critical View” \textit{The Journal of Corporation Law} 351 391.}
Chapter 7

Point in Time When the Duty Arises

This approach would be in line with pronouncements made by the court in this respect\textsuperscript{1116} and it may have the added advantage of encouraging directors to take time and obtain assistance to establish the financial state of affairs in their companies. This in turn may mean that they will discover the plight of the company early enough to be able to do something about it.\textsuperscript{1117}

7.2.1.5.3 Under-capitalized Companies and Debt Subordination

Should factual insolvency as a trigger for a duty to creditors be accepted, it is submitted that insider debts that are subordinated should be disregarded when the solvency of a company that is primarily funded by insider loans is determined. It is furthermore submitted that only those debts that are automatically subordinated, or subordinated in terms of an agreement, may be disregarded in this respect. The doctrine of equitable subordination cannot serve a similar function for disregarding debts for the purpose of establishing whether a duty to creditors is triggered, as it will only be certain at the date of the court ruling whether debts are subordinated or not.

7.2.1.5.4 Insolvency in Fact

The decision by the Delaware court in \textit{Geyer v Ingersoll Publications Co}\textsuperscript{1118} that insolvency refers to “insolvency in fact”\textsuperscript{1119} and not the institution of statutory proceedings is supported.\textsuperscript{1120}

Even though it may be argued that the institution of statutory proceedings could definitely be regarded as a “bright line of demarcation”,\textsuperscript{1121} providing both directors and creditors

\textsuperscript{1116} An objective test was introduced in \textit{In re Horsley & Weight Ltd supra} 1056. This objective test, namely whether the directors should have known, or ought to have appreciated that their conduct would cause loss to creditors or threaten the continued existence of the company, was referred to with approval by Cooke J in \textit{Nicholson v Permakraft (NZ) Ltd supra} 250 and in the Canadian case of \textit{Peoples Department Stores Inc (trustee of) v Wise supra} par 192.

\textsuperscript{1117} Keay \textit{Directors’ Duty to Creditors: Trigger} 326.

\textsuperscript{1118} Supra.

\textsuperscript{1119} Id 787.

\textsuperscript{1120} This viewpoint is also supported by authors such as Ziegel “Creditors as Corporate Stakeholders: The Quiet Revolution – An Anglo-Canadian Perspective” (1993) 43 \textit{University of Toronto Law Journal} 511 530.

262
with a clear indication that creditors’ interests are paramount, defining “insolvency” in this way will be contrary to generally accepted views of what constitutes “insolvency”.  

Another reason for supporting this decision is related to its application in a South African context. If the definition of insolvency as the institution of statutory proceedings were accepted, directors will only be under obligation to consider the interests of creditors once formal insolvent winding-up procedures have commenced, or once a company have been placed under judicial management. In both instances directors would have been divested of control of the company and requiring them to consider the interests of creditors at that particular stage would seem rather pointless.

The third and final reason for supporting this conclusion is related to the protection afforded to creditors in terms of a duty owed to them. Case law showed that creditors’ interests were prejudiced by actions on the part of directors that took place before statutory proceedings were instituted. If a managerial duty to creditors were limited to actions of directors after the institution of statutory proceedings, creditors would in many instances be left without the remedy envisaged in terms of such a duty. In order to provide the best possible remedy to creditors by way of a managerial duty, it is therefore necessary to recognise that this duty arises before the institution of statutory proceedings.


1122 A point that was made in Geyer v Ingersoll Publications Co supra 789.

1123 In terms of s 361(1) of the South African Companies Act a winding-up by court results in property of the company being under control of the Master until the appointment of a provisional liquidator, effectively taking control away from the directors. S 429 of the South African Companies Act contains similar directives in respect of a company placed under judicial management. Cf the position in, eg, the USA and Canada where directors retain their positions under a supervised reorganisation under Ch 11 of the US Bankruptcy Code 11 USC ss 101 – 1330 (1994).
7.2.2 “Doubtful Solvency”

7.2.2.1 General

This phrase refers to the stage in a company’s existence where it is not yet clearly insolvent, but where it is approaching insolvency, or where there is likelihood that it may become insolvent.\(^{1124}\)

It proved problematic to provide insolvency with an exact meaning and the case is even more so in respect of “doubtful solvency”. Even the courts were hesitant to pinpoint an exact stage prior to actual insolvency at which creditors interests should become paramount.\(^{1125}\)

It is imperative, however, that some guidelines are provided regarding the meaning of this phrase if it is to be considered as a trigger for the duty to creditors.

7.2.2.2 Definitions and Guidelines Provided by Commentators

There are two possible interpretations of the trigger specifically applied in *Credit Lyonnais Bank Netherland, NV v Pathe Communications*,\(^{1126}\) namely “vicinity of insolvency”.

In terms of the first interpretation of the phrase “vicinity of insolvency”, it is not the company’s closeness to insolvency that is relevant, but rather whether, under the circumstances, the “contemplated action would *cause* insolvency, meaning that insolvency is one of the reasonably expected outcomes”.\(^{1127}\) This particular interpretation of “vicinity of insolvency” thus seems to link this category of triggers to the third, namely

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\(^{1124}\) This trigger is phrased in a number of ways by the courts in the various jurisdictions. See *supra* n 3.

\(^{1125}\) In *Kinsela v Russell Kinsela Pty Ltd (in liq)* *supra* 733 Street CJ said: “I hesitate to attempt to formulate a general test of the degree of financial instability which would impose upon directors an obligation to consider the interests of creditors.”

\(^{1126}\) *Supra*.

\(^{1127}\) Schwarz “Rethinking a Corporation’s Obligations to Creditors” (1996) 17 *Cardozo Law Review* 647 672 (own emphasis).
“actions causing insolvency”. This conclusion is supported by a summary of the position, namely that directors of insolvent companies are under obligation to creditors, as well as directors “whose actions have a reasonable expectation of resulting in insolvency”.1128

The practical application of this interpretation thus appears to be that the directors of a company on the verge of insolvency are only regarded as being under obligation to consider the interests of creditors insofar as their conduct or actions may actually cause the eventual insolvency of the company. They will therefore escape liability for other actions infringing on creditors’ interests, as long as these actions did not actually cause the insolvency of the company.

According to the second interpretation a company is in the “vicinity of insolvency” if it is close to insolvency without being clearly insolvent.1129

It is submitted that the first viewpoint with regard to this category of triggers is not acceptable. Concerns in this regard may best be illustrated by way of the following hypothetical scenario:

The directors of a company are aware of the fact that the company is experiencing financial difficulties, or in the “vicinity of insolvency”, although not clearly insolvent. The company is overdue on payment of some accounts, but in general manages to keep most of its creditors satisfied. Among the many liabilities of the company is an overdraft facility with a bank, for which the directors stood surety in their personal capacities. The

1128 Id 678.

1129 Jelisavcic “A Safe Harbor Proposal to Define the Limits of Directors’ Fiduciary Duty to Creditors in the ‘Vicinity of Insolvency’: Credit Lyonnais v Pathe” (1992) 18 Journal of Corporation Law 145 164. Jelisavcic suggests the application of failure predictive models to aid directors in determining objectively how close a company is to solvency. An analysis of these models is provided id 164 – 172. In light of the fact that companies are very diverse and that the degree of risk that they are exposed to may vary to a large degree, the practical use of these models is uncertain.
directors hope to rescue the company, but realise the greater likelihood of it going into insolvent winding-up.

In order to be on the safe side, they decide to slow down payment of other debts and use all available monies to clear the overdraft with the bank. Nine months later the company is wound-up due to its inability to pay its debts. The directors congratulate themselves on their own foresight, without which they would have been personally liable for repayment of the overdraft that they managed to reduce in the meanwhile. As a result of their decision there is little left, or less than what should have been left, for the other creditors of the company.1130

Should the first interpretation of “vicinity of insolvency” be adopted, it would entail that the directors of the above company would not be liable to creditors, as the conduct of the directors did not actually push the company over the brink of insolvency. Their conduct simply came down to preferring their own interests under circumstances where the company was close to insolvency. The near proximity to insolvency is, however, deemed to be irrelevant.1131

Should “doubtful solvency” simply be defined as a “reasonable expectation of insolvency”, however, the creditors in the above example would not have been left without a remedy in terms of directors’ duty to them. The reasonableness of the expectation of insolvency may furthermore be determined at the hand of failure predictive models.1132

1130 Traditional insolvency law remedies, ie principles pertaining to voidable dispositions, are not available under these circumstances, as was indicated supra Ch 3 (Evaluation of Alternative Remedies) par 3.3.

1131 Schwarz supra 672 specifically states that [i]t is not the corporation’s closeness to insolvency that is relevant”.

1132 As proposed by Jelisavcic supra 164. Much has been written on tools that may be applied in this regard; see eg Belcher “Predicting Company Failure” (1991) 7 Insolvency Law & Practice 64; Hall “Predicting Financial Distress” (2002) 56 Journal of Financial Service of Professionals 12; and Gibbons & Grenier “Identifying the Danger Signals: The Unified Approach” (1981) 86 Commercial Law Journal 495.
7.2.2.3 Suggested Definition of “Doubtful Solvency”

Defining “doubtful solvency” as a “reasonable expectation” of insolvency that may result in the winding-up of the company, without any reference as to whether particular conduct in fact caused the eventual insolvency of the company, seems preferable. It will safeguard creditors’ interests in cases of a breach of duty of care by directors, as well as a breach of fiduciary duties.

The fact that it is defined as a reasonable expectation of insolvency will be indicative of an objective test. Directors’ subjective belief in the continued success of the company will thus not be relevant, insofar as this belief is not supported by surrounding circumstances. Defining “doubtful solvency” with reference to the reasonable foreseeability of the eventual demise of the company will also not be a concept that is foreign to South African law.

7.2.3 “Actions Causing Insolvency”

7.2.3.1 General

The scenario envisaged by this trigger is a solvent company becoming insolvent as a result of the fact that directors did not comply with their fiduciary duties or duty to act with care and skill. The financial situation of the company before the impugned transaction, or before the directors embarked on a particular course of conduct, will thus have to be compared with the financial situation of the company after the impugned transaction, or after the effect of the course of conduct embarked upon by the directors, can be assessed. If the company was solvent prior to the transaction, business venture, or

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1133 The test that is applied to determine liability for negligent misrepresentation regarding ability to repay a debt as discussed by De Koker supra 61 seems similar to an extent. De Koker explains that a debtor negligently misrepresents his ability to repay a debt where the debtor, at the time of conclusion of the contract, honestly believes that he will be able to repay the debt. The debtor is so unreasonably optimistic in this belief, however, that it comes down to nothing but mere hope. De Koker indicates that the debtor’s subjective belief should comprise more than mere hope and that there should be grounds for this belief.

1134 In terms of s 197B of the Labour Relations Act 66 of 1995, as amended by s 50 of the Labour Relations Amendment Act 12 of 2002, certain duties are placed on an employer that is “facing financial difficulties that may reasonably result in the winding-up or sequestration of the employer”.

267
implementation of a new policy, but insolvent thereafter,\textsuperscript{1135} the directors may incur liability to creditors of the company.

\textbf{7.2.3.2 Suggested Formulation of “Actions Causing Insolvency”}

This formulation of the trigger will therefore entail that creditors will have to prove a number of elements in order successfully to hold directors liable. These elements include the fact that the company in question is insolvent; and that the insolvency of the company resulted directly from particular conduct of the directors, namely the fact that they did not comply with their fiduciary duties, or their duty to act with care and skill.

\textbf{7.3 FACTORS INFLUENCING PREFERENCE FOR A TRIGGER}

\textbf{7.3.1 General}

A preference for a particular trigger for the duty to creditors may be determined by a number of factors such as the need for precision; the effect that a duty to creditors will have on directors’ risk-taking ability; directors’ reaction to such a duty; a possible increase in cost; and the perceived reluctance of the judiciary to pass judgment on business decisions. In the choice of a trigger one should also take into consideration whether a trigger may be reconciled with a conceptual justification for a duty to creditors.\textsuperscript{1136}

The importance and effect of these factors must be assessed before a conclusion can be drawn as to which trigger or triggers will best serve to indicate that a shift in directors’ duties has occurred.

\textsuperscript{1135} It is clear that, in order to establish director liability in terms of this trigger, the precise meaning of “insolvency” is once again very important. There seems to be no apparent reason why the meaning of insolvency as proposed \textit{supra} par 7.2.1.5 may not be applied in this instance also.

\textsuperscript{1136} As was discussed \textit{supra} Ch 2 (Conceptual Justification).
Chapter 7  
Point in Time When the Duty Arises

7.3.2 Need for Precision

Many authors emphasise the need for precision in their choice of a trigger.\textsuperscript{1137} The apparent importance of certainty or precision lies in the perception that it may temper concerns regarding the effect that a duty to creditors will have on directors’ risk-taking ability and so forth.

Those who base their preference on the need for precision seem to favour triggers which can be determined on the basis of the company’s actual state of solvency, namely “insolvency”\textsuperscript{1138} and “actions causing insolvency”.\textsuperscript{1139} These triggers are regarded as more capable of providing certainty as a trigger such as “doubtful solvency”.

It is debatable, however, whether these triggers do satisfy the need for precision, as an attempt at providing a clear definition of insolvency showed that there is much uncertainty regarding the actual meaning of insolvency.\textsuperscript{1140}

A further difficulty with regard to the application of triggers that are related to the company’s actual state of solvency, is the fact that a company may move in and out of insolvency as its fortunes fluctuate, making it very difficult to establish whose interests directors should consider in discharging their obligations to the company.\textsuperscript{1141}

\begin{itemize}
  \item \textsuperscript{1137}See eg Barnett \textit{supra} 449; Cohen \textit{supra} 379; Jelisavcic \textit{supra} 159; Keay \textit{Directors’ Duty to Creditors: Trigger} 333; Schwarz \textit{supra} 671; Tompkins “Directors’ Duties to Corporate Creditors: Delaware and the Insolvency Exception” (1993) 47 \textit{Southern Methodist University Law Review} 165 190.
  \item \textsuperscript{1138}Cohen \textit{supra} 379 justifies support for insolvency as a trigger “in order to avoid the difficulty and ambiguity of dating insolvency vicinities”; also see Nicholson “Recent Delaware Case Law Regarding Directors’ Duties to Bondholders” (1994) 19 \textit{Delaware Journal of Corporate Law} 573 591.
  \item \textsuperscript{1139}Keay \textit{Directors’ Duty to Creditors: Trigger} 334.
  \item \textsuperscript{1140}\textit{Supra} par 7.2.1.
  \item \textsuperscript{1141}Sealy “Directors’ Wider Duties – Problems Conceptual, Practical and Procedural” (1987) 13 \textit{Monash University Law Review} 164 179. In a response to Sealy’s concern Keay \textit{Directors’ Duty to Creditors: Trigger} 324 notes that this is exactly the type of company whose affairs should be run with consideration for the creditors’ interests; it is likely to collapse without warning and that this might be a good reason for having a less definite point at which the duty is triggered.
\end{itemize}
Chapter 7

Point in Time When the Duty Arises

The argument that “insolvency” and “actions causing insolvency” are infinitely preferable to a trigger such as “doubtful solvency” due to the fact that they answer the need for precision, thus seems to be unfounded.

The preference for “insolvency” or “actions causing insolvency” as triggers for the duty is not only based on the perceived preciseness of these concepts, but also on the fact that “doubtful solvency” is regarded as vague, ambiguous and uncertain.

As was indicated, “doubtful solvency” is not incapable of definition. A general positive attitude to doubtful solvency as a trigger for the duty to creditors may also be gathered from comments to the effect that company law can adjust to accept the notion of a duty to take account of creditors’ interests under such circumstances and that one would expect a reasonable director to know “doubtful solvency” when he sees it. It is furthermore possible to establish the vicinity of insolvency by making use of models that were developed to predict the insolvency of the company. This concept is also not foreign to South African law.

7.3.3 Need for Risk-taking

It is feared that the application of “doubtful solvency” as a trigger for the duty will have a very adverse effect on the risk-taking ability of directors. The concern in this regard is that directors may be held responsible for actions that they do not perceive as erroneous,

1142 Supra par 7.2.2.

1143 Sealy supra 188. He qualifies this positive stance, however, by recognising that such an adjustment will be dependent on the willingness of the court to accept a more “interventionist role” and to review directors’ commercial and policy decisions.

1144 Rao, Sokolow & White supra 64 n 78.

1145 With reference to a model developed by Altman in a long line of articles, cited by Jelisavcic supra 167 n 166, who also provides a concise summary of the model. See id 170 – 172.

1146 See s 197B of the Labour Relations Act supra.
especially under circumstances where the company is operating at or on the brink of insolvency.\textsuperscript{1147}

Matters are worsened by the fact that a director may not even know at what point his primary duty is for the benefit of creditors, rather than of shareholders.\textsuperscript{1148} The undesirable result that may follow is that directors “may feel constrained to make overly-conservative decisions when they are unsure whether their corporation is in the ‘vicinity of insolvency’”.\textsuperscript{1149}

The same argument may be applied in respect of “actions causing insolvency” as a trigger for the duty. Since the trigger “actions causing insolvency” seems to be more suited to cases in which creditors seek to hold directors liable based on a breach of duty of care, rather than a breach of fiduciary duties,\textsuperscript{1150} an obvious point of criticism against it relates to the effect that it may have on directors’ risk-taking ability. Directors operating under the continuous threat of personal liability, should the company become insolvent, will in all probability prove to be very risk averse.

It may thus be argued that insolvency will go further in promoting directors’ risk-taking ability than any of the other categories of triggers. Acceptance thereof as a trigger for the duty will entail that directors may embark on high-risk business ventures without having to worry unduly about the interests of creditors. It is only once the company in question is clearly insolvent that directors should reconsider embarking on any further risky courses of action.

\textsuperscript{1147} Rao, Sokolow & White \textit{supra} 66.

\textsuperscript{1148} \textit{Ibid.}

\textsuperscript{1149} Jelisavcic \textit{supra} 159.

\textsuperscript{1150} Although it is not inconceivable that a breach of fiduciary duties may also render the company insolvent, it seems more likely that a breach of duty of care will give rise to liability to creditors under these circumstances, as was indicated in \textit{Peoples Department Stores Inc (trustee of) v Wise \textit{supra}}, the case in which this trigger was applied.
One’s outlook regarding this aspect depends to a large extent on the premium that is placed on directors’ risk-taking ability. It is inevitable that some measure of risk-taking ability will be sacrificed should the protection of creditors be considered important. It is also true, however, that high risks yield high returns and that this is why directors should be free to take risks.

When directors engage in extremely risky transactions when the company is insolvent or when its solvency is in doubt, it must be kept in mind, however, that any yields will be enjoyed by shareholders, while the risk is being funded by the creditors.\textsuperscript{1151} Under such circumstances it does not seem unreasonable to expect directors carefully to consider the likelihood of success of high-risk transactions.\textsuperscript{1152}

The balance that will be struck between the need for risk-taking and adequate protection of creditors is thus not a static concept, but will in all probability fluctuate depending on factors like the current economic climate; perceptions regarding the role and functions of directors; the number of high-profile corporate collapses, and so forth.

\textbf{7.3.4 Director Reaction}

A concern raised in respect of the extension of directors’ duties to creditors, is that persons may be unwilling to take up the post of director, or that directors may resign, or prematurely commence with winding-up of companies for fear of personal liability. One may argue that concerns in this regard may be eased to an extent if insolvency is accepted as a trigger for the duty. Insolvency poses a high threshold for directors’ common-law liability to creditors and will reduce the likelihood of personal liability, compared to other proposed triggers such as a risk of insolvency.

\textsuperscript{1151} This so-called wealth transfer problem or moral hazard was already discussed \textit{supra} Ch 2 (Conceptual Justification) par 2.4.4.

\textsuperscript{1152} Also see De Koker \textit{supra} 196 – 197 who, in a discussion of the reckless carrying on of the business of the company in the context of s 424(1) liability, recognises the unfair exposure of creditors’ interests to risk when a last desperate attempt, often unrealistically optimistic, is made at rescuing a struggling company.
This argument only holds true insofar as insolvency is easy to define and to detect, which does not seem to be the case.\textsuperscript{1153} Directors, being in doubt as to whether a company is solvent due to uncertainty regarding the concept “insolvency”, may still decide to resign or commence with premature liquidation rather than expose themselves to the possibility, even though it might later appear to have been a remote possibility, of personal liability.

It is furthermore submitted that concerns regarding the reaction of directors to the extension of their common law duties to creditors should not be addressed through the sacrifice of a trigger, thereby reducing protection afforded to creditors in terms of the duty. By no means should this be seen as detracting from the importance of these concerns, but simply as a submission that these concerns should be addressed in other ways.

Directors, fearing personal liability when the going gets tough, may, for example, be provided with workable alternatives to resignation or premature liquidation. A properly functioning corporate rescue mechanism may prove invaluable in this regard.\textsuperscript{1154} The availability of measures providing relief from liability where appropriate may also play an important role in ensuring that honest and diligent directors do not incur undeserved personal liability.\textsuperscript{1155}

\textsuperscript{1153} See discussion \textit{supra} par 7.2.1.

\textsuperscript{1154} The South African \textit{Companies Act} (Ch XV ss 427 – 440) does provide for a formal corporate rescue mechanism, namely “judicial management”. Olver “Judicial Management – A Case for Law Reform” 1986 \textit{THRHR} 84 85 indicates that judicial management unfortunately proved to be very ineffective in rescuing struggling companies. One therefore has to agree with numerous commentators on this topic that reform in this area is essential. See the following sources for further detail in this regard: Burdette “Some Initial Thoughts on the Development of a Modern and Effective Business Rescue Model for South Africa” 2004 \textit{SA Merc LJ} 241; Kloppers “Judicial Management – A Corporate Rescue Mechanism in Need of Reform?” 1999 \textit{Stell LR} 417; and Kloppers “Judicial Management Reform – Steps to Initiate a Business Rescue” 2001 \textit{SA Merc LJ} 359.

\textsuperscript{1155} See discussion \textit{infra} Ch 9 (Relief from Liability) for more detail on measures that may provide relief from liability.
7.3.5 Increase in Cost

It may be argued that the application of insolvency as trigger will not entail the same increase in costs, as, for example, a “real risk of insolvency” or “doubtful solvency”. Insolvency, assuming once again that the meaning thereof is clear, should be easier to establish than “doubtful solvency” and should consequently involve less investigative exercises, or at least less costly investigative exercises on the part of directors.

On the other hand, it is also possible that additional costs may not only have negative consequences. Incurring costs for the purpose of establishing an accurate picture of the financial situation of a company, even if the only incentive for doing so relates to fear of personal liability, is not necessarily a bad thing – directors who realise timeously that a company is on thin ice financially will definitely be in a better position to do something about it.1156

7.3.6 Role of the Judiciary

An objective test applies in respect of all three possible categories of triggers for the duty.1157 This will require the courts to undertake an inquiry into the state of affairs of a company and pass judgment on business decisions made by directors under those circumstances.

Expecting the judiciary to engage in an ex post facto review of directors’ business decisions may prove problematic, since this is an activity that the courts are ordinarily perceived loath to engage in.1158

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1156 The shareholders will fund these costs. It is also in their best interest, however, that such steps be taken.

1157 In respect of insolvency – the fact that the directors knew, or ought have known that the company was insolvent when they embarked on a particular course of action (see supra par 7.2.1.5.2); in respect of “doubtful solvency” – the reasonable prospect that the company may eventually end up in insolvent liquidation (see supra par 7.2.2.3); and in respect of “actions causing insolvency” – the fact that the directors did foresee or should have foreseen that their actions could cause the insolvency of the company (see supra par 7.2.3.2).

1158 Wishart supra 341 notes the problem that courts are traditionally reluctant to judge directors’ commercial and policy decisions with reference to numerous English cases, eg Burland v Earle [1902] AC 83; Carlen v Drury (1812) 1 V & B 154; 35 ER 61; and Dovey & Cory [1901] AC 477 488.
According to some this reluctance on the part of the judiciary seems to be waning with the courts demonstrating “a readiness to review the way in which companies operate and the merits of decisions which have been made at a managerial level”. This development is welcomed by various commentators.

At the same time a warning is issued in this respect, namely that courts, when judging business decisions made by directors, have the luxury of hindsight, whereas directors are required to act with foresight. To circumvent this problem the courts will be required to take into account all relevant factors existing at the time that the directors made their decisions.

Keay Directors’ Duty to Creditors: Trigger 336, with reference to cases such as AWA Ltd v Daniels (1992) 7 ACSR 465 and Knightswood Nominees Pty Ltd v Sherin Pastoral Co Ltd (1988) 15 ACLR 151.

Butcher Directors’ Duties: A New Millennium, A New Approach? (2000) 184 is of the opinion that this development is to be welcomed, because judges’ perceived abandonment of their “well-documented reluctance to review directors’ judgmental and policy decision-making in favour of adopting a fresh approach that will permit of interference in the internal management of companies”, will “permit of further development in this area of the law and clarify many of the unresolved issues with which we are at present left to ponder”. Sealy supra 180 also identifies a benefit in the taking up of a new role by the courts, in that “they would be obliged to articulate more clearly the true reasons for their rulings rather than merely invoke as shibboleths the dicta collected uncritically from earlier cases”.

Keay Directors’ Duty to Creditors: Trigger 336.

Keay Directors’ Duty to Creditors: Trigger 336, with reference to a number of cases dealing with directors’ duties to creditors, eg Nicholson v Permakraft (NZ) Ltd supra; In re Welfab Engineers Ltd [1990] BCLC 833; Linton v Telnet Pty Ltd (1999) 17 ACLC 619; Brady v Brady supra, indicates that the courts are already doing this. He specifically refers to a comment made by Giles JA in Linton v Telnet Pty Ltd supra 475, that “[w]hile the net loss for the year ended 30 June 1993 could later be seen as the beginning of its decline, peril to creditors on a group basis as at August 1992 did not leap out from the figures” (emphasis added by Keay); and the taking into account of the commercial environment at the time of making a transaction alleged to constitute a breach of the duty to creditors, even though it occurred seven years in the past, in the case of In re Welfab Engineers Ltd supra. The South African judiciary seems to be equally aware of this danger. See eg the acknowledgement in Ozinsky v Lloyd 1992 3 SA 396 (C) 414 that the court “should always be careful in adjudging conduct with the wisdom of hindsight”.

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7.3.7 Reconciling Triggers with Conceptual Justification for a Duty to Creditors

7.3.7.1 General

One of the arguments that were offered to justify the extension of directors’ duties to creditors on a conceptual basis is that creditors are seen as the stakeholders with the ultimate financial interests in the company when the going gets tough.\textsuperscript{1163}

A number of questions are raised, however, if it is accepted that a duty to creditors is justifiable on the basis that they become the equitable owners of the company upon insolvency due to the fact that shareholders’ interests, not being represented by any surplus of assets over liabilities, are replaced by those of creditors. The first is how “insolvency” can be defined in any other way but with reference to a company’s balance sheet position. The second is how a trigger such as “doubtful solvency” may be considered acceptable in light of the above justification of the duty. It will finally be difficult to explain a trigger such as “actions causing insolvency”, which, by its nature, indicates that directors are considered to be under obligation to consider creditors’ interests \textit{even while the company is solvent}.

7.3.7.2 Insolvency and “Doubtful Solvency”

In addressing the first apparent contradiction, a distinction must be drawn between the theoretical justification of principles and the practical application thereof.

Justifying the extension of directors’ fiduciary duties to include creditors on the basis that an excess of assets over liabilities points to shareholders as equitable owners of the company, while the opposite will indicate that creditors’ interests are paramount, may work well enough in theory.

As was indicated already, the balance sheet solvency of a company is anything but an accurate concept due to uncertainty regarding methods to evaluate assets, and so forth.\textsuperscript{1164} It furthermore represents historical financial information.

\textsuperscript{1163} See discussion \textit{supra} Ch 2 (Conceptual Justification) par 2.4.2 and par 2.4.4.
Recognising the inability of a company to pay its debts as an indication of its insolvency is therefore simply an acknowledgement of the gap between theoretical definitions and the practical application thereof, and even more than an acknowledgement: an attempt to bridge this gap.1165

By way of extension, the same argument may be applied in respect of “doubtful solvency” as a trigger for the duty. Insolvency, in whichever way it is defined in theory, may prove to be very difficult to establish in practice. The creditors of a company that is struggling to meet its obligations, even though it is uncertain whether it is in fact insolvent, are therefore the stakeholders with the ultimate financial interest in the company. They should not be deprived of the protection afforded by a managerial duty to them under those circumstances, because of difficulty surrounding the practical application of theoretical principles.

In this regard it should also be borne in mind that the beneficiaries of directors’ duties should also be determined at the hand of identifying the residual risk bearers in the company.1166 One is therefore inclined to agree that

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\text{the question posed by the court is not simply whether the company is insolvent, but that} \\
\text{given the distribution of risk does it continue to be appropriate to regard the interests of} \\
\text{shareholders as exclusively reflecting the corporate interest.}^{1167}
\]

Creditors are clearly the residual risk-bearers should it become apparent that a company’s solvency is doubtful to such an extent that there is a reasonable prospect that it may go

1164 Wishart supra 345 identifies this problem and states that “accounting information is being called on to draw a definite line on which liability hangs yet which in many ways does not yield certain results”.

1165 Wishart supra 329 refers to it as “a trade off between complexity of definition and practicality of performance”.

1166 Supra Ch 2 (Conceptual Justification) par 2.4.4.

Chapter 7  

Point in Time When the Duty Arises

into insolvent liquidation. It is therefore in that capacity that their interests should be protected by law.

7.3.7.3 “Actions Causing Insolvency”

In order to address the issue of reconciling the trigger of “actions causing insolvency” with a conceptual justification of directors’ duties to creditors, it is firstly submitted that the application of “actions causing insolvency” as a trigger for the duty is not so much related to the company being in financial distress, as to it experiencing economic distress caused by managerial slack.\(^\text{1168}\) This may ultimately cause the insolvency of the company, resulting in loss to creditors. Creditors will therefore be entitled to hold directors liable for failing to consider their interests, if insolvency occurs under these circumstances.\(^\text{1169}\)

It must also be noted that the conceptual justification of a duty to creditors does not only rest on the argument of creditors becoming residual risk-bearers and consequently having the ultimate financial interest in the company where the company is in financial distress. It was also submitted that the importance of the perceived differences between so-called “equityholders” and “debtholders” is diminishing, in light of the blurring of boundaries between these groups of financial stakeholders in the company.\(^\text{1170}\)

This conceptual argument seems especially pertinent in relation to the trigger of “actions causing insolvency”, as both shareholders and creditors will suffer the consequences if a company becomes insolvent as a result of director misconduct or negligence.

\(^{1168}\) Triantis “Insolvency Law: Treating the Illness, Not the Symptom” in Queen’s Annual Business Law Symposium 1995 Corporate Restructurings and Insolvencies: Issues and Perspectives (1996) 93 provides an explanation of the difference between financial and economic distress. Financial distress relates to a financial state, whereas economic distress relates to “the efficiency of the firm’s deployment of its assets and occurs when the assets are not being used in their most valuable use or configuration”. Economic distress is furthermore seen to be caused by managerial slack which includes lapses in managerial competence or effort; empire building, etc.

\(^{1169}\) This argument is in line with the approach followed in cases such as Walker v Wimborne (1975 – 1976) 137 CLR 1, where the court recognised that creditors will always be threatened by the possibility of future insolvency, thereby indicating acceptance of a continuing obligation to creditors.

\(^{1170}\) See discussion supra Ch 2 (Conceptual Justification) par 2.4.6.
7.4 PRACTICAL APPLICATION OF THE TRIGGERS

7.4.1 Insolvency and “Doubtful Solvency”

There is some uncertainty as to the practical implications of a duty to creditors being triggered.1171

In terms of the first school of thought, the advent of a trigger will result in directors no longer being under obligation to consider the interests of shareholders in discharging their duties to the company, since a shift took place with directors now having to consider the interests of creditors as primary corporate constituents over those of shareholders.1172

The second school of thought holds the view that a duty to creditors being triggered will result in a dual duty, with directors being liable to creditors as well as to shareholders in varying degrees.1173 The way in which the second group envisages the operation of the

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1171 See in general Keay “Directors’ Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors” (2003) 66 Modern Law Review 665-671 who poses a series of questions in this regard, namely:

[A]re creditor interests to be regarded as one set of interests amongst others that are to be considered by directors? What importance should be attached to creditor interests? Are creditor interests to be considered to the exclusion of member interests when the duty applies?

Also see Miller “Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations” (1993) 23 Seton Hall Law Review 1467-1482; and Stilson supra 5 who recognises that “case law fails to address whether the duty to creditors gains ascendancy over, or operates as a complement to, traditionalist directorial obligations to stockholders”.

1172 Dabner supra 114 states that upon insolvency “the rights of shareholders give way to those of creditors”. Also see McDonnell supra 185 who is quite clear on the point that the “directors of the corporation which becomes insolvent or in a failing condition no longer represent stockholders, but…become trustees, or quasi-trustees, of the corporation’s assets for the benefit of its creditors”; and Van der Weide “Against Fiduciary Duties to Corporate Stakeholders” (1996) 21 Delaware Journal of Corporate Law 27-61 who states that “creditors ought to be the sole beneficiaries of management’s fiduciary duty when a corporation becomes insolvent” seeing that a “bilateral fiduciary shield would entail prohibitively high costs of collective decision making, and managers should never be made trustees for the entire community of interests in a corporation”.

1173 Schulte “Enforcing Wrongful Trading as a Standard of Conduct for Directors and a Remedy for Creditors: The Special Case of Corporate Insolvency” (1999) 20 The Company Lawyer 80-85; Schwarz supra 666. Millner supra 217 also argues in favour of a dual duty upon insolvency. His concern seems to be with arguments that directors’ duties upon insolvency should consist only of arranging an orderly sale or
trigger is therefore closely linked to the exact degree of financial difficulty, entailing that
the “greater the insolvency, the more those obligations would shift from shareholders to
creditors, in a continuum”. In terms of a dual obligation to creditors and shareholders,
directors will have a duty to shareholders and creditors simultaneously in varying
degrees, depending on the exact financial position of the company in question, and they
will therefore be required to balance the rights of creditors and shareholders.

It is conceded by proponents of the second viewpoint that balancing the rights of
creditors and shareholders is like “balancing ‘apples and oranges’”, as they are not
“comparable commodities”. A proposed solution to the above problem of having to
balance non-comparable interests is that directors, in applying the balancing test, should
have latitude to make their own good faith weighing of benefit and harm.

Another point of criticism against the way in which these commentators view the
application of a trigger, is that directors will be required to determine the exact degree of
financial distress of a company that is not clearly solvent with some accuracy in order to
establish the extent to which they are under obligation to balance the interests of creditors
and shareholders. As was indicated already, determining actual insolvency may prove to

liquidation for the benefit of creditors. He envisaged these arguments to be “weakened or defeated” by
acceptance of the duty as a dual duty, entailing that shareholders’ interests do not become totally obsolete
upon insolvency. A similar dual duty seems to be envisaged by the Canadian judiciary in one of the first
cases in which the interests of creditors were recognised upon the company experiencing financial
difficulty, namely *In re Trizec Corporation* [1994] 10 WWR 127 (Alta QB). In this case the court stated
that

[a] specific duty to shareholders becomes intermingled with a duty to creditors when the
ability of a company to pay its debts becomes questionable (*id* 139; own emphasis).

1174 Schwarz *supra* 672 n 114; see also Schulte *supra* 85 who is of the opinion that, upon questionable
insolvency, a director must “transfer a degree of allegiance to the interests of the creditors”, with a further
modification taking place upon “imminent insolvency”.

1175 Schwarz *supra* 675.

be very problematic. Proving a specific degree of financial distress may prove to be even more so.

It furthermore raises questions with regard to the enforcement of the duty and the ratification of a breach of the duty. A model in terms of which a trigger results in directors having a duty to both shareholders and creditors in varying degrees, depending on the financial situation of the company, does not provide a clear indication as to who will be able to institute action against directors in case of a breach of the duty. It also fails to indicate whether the general meeting of shareholders will be able to ratify a breach of directors’ duties.

Defining the duty as a fluctuating one, on the other hand, will provide a clear indication as to whether the general meeting of shareholders is entitled to ratify a breach of duties. As soon as the duty is triggered, a “shift” occurs resulting in creditors becoming the primary corporate constituents. An important consequence of this will be that the general meeting of shareholders will no longer be in a position to ratify a breach of directors’ duties. It will also indicate that creditors should in some way be able to enforce directors’ duties.1177

Shareholders and creditors will furthermore be provided with more certainty as to whose interests should have been considered by the directors – before the “shift” occurred the interests of shareholders should take precedence, while those of creditors become paramount after occurrence of the “shift”. This may go a long way towards limiting directors’ exposure to actions by dissatisfied corporate constituents.

Establishing clear boundaries for the duty may also aid directors in limiting possible liability for a breach of the duty. By viewing the duty as a fluctuating one, directors will at least be in a position to know when they are obligated, and to which corporate constituent, making it possible for them to comply with their duties and thus prevent

1177 See discussion infra Ch 8 (Beneficiary of the Duty) par 8.5 for more detail regarding the enforcement of a duty to creditors.
personal liability. This point is especially pertinent in the context of the degree of risk to which the directors are permitted to expose the assets of the company.

The undesirable effect of a fragmentation of duties will also be prevented by the fact that directors are not under obligation to all corporate constituents at all times.

7.4.2 “Actions Causing Insolvency”

The meaning of “actions causing insolvency”, as discussed above, indicates that the way in which this trigger operates is completely different from the other triggers previously discussed, in that the financial position of the company at the time of the impugned action or course of conduct is totally irrelevant. Directors may be held liable to creditors despite the fact that the company concerned was solvent when they failed to comply with their common-law duties, if it later appears that the company became insolvent as a direct result of the breach of duties.

Application of “actions causing insolvency” as a trigger for the duty therefore does not provide a “bright line of demarcation”, the crossing of which will result in directors having to consider the interests of creditors rather than those of shareholders in discharging their duties to the company.

The question that immediately presents itself, is how directors will be able to comply with their duties if they do not know at a particular stage whether these duties are regarded as for the benefit of the creditors or that of the shareholders of the company.

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1178 Daniels “Must Boards Go Overboard? An Economic Analysis of the effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance” (1994 – 95) 24 Canadian Business Law Journal 229 256 emphasises the importance of “crystallized, rather than fuzzy, standards”. Even though this statement and subsequent arguments were made in the context of statutorily imposed liability, it rings equally true in respect of common law liability.

1179 This aspect was already fully expounded upon. See discussion supra Ch 2 (Conceptual Justification) par 2.5.2.

1180 Supra par 7.2.3.
Chapter 7                                                                 Point in Time When the Duty Arises

In this regard it is submitted that the content of directors’ duties will not have changed, as the company was solvent at the time when the alleged breach of duties occurred. Directors will thus be required to comply with their normal fiduciary duties and duty of care and skill to the company and will not be confronted with a situation where they are informed after the fact that they should have acted for the benefit of creditors and should have adapted their conduct in compliance with their common law duties accordingly. 1181

Insolvency is still regarded as an important point in time - not for the purpose of determining whether directors are under obligation to creditors, but for the purpose of determining whether creditors may institute action against directors for having failed to comply with their duties and for the purpose of determining whether particular conduct by directors was capable of being ratified by the shareholders in general meeting. While the company is solvent, creditors are powerless to enforce this duty. As soon as the company becomes insolvent due to directors’ actions or decisions, however, creditors are in a position to hold directors liable for failing to comply with their common-law duties.

Directors of solvent companies will thus not be exposed to a multiplicity of actions and will not have to adapt their conduct in compliance with their duties in any way.

“Actions causing insolvency” is therefore not so much a trigger for identifying the beneficiary of the duty for the purposes of establishing the content of the duty, as it is a trigger for identifying the proper person to institute action against directors, based on their failure to comply with their duties. 1182 A further important consequence is that

1181 It was submitted already that the content of directors’ fiduciary duties remain the same, whether owed to shareholders or to creditors. See supra Ch 5 (Protection Afforded by Fiduciary Duties) par 5.5.3.1. The content of the duty of care and skill will furthermore only undergo a change upon the company being insolvent or where solvency is doubtful, as it is suggested that the degree of risk that directors are permitted to expose the company to will vary depending on the company’s financial state of affairs.

1182 One may thus argue that the concept of fluctuation between different stakeholders is still present in a sense. While the company is solvent, shareholders have the power to enforce directors’ duties or to ratify a breach thereof. Once the company becomes insolvent, however, they lose their position of power, as it now becomes the turn of the creditors to institute action against the directors for failing to comply with their duties. The fact that this failure occurred while the company was still solvent is irrelevant.
Chapter 7  Point in Time When the Duty Arises

director conduct causing the insolvency of the company will not be susceptible to ratification by the shareholders in general meeting.\textsuperscript{1183}

7.4.3 Summary

7.4.3.1 Insolvency or “Doubtful Solvency” as Triggers

If a company is insolvent, a duty to creditors is triggered. This means that the creditors now comprise the group that stands to benefit from proper compliance with fiduciary duties. This shift from shareholders to creditors as the constituent to be protected in terms of fiduciary duties does not, however, indicate a change in the content of directors’ fiduciary duties.\textsuperscript{1184} The practical effect of the trigger is thus simply seen as an indication that creditors are now in a position to enforce these duties and that shareholders are precluded from ratifying a breach of these duties.\textsuperscript{1185}

A practical problem in respect of insolvency as trigger, however, is the possibility that a company may not necessarily be clearly insolvent, but moving in and out of insolvency. In this respect it is submitted that it should be established whether such a company is “doubtfully solvent”, in other words whether there is a reasonable expectation of insolvency that may result in the company being wound up. Should that be the case, the duty to creditors is triggered.

This will ensure that creditors are not deprived of protection in terms of directors’ duties,\textsuperscript{1186} and also addresses the problem of directors being under obligation to shareholders one day and creditors the next – since the duty to creditors was triggered by the company being “doubtfully solvent”, a shift took place and directors’ duties will be to the creditors.

\textsuperscript{1183} A point that was clearly enunciated in Peoples Department Stores Inc (trustee of) v Wise supra par 193.

\textsuperscript{1184} Supra Ch 5 (Protection Afforded by Fiduciary Duties) par 5.5.3.1.

\textsuperscript{1185} See discussion infra Ch 8 (Beneficiary of the Duty) par 8.5 for more information on how creditors may enforce a duty owed to them, as well as information on how a breach of the duty should be ratified.

\textsuperscript{1186} Keay Directors’ Duty to Creditors: Trigger 324 indicates that this is exactly the type of company whose creditors are in need of protection, as it is likely to collapse without warning.
A shift from shareholders to creditors as primary beneficiaries of directors’ *duty of care and skill*, however, apart from indicating that creditors may now enforce this duty and that shareholders are powerless to ratify a breach thereof, will signal a change in the content of this particular duty insofar as directors’ risk-taking ability is concerned.1187

7.4.3.2 “Actions Causing Insolvency” as Trigger

A duty to creditors triggered by “actions causing insolvency” may raise the issue as to how directors will be able to comply with the duty if they only become aware of the existence thereof upon insolvency. In respect of both fiduciary duties and the duty of care and skill it is submitted that the content of the duties will not have undergone a change. It is therefore not relevant that directors did not know whether the duty to the company is to be exercised for the benefit of shareholders or of creditors.

The importance of the trigger lies therein that directors who caused the insolvency of the company through a breach of their common law duties will be liable to creditors for having done so. Therefore, any ratification of the breach by shareholders will have no effect.

In this regard it is important to emphasise that this trigger is not envisaged as placing directors under a continuous obligation to ensure that the company remains solvent. It is only under circumstances where the company becomes insolvent *as a result of a breach of fiduciary duties or the duty of care and skill*, that directors will be liable to creditors. The purpose of the trigger is also not to prevent shareholders from ever ratifying a breach of directors’ duties. They will only be deprived of this right in cases where the breach of duties actually caused the insolvency of the company.

7.5 CONCLUSION

Reference was made to the fact that many commentators prefer triggers such as insolvency and actions “causing insolvency” as triggers for the duty to creditors, based on

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1187 As discussed *supra* par 7.3.3.
the argument that they are more certain and precise than a concept such as “doubtful solvency”. It was shown that it is a mis conception that insolvency is capable of being defined and detected with absolute certainty and that “doubtful solvency” is incapable of definition. The argument that insolvency or “actions causing insolvency” should be applied as triggers for the duty, while rejecting “doubtful solvency”, can therefore not be sustained on the sole basis of certainty or precision.

The fact that it is argued that none of the triggers should be preferred over another based on its so-called preciseness, as none appears to be absolutely certain, does not, however, mean that the need for precision is unimportant. Insofar as it is possible, the various categories of triggers should be defined as accurately as possible, thereby increasing certainty and precision.

It was submitted that “insolvency”, for the purpose of determining whether directors are under obligation to consider the interests of creditors, should be defined with reference to either balance sheet insolvency or commercial insolvency. Apart from being consistent with relevant statutory guidelines, this submission can be justified on the basis that both factual and commercial insolvency place creditors’ interests at risk.

With regard to factual solvency, it was furthermore submitted that directors of companies that are technically insolvent for being primarily funded by insider loans, should not be under any obligation to creditors, as long as the company is factually insolvent by reason only of the fact that it is primarily funded by insider loans, and, furthermore, that these insider loans are subordinated to external debt.  

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1188 See discussion supra par 7.2.

1189 See discussion supra par 7.2.1.5.3.
“Doubtful solvency” is defined with reference to a company which is experiencing financial distress to such an extent that there is a reasonable expectation that the company will end up in insolvent liquidation.

It therefore seems that all three categories of triggers are capable of being defined, providing some certainty as to when directors’ duties to creditors will arise.

Whether this will allay concerns pertaining to the adverse effect that some triggers may have on directors’ risk-taking ability, their reaction to a duty to creditors and an increase in cost, remains an open question.

In this regard it is submitted that the choice of a trigger should not be dominated by concerns pertaining to these issues. Sacrificing a trigger for the duty in an attempt to address concerns pertaining to director reaction, directors’ risk-taking ability and the incurring of additional costs will definitely decrease the protection afforded to creditors. It was also shown that this is not necessarily the best possible way to address these concerns. Add to that the fact that these so-called concerns may actually have desirable results, dispelling the notion that they are exclusively negative concepts, and it becomes clear that the rejection of any of the triggers based on fear of their impact on director reaction, directors’ risk-taking ability and a possible increase in cost, cannot be supported.\textsuperscript{1190}

Another factor which may cause concern, is that it was suggested that the triggers of insolvency and “doubtful solvency” should contain an objective element in addition to knowledge, namely whether directors should have known that the company is insolvent, or that there is a reasonable prospect of it ending in insolvent liquidation. This will admittedly force the courts to engage in an \textit{ex post facto} review of directors’ business

\textsuperscript{1190} See discussion \textit{supra} par 7.3.
Chapter 7 

Point in Time When the Duty Arises

decisions – a result that some regard as problematic based on the perception that the courts are traditionally reluctant to do so.

Statutory insolvent trading provisions in some jurisdictions contain objective elements such as those discussed in this chapter. The courts are required to interpret these and did so without hesitation in some instances. Indications that the courts are assuming a more active role in this regard, venturing to comment on business decisions and economic factors, were also provided in the context of the cases dealing with directors’ duties to creditors.

Only time will tell whether the South African judiciary will follow suit in respect of a directorial duty to creditors, and abandon the traditional reluctance with which it is supposed to approach a review of business decisions. Deciding in advance against certain triggers, or elements thereof, based on the assumption that the judiciary will be unwilling to pass judgment on business decisions, will, however, be rather premature at this stage.

As far as the practical effect of the advent of a trigger on directors’ duties is concerned, a fluctuating duty, rather than a dual duty, is supported insofar as insolvency and “doubtful solvency” are concerned.

There is admittedly some appeal in the idea of linking the extent to which directors should be under obligation to consider the interests of creditors to the exact degree of financial distress experienced by the company. As was indicated already, however, creating this link by providing for a dual duty, with directors under obligation to consider the interests of both creditors and shareholders, may cause numerous practical problems and may expose directors to a multiplicity of actions.

1191 See supra Ch 3 (Evaluation of Alternative Remedies) for more detail.

1192 See discussion supra par 7.3.6.
It is submitted that this link should rather be created in terms of the *content* of the duty to creditors. This entails that the higher the financial distress, the lower the risk to which directors may expose creditors’ money.\textsuperscript{1193}

In respect of “actions causing insolvency” directors will simply be required to comply with their normal fiduciary duties and duty of care and skill. Practical problems such as determining whether creditors have *locus standi* to proceed with an action against directors, or determining whether the general meeting of shareholders may ratify a breach of the duty, are resolved in that creditors only become entitled to a remedy in terms of directors’ duties once the company is insolvent. In this way directors will once again be protected against the undesirable effect of a multiplicity of actions by dissatisfied corporate constituents.

It thus appears that all three categories of triggers may be applied successfully in determining whether directors are under an obligation to consider the interests of creditors.

The conclusion may therefore be drawn that insolvency, “doubtful solvency” and “actions causing insolvency” should be accepted as triggers for the duty. This will greatly enhance the protection afforded to creditors in respect of a directorial duty. It may furthermore be justified from a practical perspective as well as on a conceptual basis.

Accepting that creditors are vulnerable and entitled to protection if a duty to them is triggered, as suggested, is one thing. In order for a duty to creditors to function effectively it is also imperative, however, to clarify how creditors may reap the benefits in terms of such a duty. A further issue that needs to be clarified is therefore the model of

\textsuperscript{1193}This seems to be in line with comments made in *Kinsela v Russell Kinsela Pty Ltd (in liq) supra* 733, namely that “the plainer it is that it is the creditor’s money that is at risk, the lower may be the risk to which the directors...can justifiably expose the company”. Keay *Directors’ Duty to Creditors: Trigger* 332 holds the same viewpoint.
the duty to creditors that should be followed in order to facilitate enforcement of directors’ duties by creditors. This aspect is addressed in the next chapter.1194

1194 See infra Ch 8 (Beneficiary of the Duty).
CHAPTER 8

BENEFICIARY OF THE DUTY

SUMMARY

8.1 INTRODUCTION
8.2 ORTHODOX VIEW
8.3 JUDICIAL METHODS FOR EXTENDING DIRECTORS’ DUTIES TO CREDITORS
8.4 EVALUATION OF JUDICIAL METHODS
8.5 SUGGESTED METHOD
8.6 CONCLUSION

8.1 INTRODUCTION

Directors’ legal obligation to consider the interests of creditors is often referred to in the generally accepted shorthand way of “directors’ duties to creditors”.1195 An analysis of case law dealing with directors’ duties to creditors indicated, however, that the mere recognition of the fact that directors should consider the interests of creditors does not mean that they owe a direct duty to creditors.

Pronouncements by the courts indicate that different models are envisaged to effect the extension of directors’ duties to creditors.1196 In some instances the court phrased or construed a directorial duty to creditors in a way that indicated a willingness to recognise a direct duty to creditors.1197 In others, however, the obligation to creditors is construed in an indirect way, with the court merely requiring directors to consider


1196 See discussion supra Ch 4 (Judicial Framework) par 4.4.

Chapter 8

Beneficiary of the Duty

the interests of creditors in discharging their duties to the company, who remains the
primary beneficiary of directors’ duties.1198

The question that needs answering is which of these methods applied by the judiciary
will best serve to extend directors’ duties to include creditors’ interests. The answer
to this question is critical for determining the creditors’ standing to bring action
against delinquent directors and for establishing which remedies are available to
them.1199

Despite the fact that an overwhelming majority of cases on this topic seem to favour
the indirect duty method1200 and even though it is supported by numerous
commentators,1201 the choice is not an obvious one, since both possibilities are beset
with their own uncertainties.

Deciding which method is most suitable for extending directors’ duties to creditors
furthermore only provides partial clarity regarding the proper beneficiary of the
directors’ duties to creditors. Many authors have noted that creditors are not a
homogenous group and that any particular company may have a great variety of

1198 See eg In re New World Alliance Pty Ltd (rec and mgr app'td); Sycotex Pty Ltd v Baseler (1994)
122 ALR 531 550; Lyford v CTH Bank (1995) 130 ALR 267 283; Spies v The Queen (2000) 173 ALR
529 par 95; Sheahan v Verco (2001) 79 SASR 109 132; Nicholson v Permakraft (NZ) Ltd [1985] 1
NZLR 242 249; Lonrho v Shell Petroleum Co Ltd [1980] 1 WLR 627 634; In re Horsley & Weight Ltd
[1982] 3 All ER 1045 1055; Peoples Department Stores Inc (trustee of) v Wise [1998] QJ No 3571
(QSC (Bankruptcy and Insolvency Division) par 200.

1199 Trethowan “Directors’ Personal Liability to Creditors for Company Debts” (1992) 20 Australian
Business Law Review 41 53.

1200 See cases listed supra n 4.

1 13 justifies his preference for this method on the basis that it is favoured by the majority of cases and
because, unlike the direct duty method, this method “may suggest solutions to its problems”. Beveridge “Does a Corporation’s Board of Directors Owe a Fiduciary Duty to Its Creditors?” (1994) 25 St Mary’s Law Journal 589 619 are of the opinion that the purpose of the trust fund doctrine,
applied to protect the interests of creditors, is not to allow “direct actions by contract creditors against
directors or to create direct fiduciary duties running to creditors”; Riley “Directors’ Duties and the
Interests of Creditors” (1989) 10 Company Lawyer 87 92 admits that “attractive as the contrary may
appear to the unsecured creditor, it appears that the duty to consider creditors is owed to the company
alone, and desirable that it should be so”; also see Trethowan supra 54.
creditors.1202 The problem that flows from this fact is that the interests of various categories of creditors may be dissimilar, and even in conflict. Directors, in considering the interests of one category of creditors, may very well expose themselves to legal action by another group of creditors.1203

It is imperative to determine a model for a directorial duty of creditors and to identify the various categories of creditors who may be entitled to the protection afforded by a directorial duty, as well as to establish the extent of the protection to which they are entitled. Without clarity in this regard it is impossible to provide a fully functional framework for directors’ duties to creditors – directors will be left in the dark as to precisely whose interests should be considered, while creditors will have no indication as to who will be entitled to the benefits from a directorial duty to creditors, or who will be able to enforce such a duty.

In order to address the issue of the proper recipient of directors’ duties, some background must firstly be provided on the orthodox viewpoint concerning the beneficiary of directors’ fiduciary duties and duty of care and skill. Some commentators are also of the opinion that the duty to creditors should be modelled as closely as possible on traditional directorial duties.1204 In order to succeed with this

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1203 An analysis of the cases in which directors’ duties to creditors were discussed indicated that the courts grappled with the question as to whether the interests of current, as well as prospective or future creditors, should be encompassed in a directorial duty to creditors. See discussion *supra* Ch 4 (Judicial Framework) par 4.5. This is only one of many possible variances on this particular theme, however. One may also set secured creditors *versus* unsecured creditors; voluntary creditors *versus* involuntary creditors; financial creditors *versus* trade creditors; and holders of debt equity *versus* other creditors. For more information on the various classes of corporate creditors, see Nicholls “Liability of Corporate Officers and Directors to Third Parties” (2001) 35 *The Canadian Business Law Journal* 1 23 – 30; Schwarz “Rethinking a Corporation’s Obligations to Creditors” (1996) 17 *Cardozo Law Review* 647 659 – 665.

replication one should obviously have a clear idea of what traditional directorial duties entail.

For these reasons a brief overview of traditional principles, focussing specifically on the beneficiary of directors’ common law duties, is provided.\textsuperscript{1205}

This is followed by a discussion of the various methods used by the judiciary to facilitate the extension of directors’ duties to creditors.\textsuperscript{1206} An analysis of the perceived advantages and disadvantages of the methods used by the judiciary is subsequently provided,\textsuperscript{1207} and finally a method for the extension of directors’ duties to creditors is suggested.\textsuperscript{1208}

\section*{8.2 ORTHODOX VIEW}

\subsection*{8.2.1 Interest of the Company}

The orthodox view of directors’ common law duties is that directors owe their common law fiduciary duties and the duty of care and skill to the company.\textsuperscript{1209} This means that directors, when required to act in the best interest of “the company”, are

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\textsuperscript{1205} \textit{Infra} par 8.2.
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\textsuperscript{1206} \textit{Infra} par 8.3. In this discussion an outline is provided of the basic elements of each of the methods as they appear from the cases. Questions that are left unanswered and problem areas will be discussed in the following paragraph.
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\textsuperscript{1207} \textit{Infra} par 8.4.
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\textsuperscript{1208} \textit{Infra} par 8.5.
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\textsuperscript{1209} In \textit{In re Smith & Fawcett} [1942] Ch 304 306 the court clearly stated that directors should act “\textit{bona fide} in what they consider…is in the interest of the company” (own emphasis). See also Cilliers & Benade \textit{Corporate Law} (2000) par 10.09; Farrar & Hannigan \textit{Farrar’s Company Law} (1998) (hereinafter Farrar) 378; 380; and Pennington \textit{Pennington’s Company Law} (2001) 709 who is also very clear on the point that directors’ common law duties “are owed \textit{exclusively to the company} of which the defendant is a director” and that this fact does not “impose parallel duties on a director toward the company’s members or creditors” (own emphasis).
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under no obligation to act in the best interests of individual shareholders or creditors.\footnote{1210}

This well-known principle was reaffirmed in \textit{Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd},\footnote{1212} the court leaving no room for doubt that

\begin{quote}
    directors indeed stand in a fiduciary relationship to the company, as they are appointed to manage the affairs of the company and they owe fiduciary duties to the company \textit{though not to the creditors, present or future, or to individual shareholders}.\footnote{1213}
\end{quote}

Treating a metaphysical entity as the beneficiary of directors’ duties may naturally present certain problems.\footnote{1214} The statement that directors should act in the best interests of the company immediately raises the question as to what should be considered as the best interests of the company.

For many years it was generally accepted that the “company as a whole” refers to the body of shareholders,\footnote{1215} which meant that directors, when required to act in the best interests of the company, actually had to consider the best interests of the shareholders of the company. In terms of this viewpoint the company is equated with its collective

\footnote{1210} \textit{Percival v Wright} [1902] 2 Ch 421. The judgment in \textit{Kalinko v Nisbet} 2002 5 SA 766 (W), however, signals a significant change in the way in which the courts regard the beneficiary of directors’ fiduciary duties. In this case the court indicated that it would be willing to permit an individual shareholder to bring action against the directors for losses that he sustained in that there was a diminution in the value of his shareholding in the company, due to the fact that the directors did not comply with their fiduciary duties, as long as it would not result in “double recovery” by both the shareholder and the company (\textit{id} 777 – 778).

\footnote{1211} In \textit{In re Wincham Shipbuilding, Boiler, and Salt Company} (1878) 9 ChD 322 328 – 329 it was stated emphatically that “directors are trustees for the shareholders, that is, for the company”, but not “trustees for the creditors of the company”.

\footnote{1212} [1983] 2 All ER 563.

\footnote{1213} \textit{Id} 585; own emphasis.


\footnote{1215} \textit{Dodge v Ford Motor Co} 170 NW 668 (Mich 1919); \textit{Greenhalgh v Arderne Cinemas Ltd} [1951] 1 Ch 286.
membership, which is traditionally understood to comprise the general body of shareholders.1216

In may therefore be concluded that directors’ duties to act in the best interests of the company are owed to the company as a separate entity. In terms of the orthodox position the content of the interest of the company is determined with reference to the interests of shareholders of the company.

8.2.2 Enforcement of Directors’ Duties

A logical consequence of the above view is that should the directors act in breach of their common law duties to the company, the company as a juristic person is the proper person to sue them. This principle, which is usually referred to as the rule in Foss v Harbottle, was laid down by two well-known cases, namely Foss v Harbottle1217 and Mozley v Alston1218 and was succinctly summarised as follows:

The proper plaintiff is prima facie the company. Where the wrong or irregularity might be made binding on the company by a simple majority of its members, no individual shareholder is allowed to maintain an action in respect of that matter.1219

The company is able to institute action against the wrongdoers through one of its organs. This includes the board of directors, the general meeting of members by

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1216 Sealy “The Directors as Trustees” 1967 Cambridge Law Journal 83 89 explains the rationale for defining the company as the members on the basis of the historical development of the company as a form of enterprise. In a deed-of-settlement company, the members were in fact the company. A more modern formulation of this principle may be found in the “enlightened shareholder value” approach, as discussed supra Ch 2 (Conceptual Justification) par 2.2.3, in terms of which directors are permitted to consider the interests of other stakeholders, but only insofar as it will promote the shareholders’ interests. The interests of the shareholders are thus interpreted on a long-term basis with the emphasis on the company being managed in a sustainable manner. Shareholders’ interests are therefore still regarded as central, which means that the interests of the company are still primarily defined with reference to the interests of its shareholders.

1217 (1843) 2 Hare 461.

1218 (1847) 1 Ph 790.

1219 Farrar supra 431. This is a basic summary of a rule with many complexities and uncertainties. A detailed analysis of all the complexities of this rule will be superfluous for present purposes, however. See the following sources for a more detailed analysis of the content and the complexities of the rule in Foss v Harbottle: Farrar supra 430 – 441; Gower supra 449 – 465; Pennington supra 791 – 812; Wedderburn “Shareholders’ Rights and the Rule in Foss v Harbottle 1957 Cambridge Law Journal 194 (hereinafter Wedderburn Part I); Wedderburn “Shareholders’ Rights and the Rule in Foss v Harbottle (cont) 1958 Cambridge Law Journal 93 (hereinafter Wedderburn Part II).
ordinary resolution, or the liquidator once winding-up proceedings have commenced.\textsuperscript{1220}

Individual shareholders are therefore generally precluded from acting against delinquent directors on behalf of the company. However, in some circumstances individual shareholders are permitted to act against wrongdoers on behalf of the company by way of a “derivative action”, described in this way because “the individual member sues to enforce a claim which belongs to the company, and his right to sue is derived from it”.\textsuperscript{1221} As a derivative action is instituted on behalf of the company, any benefit accruing from a successful action will belong to the company.\textsuperscript{1222}

8.2.3 Ratification of a Breach of Directors’ Duties

8.2.3.1 Distinction between Ratifiable and Unratifiable Wrongs

Taking action against directors is, however, not the only option available in the case of a breach of duties by the directors.

It is said that it is a “normal principle of the law relating to fiduciaries that those to whom the duties are owed may release those who owe the duties from their legal obligations”.\textsuperscript{1223} This may be done prospectively or retrospectively, provided that full

\textsuperscript{1220} Pennington \textit{supra} 793 and authority there referred to.

\textsuperscript{1221} Pennington \textit{supra} 795. These instances are construed as exceptions to the rule in \textit{Foss v Harbottle}. For more detail on exceptions to the rule in \textit{Foss v Harbottle} see Farrar \textit{supra} 435 - 441; Gower \textit{supra} 458 et seq; Naudé \textit{Die Regposisie van die Maatskappydirekteur met Besondere Verwysing na die Interne Maatskappyverband} LLU UNISA (1969) 266 – 275; Pennington \textit{supra} 799 et seq; Wedderburn Part I 203 – 215; and Wedderburn Part II. Today many jurisdictions have enacted statutory exceptions to the rule in \textit{Foss v Harbottle}, in terms of which provision is made for the institution of actions by members of the company for wrongs done to the company, where the company itself failed to do so. See eg s 266 of the South African \textit{Companies Act} 61 of 1973 (hereinafter South African \textit{Companies Act}); ss 236 and 237 of the Australian \textit{Corporations Act} 2001 (hereinafter Australian \textit{Corporations Act}); s 459 of the English \textit{Companies Act} 1985 (hereinafter English \textit{Companies Act}), which in actual fact provides that a member may approach the court for relief if the company’s affairs have been conducted in a manner which is unfairly prejudicial to the interest of its \textit{members}, but which is allowed to be used to secure the redress of wrongs done to the company; and s 239 of the \textit{Canada Business Corporations Act} (RSC 1985, c C-44; hereinafter \textit{CBCA}).

\textsuperscript{1222} Unless the viewpoint in \textit{Kalinko v Nisbet supra} gains general acceptance, in which case an individual shareholder will be allowed to recover from the directors the losses that he personally suffered as a result of the diminution of the value of his shareholding, which reduction in value resulted from the directors not having complied with their fiduciary duties.

\textsuperscript{1223} Gower \textit{supra} 437.
disclosure of relevant facts was made in advance of the decision.\textsuperscript{1224} Case law also indicated that it is not only a breach of fiduciary duties that may be ratified by the company, but also a breach of the duty of care and skill.\textsuperscript{1225} The effect of a valid ratification is that the right of shareholders to sue in future is extinguished.\textsuperscript{1226}

In principle the company should therefore be able to ratify breaches of directors’ duties.\textsuperscript{1227} There are exceptions to this principle, however, and certain wrongs against the company are categorised as “unratifiable”.\textsuperscript{1228} These include conduct in breach of the company’s rights as per the company constitution; illegal conduct; conduct in breach of the common law; and instances of what is commonly referred to as “fraud on the minority”.\textsuperscript{1229}

The last category, namely “fraud on the minority”, created much confusion, with the courts recognising the ability of the general meeting to ratify a breach of directors’ duties in one instance,\textsuperscript{1230} while denying it in the next.\textsuperscript{1231} The basis on which the

\begin{footnotesize}
\begin{enumerate}
\item In Pavlides v Jensen [1956] 2 All ER 518 523 the court recognised that “it was open to the company by a vote of the majority to decide that, if the directors by their negligence or error of judgment had sold the company’s mine at an undervalue, proceedings should not be taken by the company against the directors” (own emphasis).
\item Payne “A Re-examination of Ratification” (1999) 58 Cambridge Law Journal 604 616 and authority there referred to. Ratification and a decision not to sue should therefore not be regarded as synonymous.
\item Bamford v Bamford [1970] Ch 212.
\item Ie incapable of being ratified by the majority of members in general meeting.
\item Cilliers and Benade supra par 19.14; see also Rider “Amiable Lunatics and the Rule in Foss v Harbottle” (1978) 37 Cambridge Law Journal 270 273, according to whom this is the main exception to the rule in Foss v Harbottle; and Sealy Directors’ “Wider” Responsibilities 169. Naude supra 260 et seq indicates that the proper term in regard to the company having been wronged is “fraud on the company”. See discussion infra par 8.2.3.3 for further information.
\item Regal Hastings Ltd v Gulliver [1942] 1 All ER 378.
\item Cook v Deeks [ 1916] 1 AC 554.
\end{enumerate}
\end{footnotesize}
courts distinguished between a breach of duties that may be ratified and breaches that are incapable of being ratified, is not at all clear.\textsuperscript{1232} \textsuperscript{1233} A number of commentators are troubled by this conflict\textsuperscript{1234} and a principled exposition of the reason for this distinction is often attempted. The conflict between reported decisions is sometimes explained on the basis of the fact that directors acted \textit{bona fide} in the first case, while the latter case represented the opposite end of the spectrum, namely the actual misappropriation of company funds by directors.\textsuperscript{1235} Some list specific examples of director conduct that is not be capable of being ratified by an ordinary majority of shareholders, for example the misappropriation of the company’s property,\textsuperscript{1236} the expropriation of minority members’ shares,\textsuperscript{1237} \textit{mala fide} actions,\textsuperscript{1238} or where the director benefited himself at the expense of the company.\textsuperscript{1239} The general meeting is also regarded as powerless to relieve directors from their fiduciary obligation to act \textit{bona fide} for the benefit of the company.\textsuperscript{1240}

It is rightly conceded, however, that there is no authority for the proposition that the conduct of directors acting \textit{mala fide} towards the company is incapable of being

\textsuperscript{1232} According to Gower \textit{supra} 439 a “satisfactory answer, consistent with common sense and with the decided cases, is difficult (and perhaps impossible) to provide”.

\textsuperscript{1233} This distinction is of course also important insofar as it has to be determined whether a minority member has the right to bring a derivative action. According to the rule in \textit{Foss v Harbottle} a minority member of the company will generally be able to institute action on behalf of the company if the wrong done to the company is an unratifiable wrong and the wrongdoers are in control of the company. See Gower \textit{supra} 458. Also see Naude \textit{supra} 272.

\textsuperscript{1234} Cilliers & Benade \textit{supra} par 19.14; Farrar \textit{supra} 424; Wedderburn Part I 194; Wedderburn Part II.

\textsuperscript{1235} See Farrar \textit{supra} 424; in n 16 reference is made to Sealy \textit{Cases and Materials in Company Law} (1996) 297, where it is stated that this apparent conflict can only be explained on the basis that the finding of \textit{bona fides} is crucial.

\textsuperscript{1236} Glover \textit{Commercial Equity – Fiduciary Relationships} (1995) 201, with reference to \textit{Menier v Hooper’s Telegraph Works} (1874) LR 9 Ch App 350; and \textit{Cook v Deeks supra}.

\textsuperscript{1237} Glover \textit{supra} 201, with reference to \textit{Brown v British Abrasive Wheel Co} [1919] 1 Ch 290; and \textit{In re Bugle Press} [1961] Ch 270.

\textsuperscript{1238} Naude \textit{supra} 272 provides one such an example, namely the receiving of bribes.

\textsuperscript{1239} Naude \textit{supra} 272. This viewpoint is endorsed by Cilliers & Benade \textit{supra} par 19.14.

\textsuperscript{1240} Glover \textit{supra} 201.
ratified.\textsuperscript{1241} The single certainty provided by the cases on this point therefore seems to be that the only breaches of fiduciary duties that are not capable of being ratified, are where the delinquent director benefited at the expense of the company or misappropriated company property.\textsuperscript{1242}

\textbf{8.2.3.2 Ratification by Directors as Shareholders}

A further question in this respect is whether it is possible for directors, acting in their capacity as shareholders, to ratify a breach of their duties as directors. Shareholders are traditionally viewed as not subject to fiduciary duties when voting on resolutions to ratify director conduct.\textsuperscript{1243} In principle directors should therefore be able to absolve themselves from liability in their capacity as shareholders, insofar as the particular wrong is ratifiable,\textsuperscript{1244} although some cases hold a contrary view.\textsuperscript{1245} The resulting ratification may, however, be open to challenge.\textsuperscript{1246}

\textsuperscript{1241} Naude supra 266.

\textsuperscript{1242} As was the case in Cook v Deeks supra; Menier v Hooper Telegraph Works supra; Daniels v Daniels [1978] 2 All ER 89; and Prudential Assurance Co Ltd v Newman Industries Ltd (2) [1980] 2 All ER 841 862. One is therefore inclined to agree with Gower supra 440 that “[b]eyond the proposition that ratification is not effective where it would amount to misappropriation of corporate property, it is difficult to formulate any further limitations which command general consent”.

\textsuperscript{1243} In Menier v Hooper’s Telegraph Works supra 354 the court, per Mellish LJ, held that “shareholders of a company may vote as they please, and for the purpose of their interests”. Also see North-West Transportation Co Ltd and Beatty v Beatty (1887) 12 App Cas 589 593, where the court specifically stated:

Every shareholder has a perfect right to vote upon any such question, although he may have a personal interest in the subject matter opposed to or different from the general or particular interest of the company.

A similar principle appears from Pender v Lushington (1877) 6 ChD 70 75 – 76; Burland v Earle [1902] AC 83; Goodfellow v Nelson Line [1912] 2 Ch 324; and Northern Counties Securities Ltd v Jackson & Steeple Ltd [1974] 1 WLR 1133. The South African judiciary confirmed this principle in a number of cases, eg Gundelfinger v African Textile Manufacturers Ltd 1939 AD 314 325; Sammel v President Brand Gold Mining Co Ltd 1969 3 SA 629 (A) 679; Desai v Greyridge Investments (Pty) Ltd 1974 1 SA 509 (A) 519; and Ben Tovim v Ben-Tovim 2001 3 SA 1074 (C) 1088, in which case the court made it clear that “[a] director, in his capacity as a shareholder of a company, may act entirely in his personal interests without taking any account of any conflicting interests of the company, provided he is not guilty of fraud or oppression of minority shareholders”. See Hannigan “Limitations on a Shareholder’s Right to Vote – Effective Ratification Revisited” 2000 Journal of Business Law 493 507 - 511 for further discussion.

\textsuperscript{1244} Farrar supra 437 and Gower supra 438 n 99 are in support of this viewpoint, with Gower going so far as to describe the contrary views of Vinelott J in Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) supra, namely that interested shareholders may not vote on ratification resolutions, as “heretical”. Wedderburn “Derivative Actions and Foss v Harbottle” (1981) 44 Modern Law Review 202 204 (hereinafter Derivative Actions and Foss v Harbottle) is also of the opinion that Vinelott J’s contrary views are “wrong in law and policy”.

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It is a very difficult task to identify the limits that the courts have placed on the power of directors *qua* shareholders to ratify breaches of directors’ common-law duties.\(^{1247}\) The most commonly formulated proposition in this regard is that a majority of the shareholders may not by resolution appropriate company property to themselves, because the property of the company is something in which all the shareholders of the company have an interest.\(^{1248}\)

Other commentators also recognise the limitation on the ability of directors to ratify a breach of fiduciary duties in their capacity as shareholders, but do not confine this limitation to the specific instances of a misappropriation of company property, however, and regard it as applicable in respect of any breach of duties by directors.\(^{1249}\) Ratification by a majority of the independent minority will, however, exonerate directors insofar as the particular breach may be regarded as a ratifiable wrong.\(^{1250}\)

\(^{1245}\) *Atwool v Merryweather* (1867) LR 5 Eq 464; *Cook v Deeks* *supra*; *Daniels v Daniels* *supra* 96; *Prudential Assurance Co Ltd v Newman Industries Ltd* (No 2) *supra*.

\(^{1246}\) Hannigan *supra* 510.

\(^{1247}\) As rightly noted by Gower *supra* 439 – 440.

\(^{1248}\) Gower *supra* 440. Authority for this proposition may be found in *Burland v Earle* *supra* 93, where the court clearly stipulated that the majority cannot “appropriate to themselves money, property or advantages which belong to the company or in which the other shareholders are entitled to participate”.

\(^{1249}\) Pennington *supra* 719 is of the opinion that “directors who are controlling shareholders cannot absolve themselves from liability for breaches of duties which they owe to the company…by using their votes as shareholders”. McLennan “The Condonation by Companies of Wrongs Committed Against Themselves” 1998 *SALJ* 129 140 seems to favour this approach and feels that it is time for the law to put an end to the ability of wrongdoers to ratify wrongs committed by themselves. Sealy *Directors’ “Wider” Responsibilities* 182 also seems to be of the opinion that the law ought to be changed, so that “a perverse or self-serving misappropriation of corporate funds by directors in disregard of the claims of creditors should not be capable of condonation or release by the votes of shareholders…who may even be the same persons as the directors”.

\(^{1250}\) Pennington *supra* 807. Payne *supra* 621 concedes that this solution may seem attractive at first glance, but that it may raise numerous practical problems. The first is how dependence should be defined and secondly, how it should be detected. A further problem is that none of the shareholders might pass the independency test.
A further suggestion is that all shareholders should be required to act *bona fide* in the interests of the company when ratifying director conduct in breach of their duties.\(^{1251}\) A deviation from the principle that shareholders are entitled to exercise their voting rights in any way they please is not supported by South African case law, however.\(^{1252}\) The legal principle, in general,\(^{1253}\) is therefore that members of a company do not stand in a fiduciary relationship to the company and are therefore not under a duty to exercise their votes *bona fide* in the interests of the company as a whole.

Directors are therefore in principle entitled to use their power as shareholders to absolve themselves from any liability flowing from a breach of fiduciary duties.\(^{1254}\) The only instances where directors are precluded from using their votes as shareholders as they please, are in cases where the directors misappropriated company property,\(^{1255}\) where directors benefited at the expense of the company,\(^{1256}\) or in

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\(^{1251}\) Cranston “Limiting Directors’ Liability; Ratification, Exemption and Indemnification” 1992 *Journal of Business Law* 197 204, according to whom there is Australian authority to this effect in the case of *Ngurli Ltd v McCann* (1953) 90 CLR 425 438.

\(^{1252}\) See cases referred to *supra* n 49.

\(^{1253}\) It must be kept in mind, however, that an application for the winding-up of a company can be brought by a member in case of oppression by the majority, on the ground that it would be just and equitable (in terms of s 344(h) of the South African *Companies Act*, as interpreted by the court in *Rand Air (Pty) Ltd v Ray Bester Investments (Pty) Ltd* 1985 2 SA 345 (W) 349 – 351). Members are therefore free to exercise their voting rights in any way they want, but do expose themselves to the possibility that it would constitute a basis for the winding-up of the company should they exercise their voting rights in bad faith in oppression of the minority in the company. Pennington *supra* 819, with reference to the ability of a member to apply for the winding-up of a company on the basis that the affairs of the company are being conducted in a manner which is unfairly prejudicial to the interests of its members (in terms of s 459(1) of the English *Companies Act*), confirms that “the court’s reluctance to examine business decisions would disappear if it were shown that the…controlling shareholders concerned did not make the impugned decisions in good faith in the interests of the members of the company as a whole” (own emphasis).

\(^{1254}\) Rider *supra* 285 agrees that “there would appear to be no objection to the persons implicated in the breach of duty using their own votes in general meeting”. In *Ben-Tovim v Ben-Tovim supra* 1088 the South African judiciary confirmed that a director, “in his capacity as a shareholder of a company, may act entirely in his personal interests without taking any account of any conflicting interests of the company…”.

\(^{1255}\) In *Regal Hastings Ltd v Gulliver supra* the court indicated its willingness to allow directors who controlled the majority vote at the general meeting of shareholders to ratify a breach of their duties where they did not misappropriate company property. In *Cook v Deeks supra*, however, the court refused to allow directors to ratify their own conduct in their capacity as shareholders as their misconduct entailed the misappropriation of company property.

\(^{1256}\) *Daniels v Daniels supra*. 

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instances of oppression of minority shareholders. In such cases the ratification is open to challenge.

This state of affairs seems to be the only satisfactory option. A prohibition on directors to cast their votes as shareholders in any way they please is impossible to police and easy to evade by transferring votes to family members and other nominees. One is therefore inclined to agree that it is much more satisfactory to “allow a director to vote as a shareholder in all circumstances and to invite the court then to consider the substance of the transaction which has been ratified”.

8.2.3.3 Ratification by Unanimous Consent

The classification of certain wrongs as unratable took place in the context of providing protection to minority shareholders. A question that is left unanswered, however, is whether directors who are not only the controlling shareholders, but the sole shareholders of a company, are, in their capacity as shareholders able to ratify their wrongful conduct as directors.

Uncertainty in this regard seems to derive from the fact that the limitation of the power of directors to absolve themselves from liability in their capacity as shareholders where they misappropriated company property was justified on the basis that it would constitute a “fraud on the minority”. If there were no minority that could be defrauded, which would be the case where the directors are the sole shareholders of the company, it would indeed be problematic to justify the limitation that is placed on the right of directors to exercise their votes as shareholders in any way they wish.

1257 In Ben-Tovim v Ben-Tovim supra 1088 the court listed two instances where directors will not be able to use their votes as shareholders in their own interests, namely fraud and oppression of minority shareholders.

1258 Ibid.

1259 Hannigan supra 510. Payne supra 625 – 626 draws the same conclusion. See also Worthington “Corporate Governance: Remedying and Ratifying Directors’ Breaches” (2000) 116 Law Quarterly Review 639 647 who regards any limitation on a shareholder’s voting power as an “inconsistent, and therefore unacceptable, infringement of the property rights inherent in share ownership”.

303
This is an unfortunate result of the fact that it is a misnomer to refer to this type of conduct as “fraud on the minority”.\textsuperscript{1260} It is in reality “fraud on the company” and the question as to whether there is a minority that should be protected should not even be raised, since it is the company as a legal entity that is wronged.\textsuperscript{1261}

Cases such as \textit{In re Halt Garage (1964) Ltd}\textsuperscript{1262} and \textit{Rolled Steel Products (Holdings) Ltd v British Steel Corp}\textsuperscript{1263} are indicative of the qualification that ratification will only be effective insofar as the transaction have not been fraudulent.\textsuperscript{1264}

It can thus be concluded that directors who misappropriated company property or benefited at the expense of the company will not be able to use their votes as shareholders, whether they are controlling shareholders or the sole shareholders of the company, to ratify their conduct and in so doing to escape liability.\textsuperscript{1265}

By way of summary it can thus be said that a majority at the general meeting of shareholders is entitled to ratify a breach of directors’ duties. Directors are allowed to use their votes as shareholders to ratify their own wrongdoing. Where the breach constitutes a misappropriation of company property, or directors benefiting at the expense of the company, the wrong is regarded as unratifiable. In the case of an

\textsuperscript{1260} Naude \textit{supra} 260 \textit{et seq}.

\textsuperscript{1261} The fact that directors, in their capacity as sole shareholders, are precluded from ratifying a breach of common-law directorial duties, seems to indicate support for the viewpoint that the interest of the company can no longer be defined simply with reference to the interests of the shareholders of the company.

\textsuperscript{1262} [1982] 3 All ER 1016 1037.

\textsuperscript{1263} [1986] Ch 246.

\textsuperscript{1264} According to Hannigan \textit{supra} 496 “fraudulent” here essentially means the “misappropriation of assets of the company by the shareholders to the fraud of the company’s creditors” (own emphasis). She rightly notes that this will only become an issue in insolvent companies, as the matter may never come to light in solvent companies (\textit{id} 498).

\textsuperscript{1265} Support for this conclusion can be found in a number of cases. See eg \textit{S v De Jager} 1965 2 SA 616 (A) 624; \textit{S v Hepker} 1973 1 SA 472 (W) 484, where the court emphatically stated that “directors are not allowed knowingly to bind their companies to transactions which are unprofitable to the company and are intended to serve the directors’ own ends…even when they hold all the shares” (own emphasis). Authors such as McLennan \textit{supra} 131 are also of the opinion that it “would obviously be absurd” to allow directors as sole shareholders to ratify their own wrongdoings.
unratifiable wrong, any proposed ratification is open to judicial scrutiny and minority shareholders, if there are any, will generally be entitled to proceed against the delinquent directors on behalf of the company by way of a derivative action, should the company fail to do so.1266

8.3 JUDICIAL METHODS FOR EXTENDING DIRECTORS’ DUTIES TO CREDITORS

8.3.1 Indirect Duty Method

8.3.1.1 Beneficiary of Duty

The indirect duty method is to a large extent based on the traditional viewpoint as referred to above,1267 in terms of which directors are still considered to owe their common law duties to the company. The indirect duty method is supported in most jurisdictions.1268 Creditor protection by way of a directorial duty is contemplated on the basis that creditors’ interests should be the dominating factor in determining the interest of the company when it experiences economic or financial distress.1269 It is usually phrased to indicate that directors are under an obligation to consider the interests of creditors in discharging their duties to the company. The company, as a separate legal entity, thus remains the beneficiary of directors’ duties.1270

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1266 Unless the majority of the independent shareholders decided against bringing the action. See Smith v Croft (No 2) [1987] 3 All ER 909 956.

1267 Supra par 8.2.

1268 According to Thomson “Directors, Creditors and Insolvency: A Fiduciary Duty Or a Duty Not to Oppress” (2000) 58 University of Toronto Faculty of Law Review 31 43 the general position under English, Australian and New Zealand law is that “directors do not owe a fiduciary duty directly to creditors – the fiduciary duty is owed to the corporation, which continues to be regarded implicitly as the body of shareholders.”

1269 The interests of creditors thus seem to replace the interests of shareholders as the most important factor in determining the interest of the company. Uncertainty exists as to whether shareholders’ interests will be totally replaced by creditors’ interests upon the company experiencing distress, or whether shareholders’ interests will only become of secondary importance upon the company experiencing distress. This matter is dealt with in more detail supra Ch 7 (Point in Time When the Duty Arises) par 7.4, under the discussion as to whether the duty should be viewed as a dual or a fluctuating duty.

1270 Gower supra 373 regards directors’ duties to creditors as a duty that is owed to “the creditors as a group through the mechanism of their interests being identified as constituting the company’s interests as insolvency approaches”. Sarra & Davis Director and Officer Liability in Corporate Insolvency: A Comprehensive Guide to Rights and Obligations (2002) 15 interpret directors’ duties to creditors in the same way and comment that
A directorial duty to creditors on this basis seems to be couched in similar terms to section 309 of the English *Companies Act*. This provision endows directors with the right to consider the interests of company employees in discharging their duties to the company. The resemblance between the statutory formulation of a directorial right to consider the interests of corporate employees and the judicial extension of directors’ duties to creditors as corporate constituents creates the possibility that section 309 of the English *Companies Act* may provide helpful insights as to how the application of the indirect duty to creditors should be viewed.

Section 309 provides as follows:

(1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company’s employees in general, as well as the interests of its members.

(2) Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.

**8.3.1.2 Right of Action**

It seems fairly obvious that, since directors are still deemed to owe their duties to the company in terms of the indirect duty method, the company is still the proper party to bring action against directors if they fail to comply with their duties. The company, as a metaphysical entity, will be able to enforce directors’ duties to consider the interests of creditors through the liquidator upon the commencement of formal

[a]t the point of insolvency, while directors and officers continue to be obliged to manage in the best interests of the corporation, the focus of those interests shifts from one in which shareholder interests are paramount, to one in which the interests of creditors become important.

1271 Riley *supra* 91; Trethowan *supra* 54. S 309(2) is very specific on the point that a duty to employees is “enforceable in the same way as any other fiduciary duty owed to a company by its directors”, which indicates that this interpretation of directors’ duties to creditors is in line with the general way in which the English legislature views the manner in which the interests of other corporate constituents should be considered.
winding-up procedures.\textsuperscript{1272} Creditors themselves have no right at common law to enforce the duties owed by directors.\textsuperscript{1273}

Any action brought for the benefit of creditors will furthermore be for the benefit of creditors as a whole and not for the benefit of individual creditors.\textsuperscript{1274} The proceeds of a successful action will therefore be applied to the general pool of assets available for distribution among the creditors.

\textbf{8.3.1.3 Power of Ratification}

The orthodox viewpoint is that the beneficiary of directors’ fiduciary duties and duty of care and skill, namely the company, is capable of ratifying a breach of directors’ duties. The general meeting of shareholders is traditionally vested with this power.\textsuperscript{1275}

It was recognised in numerous decisions, however, that shareholders are unable to ratify a breach of directors’ duties once the duty to creditors is triggered.\textsuperscript{1276} A number of authors agree with this limitation on the power of shareholders to ratify a breach of directors’ duties to consider the interests of creditors.\textsuperscript{1277} This leads one to conclude that, once creditors become the beneficiaries of directors’ duties, ratification

\textsuperscript{1272} See discussion \textit{supra} par 8.2.2.

\textsuperscript{1273} In \textit{Yukong Line Ltd v Rendsburg Investments} [1998] 2 BCLC 485 503 the court stated that a director does not “owe a direct fiduciary duty towards an individual creditor, \textit{nor is an individual creditor entitled to sue for breach of the fiduciary duty owed by the director of the company} (own emphasis); and in \textit{In re New World Alliance Pty Ltd (rec and mgr apptd); Sycotex Pty Ltd v Baseler} (1994) 122 ALR 531 550 it was also made very clear that “the duty to take into account the interests of creditors…does not, in the absence of any conferral of such right by statute, confer upon creditors any general law right against former directors of the company to recover losses suffered by those creditors”. Also see Hargovan “Directors’ duties to creditors in Australia after Spies v The Queen – Is the Development of an Independent Fiduciary Duty Dead or Alive?” (2003) 21 \textit{Company & Securities Law Journal} 390 409.


\textsuperscript{1275} See discussion and authority referred to \textit{supra} par 8.2.3.

\textsuperscript{1276} See authority referred to \textit{supra} Ch 4 (Judicial Framework) par 4.6. In none of the decisions did the courts provide an indication as to whether \textit{creditors} will be able to ratify the particular breach of duties, however. See \textit{infra} par 8.4.1.2 for further discussion on this aspect and other potential problem areas in respect of the direct duty method.

\textsuperscript{1277} See eg Grantham \textit{supra} 17 and Parkinson “Non-commercial Transactions and the Interests of Creditors” (1984) 5 \textit{The Company Lawyer} 55 63, who puts it quite strongly that it would be “irrational that the directors should be excused from liability by ratification by the members” in the case of a transaction that constitutes a breach of duty because of its prejudicial effect on creditors, as it is not members’ interests that are at stake.
of a breach by the company in general meeting will be invalid and that creditors may not be deprived of a remedy flowing from the breach in this way.\footnote{1278}

\textbf{8.3.2 Direct Duty Method}

\textbf{8.3.2.1 Beneficiary of Duty}

In terms of the direct duty method, or independent duty as it is called by some,\footnote{1279} creditors are the direct beneficiaries of directorial duties. Any protection afforded to them in terms of such a duty therefore does not devolve upon them through their position as one of the constituents of the corporate enterprise, but in their own right.

\textbf{8.3.2.2 Right of Action}

The direct duty method is not based on existing company law principles, but supposes a new set of principles which are not clarified by the few court cases in which a duty to creditors on this basis was mooted. As a result, it is more difficult to define the basic principles upon which such a duty is founded, as would be the case with the indirect duty method.

The fact that it is viewed as diametrically opposite to the indirect duty method does, to a certain extent, aid an attempt to establish the elements of a separate duty. If the

\footnote{1278}{Granatham \textit{supra} 17 explains this departure from the orthodox position as follows:}

\begin{quote}
The shareholders’ right to waive a breach of duty derived from the traditionally exclusive association of the company with its shareholders. The new conception, however, reflecting a community of interests, will in some circumstances displace the shareholders as “owners” and thus render it inappropriate, in those circumstances, for shareholders to forgive the breach.
\end{quote}

\footnote{1279}{Parkinson \textit{supra} 64 interprets this limitation on the power of shareholders with reference to the fact that creditors form part of the “company as a whole”. A transaction that is a breach of duty because of its effect on creditors cannot be ratified by the shareholders alone, as the consent of the “company as a whole” was not obtained. Sealy \textit{Directors’ “Wider” Responsibilities} 181 stated his disagreement with this proposition in no uncertain terms and argued that “we cannot conclude that the shareholders are no longer competent to act, for they are the only residual organ that the company has”.

\textit{McConvill “Directors’ Duties to Creditors in Australia after Spies v The Queen”} (2002) 20 \textit{Company & Securities Law Journal} 4 13, who distinguishes between a duty of imperfect obligation, in terms of which the duty to creditors is mediated through the company, and an “independent” fiduciary duty.}
creditors are not allowed to enforce a directorial duty directly in terms of the indirect duty method, they should be able to do so in terms of the direct duty method.\footnote{1280}

There is little clarity, however, on the point as to whether an individual creditor may bring action on his own behalf, or whether creditors should act collectively. If it is assumed that they should act collectively, another problem presents itself, namely the fact that company law does not provide creditors with a mechanism to enable them to act collectively against directors in breach of their duties to creditors.\footnote{1281} Creditors are therefore in need of some type of class action to enable them collectively to enforce a duty owed to them directly.

It is also uncertain who will be entitled to the proceeds of a successful action. If any individual creditor is entitled to proceed against delinquent directors on his own behalf, the proceeds of a successful action should go to the creditor who instituted action. On the other hand, if creditors are regarded as a single body, the proceeds of a successful action should be applied towards the general pool of assets available for distribution. The latter option diminishes the incentive for an individual creditor to take action against directors.

\subsection*{8.3.2.3 Power of Ratification}

Case law provided clear indication that shareholders are divested of the power to ratify a breach of directors’ duties once it is established that directors’ duty to creditors has come into operation. This should be the case whether the direct or indirect duty method is applied.

As was the case with the indirect duty method, the question remains whether creditors themselves are able to ratify a breach of directors’ duties to them.

\footnote{1280}{This surmise is reinforced by the fact that commentators such as Riley \textit{supra} 91 also seems to view the direct duty in this way, as well as the fact that creditors are sometimes allowed to maintain a direct action against directors. See eg \textit{Geyer v Ingersoll Publications Co} 621 A 2d 784 (Del Ch 1992). This case is criticised by authors such as Beveridge \textit{supra} 619, however, for its flawed analysis in that the cases cited in \textit{Geyer} do not support giving creditors a direct cause of action against directors of an insolvent company.}

\footnote{1281}{In case of a duty owed directly to creditors, creditors will not be able to use the vehicle of the company to enforce this duty collectively, as was the case with the indirect duty method.}
8.4 EVALUATION OF JUDICIAL METHODS

8.4.1 Indirect Duty Method

8.4.1.1 Perceived Advantages

The indirect duty method, as construed above,\textsuperscript{1282} at first glance seems simplistic and its attraction for being modelled on known principles may well be understood.\textsuperscript{1283} The fact that existing principles pertaining to directors’ duties provide some sort of basis for a directorial duty to creditors in terms of the indirect duty method is, however, not the only reason why numerous commentators prefer this method.

Further reasons are based on concerns that a duty that is directly enforceable by creditors will lead to a multiplicity of actions against directors; encourage litigation; result in too much time being spent on such matters; and a huge increase in costs, all of which may largely be allayed if the company were the only possible plaintiff.\textsuperscript{1284}

A further perceived advantage of the indirect duty method is that it circumvents the potential problem of a conflict of interest between various classes of creditors. The duty would still be owed to the company, which would entail that the proceeds of any action is to be paid into the corporate estate to be distributed without regard to any categorisation of creditors’ interests that should have been considered. If the rules of distribution are fixed the need to distinguish between creditors in the definition of the duty is therefore removed.\textsuperscript{1285}

\textsuperscript{1282} \textit{Supra} par 8.3.1.

\textsuperscript{1283} See eg Trethowan \textit{supra} 52 who acknowledges the value of traditional principles pertaining to directors’ fiduciary duties and suggests that problems regarding directors’ duties to creditors must be addressed with reference to the nature of a director’s duty to the company.

\textsuperscript{1284} Riley \textit{supra} 92. Cohen \textit{supra} 357 provides a similar list of reasons justifying the restraint on directors’ ability to institute action against directors directly and added that the grant of a right of action to individual creditors could expose directors to the risk of a double claim. In Kalinko v Nisbet \textit{supra} 778, a case in which the court had to pronounce on the right of an individual shareholder to proceed against directors for not having complied with their fiduciary duties, the court indicated, however, that the “potential mischief of a ‘double recovery’” should not preclude a plaintiff from attempting to pursue his remedy (own emphasis). The court thus seems to hold the opinion that the danger of double recovery should clearly be present, and not only be feared, before a plaintiff will be disallowed from individually proceeding against directors.

\textsuperscript{1285} Wishart \textit{supra} 330.
A final factor that seems to swing the balance in favour of the indirect duty method is the application of certain principles of insolvency law, specifically those pertaining to an equitable distribution of assets upon winding-up. It is assumed that the rationale of ordering delinquent directors to make payment to the company is to ensure that the proceeds are distributed in accordance with established rules relating to priorities of debts in a winding-up. Should each creditor be allowed to institute action on his own behalf, the rules aimed at achieving some measure of justice and certainty between creditors will in effect be by-passed.

8.4.1.2 Perceived Problems

Despite the apparent persuasive power of the above arguments, the indirect duty method does not enjoy uncritical support and closer analysis reveals a number of possible deficiencies.

The first problem relates to the enforcement of the duty by the creditors. It is proposed that their interests should enjoy prime consideration upon the company.

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1286 In a South African context the concept of concursus creditorum will play a key role in this regard. This concept was explained as follows in Walker v Syfret 1911 AD 141 166:

The sequestration order crystallises the insolvent’s position; the hand of the law is laid upon the estate, and at once the rights of the general body of creditors have to be taken into consideration. No transaction can thereafter be entered into with regard to estate matters by a single creditor to the prejudice of the general body. The claim of each creditor must be dealt with as it existed at the issue of the order.

The same underlying philosophy is often expressed with reference to the concept of pari passu. See eg the Report of the Review Committee on Insolvency Law and Practice, HMSO, London, Cmd 8558, 1982 par 26, in which it is stated as a fundamental objective of insolvency law to “achieve a rateable, that is to say pari passu, distribution of the uncharged assets of the insolvent among the unsecured creditors”.

1287 Riley supra 92. Sealy Directors’ “Wider” Responsibilities 177 also recognises that affording some creditors a remedy in insolvency which is denied to others will undermine the fundamental principle that all creditors should participate pari passu in the bankrupt estate. Also see Trethowan supra 59 who is of the opinion that there is no justifiable reason why “individual creditors with sufficient resources to litigate should be in a better position than other creditors in insolvency”.

1288 Dean “Stakeholding and Company Law” (2001) 22 The Company Lawyer 66 72 rightly notes that “[i]n the absence of effective sanctions to back them up, new legal responsibilities are likely to prove ineffectual” and that “[a]ny law that is not enforced or enforceable in practice is in danger of becoming a dead letter”.

311
Chapter 8

Beneficiary of the Duty

being in distress. Creditors are powerless, however, to enforce this duty, except through the liquidator once the company is in formal liquidation.\textsuperscript{1289}

It is furthermore uncertain whether they would be entitled to proceed on their own behalf, should the liquidator refuse to take action against the delinquent directors. This construction of the duty led to it being termed a “duty of imperfect obligation”\textsuperscript{1290} and seems to regard the duty to creditors as nothing more than a limitation of the power of shareholders to ratify a breach of directors’ duties.\textsuperscript{1291}

An indirect duty to creditors may also serve as a defence for directors in actions instituted against them by dissatisfied shareholders on behalf of the company.\textsuperscript{1292} Directors may, for example, very well justify actions that caused complaints among shareholders as being in the best interest of creditors of the company.\textsuperscript{1293} An indirect

\textsuperscript{1289} A fact that contributed to many authors’ rejection of directors’ duties to creditors or criticism against this particular method. See eg Hill “Duties of Directors Towards Creditors – Whether There Are Such Duties When the Company Is Insolvent” (1986) 60 Australian Law Journal 525 527 who considers it as “odd” that “creditors have not to date been considered to have an independent cause of action in respect of breach of directors’ duties…where the directors have a duty to consider their interests”; and Renard, in a commentary on a paper by Heydon “Directors Duties and the Company’s Interests” in Finn (ed) Equity and Commercial Relationships (1987) 120 140 who asks the question why creditors are not entitled to sue in equity if directors owe a duty to them; Sealy Directors’ “Wider” Responsibilities 177 who rejects the notion of a duty to creditors on the basis that a “supposed legal duty which is not matched by a remedy is a nonsense”.

\textsuperscript{1290} This term was first used by Heydon supra 131 and was subsequently applied in In re New World Alliance Pty Ltd; Sycotex Pty Ltd v Baseler supra 550.

\textsuperscript{1291} McConvill supra 6.

\textsuperscript{1292} This perception seems to be reinforced by explanatory comments on the purpose of section 309 of the English Companies Act, which provides statutory protection to company employees along similar lines as the indirect common law duty to creditors. The purpose of this provision is apparently to leave room for directors to look after the well-being of company employees without exposing themselves to liability that may flow from actions by dissatisfied shareholders.

\textsuperscript{1293} The fact that directors may use their allegiance to various corporate constituents as a defence in actions against them is one of the main points of criticism against a duty to creditors, and the point that a duty to everyone is in fact a duty to no one was made by various commentators. See eg Sealy Directors’ “Wider” Responsibilities 175; as well as the introduction to the King Report on Corporate Governance for South Africa 2002 (hereinafter King II) where it is expressly stated in par 5.1 that

[t]he stakeholder concept of being accountable to all legitimate stakeholders must be rejected for the simple reason that to ask boards to be accountable to everyone would result in their being accountable to no one.

312
duty to creditors is therefore in danger of being perceived as a shield providing protection to directors, rather than a sword in the hands of creditors.

A further problem relates to the ratification of a breach of directors’ duty to consider creditors’ interests. Reference was already made to the fact that the beneficiary of fiduciary duties is in principle entitled to ratify a breach of such duties. This principle was adapted for company law to provide that the company, acting through its organ, the general meeting, is entitled to ratify a breach of directors’ fiduciary duties. On the whole this adaptation of the principle seems to be acceptable, as the interest of the company is traditionally determined with reference to the interest of the shareholders.

This clear picture becomes blurred at the edges, however, once the interests of creditors intrude. The fallacy of allowing shareholders to ratify directors’ failure to consider the interests of creditors was recognised by the courts. Questions that were not addressed by the courts, however, are whether creditors are able to ratify a breach of duties to consider their interests, and how they will be able to do so.

8.4.2 Direct Duty Method

8.4.2.1 Perceived Advantages
The most obvious advantage of the direct duty method lies in the fact that any uncertainty regarding creditors’ *locus standi* is removed, as a duty owed directly to creditors “will permit them to bring actions in their own right, and for their own benefit”. This will render the duty more effective, since it will place enforcement in the hands of those with the keenest interest in taking action for its breach.

The possibility that the proceeds of a successful action by a creditor for breach of duty would go to the particular creditor, rather than merely to the company for division amongst some or all creditors, may also be regarded as an advantage.

### 8.4.2.2 Perceived Problems

The direct duty method is criticised for its potential to allow inappropriate interference in corporate management by creditors and to create unwarranted threats of director liability by raising conflicting duties to shareholders and to creditors.

A direct duty may also infringe on directorial freedom when making corporate decisions and may inhibit qualified people from taking on the responsibilities and duties of directors.

It is furthermore rejected for its apparent disregard of fundamental principles of insolvency law and for cutting across the prime economic function of a company, namely the “pursuit of maximum profits and the directors as the agents of this maximisation”.

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1301 Riley *supra* 91.

1302 *Ibid*.

1303 Beveridge *supra* 621.

1304 *Id* 622.


1306 Grantham *supra* 12.
Application of the direct duty method may furthermore lead to double recovery, in that the creditors will be able to sue individually and the liquidator may sue on behalf of the company if it ends up in insolvent liquidation.\(^{1307}\)

Further criticism against the direct duty method is that it does not sit easily alongside the board’s existing fiduciary duties. Although a direct duty to creditors is apparently an extension of traditional rules, it is largely inconsistent with them.\(^{1308}\)

It may also prove difficult to enforce a direct duty in that a creditor who wishes to take action against delinquent directors on this basis will first have to establish that a duty was indeed owed to him.\(^{1309}\)

Creditors’ ability to sue in case of a breach of the duty is also not as clear-cut as it appears to be at first glance. In case of the indirect duty to creditors, creditors are in a position where they may use the separate entity of the company as a vehicle to enable them to act collectively.\(^{1310}\) If the duty is construed as being owed to creditors directly, this option is not available to them. Company law furthermore does not provide creditors with a mechanism such as a class action through which to act collectively against directors in breach of their duties to creditors, making it very difficult for creditors to act collectively in enforcing a direct duty owed to them.\(^{1311}\)

The direct duty method furthermore provides for a “separate duty” to creditors under circumstances where the company is in financial or economic distress.\(^{1312}\) Nothing in the composition of a direct duty indicates that it replaces directors’ traditional duties

\(^{1307}\) Keay *Contractarian Concerns* 670. The South African judiciary would, however, not seem to be concerned about the potential danger of double recovery. See Kalinko v Nisbet *supra*.

\(^{1308}\) Grantham *supra* 13.

\(^{1309}\) Trethowan *supra* 53.

\(^{1310}\) See discussion *supra* par 8.3.1.2.

\(^{1311}\) The *Constitution of the Republic of South Africa* 1996 does provide for a class action in terms of s 38(c). Such a class action is, however, limited to instances where it is alleged that a right in the Bill of Rights has been infringed or threatened. Whether the provision of a class action for an infringement of a fundamental right will provide impetus for the development of a class action in other areas of the law remains to be seen.

\(^{1312}\) Trethowan *supra* 53.
to the company. It thus appears that directors of fully solvent companies owe traditional common-law duties to the company. Directors of companies that are in economic or financial distress, will, however, in addition to the common law duties that they owe to the company, owe certain duties, the content of which is not clear, to the creditors of the company.

Establishing how an independent duty to creditors should operate is thus complicated by the fact that it is not modelled as closely on existing principles as the indirect duty method. This causes a number of problems and uncertainties, for example whether creditors are allowed to act independently in bringing action, or whether they are required to act collectively; the apparent necessity of a class action which is not currently provided for; the lack of rules regarding the distribution of the proceeds of a successful action; the basis on which various classes of creditors should be differentiated; the content of the duty; and its relationship with directors’ traditional common-law duties when they exist in the same company and at the same time.

8.4.3 Summary

The biggest advantage that the indirect duty method seems to have over the direct duty method, being based on existing principles, is the fact that some basis for the operation of a duty to creditors is provided for. This may facilitate the extension of directors’ duties to creditors.

The fact that the company remains the beneficiary of directors’ duties in application of the indirect duty method will furthermore dispel concerns that principles of insolvency pertaining to the distribution of assets will be undermined. It will also make a complicated differentiation between various classes of creditors, each with its own rights in respect of directors’ duties, unnecessary.

Criticism that a duty to creditors will allow them to interfere with the management of the company while it is still a going concern is also addressed by the fact that creditors are powerless to enforce the duty prior to liquidation. This so-called
advantage is, however, also the biggest shortcoming of the indirect duty method. The question has been asked whether a duty without a remedy is of any use.\textsuperscript{1313}

Creditors are not left completely without a remedy, as the liquidator is still entitled to proceed on their behalf once the company is in liquidation. The fact that a liquidator is entitled to proceed against delinquent directors when the company is in liquidation is nothing new, however, and this fact raises another question, namely why such a right should be formulated in connection with a duty to creditors.

The only apparent reason seems to be that the liquidator may sometimes be faced with a wrong to the company that was ratified by the directors in their capacity as shareholders. Under such circumstances the liquidator is, in principle, not allowed to proceed against the directors, as they have been absolved from all possible liability. This may lead some to regard the duty to creditors as nothing more but an attempt by the court to address this apparent injustice by declaring the shareholders to be incapable of ratifying a breach of directors’ duties, as the duty was in fact owed to the creditors under specific circumstances.\textsuperscript{1314}

An indirect duty to creditors thus seems to provide directors with a defence in actions by dissatisfied shareholders and only to aid creditors insofar as a limitation is placed on the right of shareholders to ratify a breach of directors’ duties under particular circumstances.

It is submitted that this formulation of the duty is too narrow and that criticism against it on the basis that a duty without a remedy is nonsense,\textsuperscript{1315} is absolutely justified. This may lead to the whole concept of a directorial duty to creditors being discarded.

\textsuperscript{1313} Sealy \textit{Directors’ “Wider” Responsibilities} 177 put it quite strongly that a “supposed legal duty without a remedy is a nonsense”; Wishart \textit{supra} 326 also emphasised the importance of a \textit{nexus} between those to whom the duty is owed and those protected by the duty.

\textsuperscript{1314} See \textit{supra} Ch 7 (Point in Time When the Duty Arises) for a discussion on the circumstances that would trigger a duty to creditors.

\textsuperscript{1315} Sealy \textit{Directors’ “Wider” Responsibilities} 177. It must be noted, however, that Sealy made this statement to indicate absolute opposition to a duty to creditors, and not by way of advocating a remedy.
It is therefore crucial that creditors be provided with some sort of mechanism to maintain an action to enforce the duty owed to them, albeit in an indirect way.

8.5 SUGGESTED METHOD

8.5.1 Beneficiary of Duty

It is submitted that, since a duty to creditors is generally triggered by the company in question being in financial difficulty,\textsuperscript{1316} the operation of the duty should not be contrary to principles of insolvency law, specifically those regarding the equitable distribution of assets upon insolvent winding-up. The duty to creditors should therefore be formulated in such a way that the proceeds of a successful action are applied to the general pool of assets.\textsuperscript{1317} Such a formulation will allay concerns that a directorial duty to creditors will be contrary to the fundamental principles of insolvency law regarding distribution.

It is furthermore submitted that a duty in terms of which individual creditors are the direct beneficiaries of the duty is too foreign to existing company law principles for it to be capable of successful judicial development.\textsuperscript{1318} The orthodox viewpoint regarding the beneficiary of directors’ duties should, in other words, be replicated as to be linked to the duty to creditors. Heydon supra 131 and Renard supra 140, in a commentary on Heydon’s paper, voiced similar concerns.

\textsuperscript{1316}See discussion supra Ch 7 (Point in Time When the Duty Arises) for more detail.

\textsuperscript{1317}This submission naturally raises the question as to whether a duty to creditors is then necessary, since it is proposed that the result should be similar to what may be achieved by way of insolvency law principles. In a previous discussion it was indicated, however, that traditional insolvency law remedies will not always be able to address prejudice suffered by company creditors, which fact indicates scope and need for a directorial duty to creditors. See supra Ch 3 (Evaluation of Alternative Remedies) par 3.3.

\textsuperscript{1318}The judgment in Kalinko v Nisbet supra, in terms of which the court seemed to be open to the idea that individual shareholders may be allowed to enforce directors’ fiduciary duties, may perhaps be interpreted to contradict this submission. It must be noted, however, that a duty to creditors is proposed in respect of insolvent companies or companies whose solvency is in doubt. For that reason it was suggested that the duty be formulated in such a way that it does not undermine insolvency law principles regarding an equitable distribution of assets. A direct duty enforceable by individual creditors holds the danger that these principles will indeed be undermined. The more liberal approach of the court in Kalinko v Nisbet supra should thus not be extended to directors’ duties to creditors.
far as possible, since courts would then at least be provided with a basis from which they could develop existing principles to provide for creditors’ interests.

The logical conclusion flowing from these submissions is therefore that the company should remain the primary beneficiary of directors’ duties when extending directors’ duties to include creditors, as suggested by the majority of judicial opinion and commentators on this topic.\footnote{See eg Worthington “Directors’ Duties, Creditors’ Rights and Shareholder Intervention” (1991) 18 Melbourne University Law Review 121 131 who agrees that “some of the confusion and controversy might be removed if it were held that the fiduciary duty is owed to the company as a separate legal entity”. Such an approach will be advantageous for according with the existing conceptual framework of company theory and the underlying principles of fiduciary powers; and will furthermore be simple (\textit{id} 131).}

The interest of the company should, however, not automatically be equated with the interests of the shareholders. In this regard the suggestion that the interest of the company should be defined according to the interests of its members, with a flexible definition of “membership”, is supported.\footnote{Wishart \textit{supra} 349 et seq.} In terms of this flexible definition the residual risk bearers should be regarded as the members of the company. When the company is financially and economically sound the shareholders will in other words constitute the members of the company, while the creditors will do so when that is not the case.\footnote{Wishart \textit{supra} 350. Also see Sarra & Davis \textit{supra} 15.}

The indirect method of extending directors’ duties to include creditors is thus supported insofar as it provides for a duty that is mediated through the juristic person of the company. This will in turn mean that the company remains the recipient of the fruits of a successful action, which can then be distributed among creditors according to the normal rules of distribution upon winding-up.

\subsection*{8.5.2 Classes of Creditors}

The suggestion that the company is to remain the beneficiary of directors’ duties would, to a large extent, address the problem of creditors not being a homogenous group. If the proceeds of a successful action were to be distributed according to the
normal rules of distribution upon winding-up, it would be irrelevant whether a creditor is a trade creditor; holder of debt equity; a voluntary creditor; or an involuntary creditor.

A question that will still remain is whether future creditors should be regarded as a group who are entitled to the protection afforded by directors’ duties. This issue will come to the fore in a scenario similar to the one that the court was confronted with in *Jeffree v National Companies and Securities Commission*.\(^{1322}\) In this case directors of a company, in anticipation of a judgment being delivered against the company, the effect of which would be to render the company insolvent, decided to pay existing creditors in full and to transfer the assets of the company to a new company, specifically formed for that purpose. The new company comprised the same shareholders, same directors and conducted the same business. The judgment creditor was eventually left with a successful claim against a dormant shell.

In such a case the other creditors of the company will clearly be satisfied since their claims were settled in full and they will obviously have no interest in proceeding with any actions against the directors. The initial company was furthermore not put into formal liquidation, thereby leaving the judgment creditor without the option of recourse through a liquidator. Action was instituted against the directors personally on the basis that they failed to comply with their duties to the company, as the interests of “future” creditors were disregarded.

The inclusion of future creditors in the group of creditors whose interests should, as a general rule, be considered by directors may prove problematic specifically with reference to aspects such as the bringing of actions or ratification in case of a breach of the duty. It will also complicate the already complex issue of determining the solvency of the company in question even further. It is therefore submitted that directors’ duties to creditors should be limited to existing creditors.\(^{1323}\)

\(^{1322}\) (1989) 15 ACLR 217.

\(^{1323}\) The interests of the company have been defined in some cases such as *Gaiman v National Association for Mental Health* [1971] Ch 317 338, as the interests not of specific shareholders, but as the “interests of both present and future members” (own emphasis). This may lead one to conclude that
Future creditors, such as the judgment creditor in *Jeffree v NCSC*,\(^{1324}\) will not be left without remedies and may rely on an individual delictual action against the directors,\(^{1325}\) or they may request the piercing of the corporate veil in order to institute action against the newly formed company.\(^{1326}\) A remedy such as the *Mareva* injunction may also prove valuable in safeguarding the interests of future creditors, such as the judgment creditor in *Jeffree v NCSC*.\(^{1327}\)

### 8.5.3 Right of Action

The principle that creditors will have to rely on traditional company organs\(^{1328}\) to enforce a duty to consider creditors’ interests is not supported, however. For the duty to creditors to be more than just a shield behind which directors may hide, or a limitation on the right of shareholders to ratify a breach of directors’ duties under when the interests of the company are defined with reference to the interests of its creditors, the interests of future creditors should be included. In this respect it is submitted, however, that the reference to the interests of the future members does not relate to the enforceability of directors’ duties by future members, just as future creditors will not be able to enforce directors’ duties, but that it simply provides an indication that “a long-term view should be balanced against the short-term interests of present members”, as noted by Heydon *supra* 123, with reference to Gower “Corporate Control: The Bottle for the Berkeley” (1954) 68 *Harvard Law Review* 1176 1185. Any reference to future members thus seems to come down, in effect, to nothing more but the fact that the directors must manage the company in a sustainable manner.

\(^{1324}\) *Supra*.

\(^{1325}\) It must be conceded, however, that the legal principles regarding liability of directors for delicts committed by the company are far from clear. See in general De Koker *Die Roekelose en Bedrieglike Dryf van Besigheid in die Suid-Afrikaanse Maatskappyereg* LLD UOVS (1996) 107 *et seq*; De Koker “Die Aanspreeklikheid van Direkteure vir Delikte Gepleeg in Ampsverband” 2002 *TSAR* 18; Du Plessis *Maatskappyregtelike Grondslae van Die Regsposisie van Direkteure en Besturende Direkteure* LLD UOVS (1990) 251; Du Plessis & Henning “Die Deliktuele Aanspreeklikheid van Persone wat as Maatskapyorgane Optree” 1989 *THRHR* 540.

\(^{1326}\) See discussion *supra* Ch 3 (Evaluation of Alternative Remedies) par 3.4 for more information on the application of this doctrine.

\(^{1327}\) *Supra*. The *Mareva* injunction seems to be ideally suited to protect the interests of future creditors, as it is an order whereby a defendant can be compelled to leave his assets within the court’s jurisdiction until the court has reached a decision about the claim made against the defendant. Faul & Malan “The *Mareva* Injunction” 1990 *SA Merc LJ* 305 explain that it enables “the seizure of assets so as to preserve them for the benefit of the creditor, but not to give a charge in favour of any particular creditor”. Also see Cane “Prejudgment *Mareva*-type Interdicts in South African Law” 1997 *SALJ* 77 for more information on the application of this type of remedy in South African law.

\(^{1328}\) I.e the general meeting of shareholders when the company is a going concern, and the liquidator when the company is being wound-up.
limited circumstances, creditors should be provided with a mechanism to enforce a duty in terms of which their interests should be considered.

There are two options available in this regard. The first is a derivative action for creditors and the second is through acceptance of the flexible definition of “membership” of the company – not only for the purpose of determining the company’s interest, but also for the purpose of determining who has the right to institute action on behalf of the company.1329

8.5.3.1 Creditors’ Derivative Action

One is inclined to agree that any benefit by way of a directorial duty should benefit the creditors as a whole, just as traditional directors’ duties should benefit the company as a whole and not individual shareholders.1330 An important distinction is, however, that creditors, unlike shareholders, have no concept of a derivative action on which to rely.1331

In some of the other jurisdictions discussed so far, specifically Canada, it is possible for creditors, however, to maintain a derivative action against directors on behalf of the company. The derivative action is provided for in terms of section 239 of the CBCA, which reads as follows:

(1) Subject to subsection (2), a complainant may apply to a court for leave to bring an action in the name and on behalf of a corporation or any of its subsidiaries, or intervene in an action to which any such body corporate is party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate.

(2) No action may be brought and no intervention in an action may be made under subsection (1) unless the court is satisfied that

1329 Wishart supra 348 – 353 proposes a flexible definition of membership in order to determine the interest of the company.

1330 Dabner supra 114. See Kalinko v Nisbet supra for a possible deviation from this principle.

1331 As noted by Dabner supra 114. This certainly rings very true for company creditors in South Africa. Both the common law derivative action and statutory derivative action in terms of s 266 of the South African Companies Act provide for an action to be instituted on behalf of the company by a shareholder of the company. Creditors are thus precluded from proceeding against directors on behalf of the company by way of a derivative action
(a) the complainant has given notice to the directors of the corporation or its subsidiary of the complainant’s intention to apply to the court under subsection (1) not less than fourteen days before bringing the application, or as otherwise ordered by the court, if the directors of the corporation or its subsidiary do not bring, diligently prosecute or defend or discontinue the action;

(b) the complainant is acting in good faith; and

(c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.

The court held that a creditor qualifies as “a complainant” in terms of subsection (1) in cases where the interest of the creditor is a direct financial interest or a particular legitimate interest in the manner in which the affairs of the corporation are being managed.\textsuperscript{1332} The creditor who brings the derivative action must furthermore be in a position that is analogous to that of a minority shareholder, who has no right to influence what would seem to be abuses of management or conduct contrary to the company’s interests.\textsuperscript{1333}

A derivative action by creditors may operate as follows: In cases where the company is a going concern, a creditor or creditors may maintain a derivative suit on behalf of the company if the directors fail to consider their interests. It should be emphasised, however, that creditors will only be entitled to use this mechanism once the duty to them is triggered.\textsuperscript{1334} In all other circumstances the general meeting of shareholders, or individual shareholders by way of derivative action, will still be the only possible parties to enforce directors’ duties on behalf of the company.

\textsuperscript{1332} In re Daon Development Corporation (1984) 54 BCLR 235 243 (BCSC); Kosmopoulos v Constitution Insurance Co of Canada [1987] 1 SCR 2 par 12; and Jacobs Farms Ltd v Jacobs [1992] OJ No 813 (Ont Crt (Gen Div)) 12 14, as referred to by Sarra “Taking the Corporation Past the ‘Plimsoll Line’ – Director and Officer Liability when the Corporation Founders” (2001) 10 International Insolvency Review 229 244.

\textsuperscript{1333} In re Daon Development Corporation (1984) 54 BCLR 235; Jacobs Farms Ltd v Jacobs supra, as referred to by Sarra supra 245.

\textsuperscript{1334} In other words, when creditors replace shareholders as the corporate constituent whose interests should enjoy prime consideration. See supra Ch 7 (Point in Time When the Duty Arises) for more detail.
All benefits from a successful action, it being a derivative action, will go to the company to be distributed according to the normal principles of distribution. Moreover, since the action is derivative the company will fund the costs of litigation and the creditor will not have to risk his own resources to this end.\textsuperscript{1335}

Care should be taken, however, that the funds of a struggling company are not wasted on vexatious litigation. Rigorous statutory tests, such as those contained in section 239 of the \textit{CBCA}, namely that the complainant explored other avenues; is acting in good faith; and that the action appears to be in the interests of the company or its subsidiary, along with high thresholds set by the courts for the institution of the action, may prevent this from happening.\textsuperscript{1336}

Once the company is in the process of being wound-up, a standard requirement for the institution of a derivative action will apply, namely that a creditor or creditors will only be entitled to proceed against delinquent directors by way of derivative action if the company, through the liquidator, failed to do so itself.\textsuperscript{1337}

Extending traditional directors’ duties to include creditors’ interests occurred through the development of common-law principles by the judiciary. The question to be asked is whether a derivative action by creditors will develop in the same way.

Whether the courts would be willing to go so far as recognising a common law duty to creditors as well as a common law derivative action by creditors, is doubtful. In light of this fact it is submitted that it may be easier to enjoin the legislature to amend present provisions governing the statutory derivative action so as to make it possible

\textsuperscript{1335} Sarra \textit{supra} 245.

\textsuperscript{1336} \textit{Ibid}.

\textsuperscript{1337} This standard is similar to the current statutory derivative action provided for by s 266(1) of the South African \textit{Companies Act}. This provision expressly states that a member is entitled to proceed on behalf of the company, provided that “the company has not instituted proceedings for the recovery of such damages, loss or benefit”.

324
for creditors to proceed derivatively on behalf of the company under specific circumstances, as is the case in Canada.\footnote{1338}  

8.5.3.2 Flexible Definition of “Membership” 

Another way in which the problem of a “duty without a remedy” may be addressed, is by acceptance of a flexible definition of “membership”, not only for the purpose of determining the company’s interest, but also for the purpose to determine who has the right to institute action on behalf of the company.\footnote{1339} If creditors were regarded as the members of the company when it is in distress and directors fail to consider their interests in those circumstances, nothing will hinder the body of creditors to take action against the directors, as they are in fact “the company” at that stage.

This flexible definition seems to indicate the substitution of the general meeting of shareholders as company organ by the body of creditors. One assumes that the judiciary’s instinctive reaction to such a suggestion will be one of discomfort, a sentiment that will probably be shared by many company law scholars.

Another point of criticism that may be levelled against this approach is that shareholders are statutorily provided with a mechanism to act collectively, namely the general meeting. The manner in which the general meeting should operate is regulated extensively in the Companies Act.\footnote{1340} The same cannot be said of a body of creditors.

This problem is not insurmountable. The South African Companies Act does regulate collective action by creditors under particular circumstances, for example with regard to a compromise in terms of section 311(1); section 311(2) and section 312. Collective action by creditors to enforce directors’ duties may be developed along similar lines.

\footnote{1338} Davis “Hoff and Harff: Does the Convertible Debenture Holder Have Standing to Maintain a Shareholder Derivative Action?” (1975) 26 Syracuse Law Review 730 753 is of the opinion that if the derivative action is to be “a truly effective check on the actions of corporate management, it should be available to all”.

\footnote{1339} See Wishart supra 348 – 353 for a comprehensive discussion on “membership” of the company.

\footnote{1340} See Cilliers & Benade supra par 8.05 – 8.46 for a comprehensive discussion on these provisions.
It is furthermore submitted that classes of creditors should be distinguished according to the same principles applied with regard to section 311(1) of the South African Companies Act, namely on the basis of a similarity of rights. Secured creditors, for example, will not be interested to proceed against directors where their claims are covered in full by the security that they hold over the company’s assets, and they should therefore be excluded from meetings that are convened for the purpose of protecting the position of unsecured creditors.

The total displacement of the general meeting as company organ by creditors may, however, affect the whole fabric of company law, which is based on the idea that the company as a going concern has two organs only, namely the board of directors and the general meeting of shareholders.

8.5.3.3 Summary

For the sake of clarity the proposal advanced here may be summarised as follows. In a solvent company the interests of the company are equated with those of its shareholders, who will be the only organ vested with authority to proceed against directors in breach of their duties.

Should the company experience financial or economic distress, however, prior to formal winding-up procedures having been instituted, the interests of the company comprise those of the creditors. Creditors should then be able to proceed against directors who acted in breach of their duties to the company by failing to consider the interests of creditors.

This may be done by way of a statutory derivative action for creditors, or by acceptance of the notion of “flexible membership” of the company, in terms of which creditors displace shareholders as “members” in a struggling company. This will provide creditors with the right to proceed collectively against delinquent directors.

1341 See Cilliers & Benade supra par 25.13 – 25.14; 25.16 and authority there referred to.

1342 Consequences of such displacement could eg cause a question mark to be placed on the right of shareholders to appoint and remove directors from office.
Chapter 8                                                                 Beneficiary of the Duty

The way in which creditors will be able to act collectively may develop by way of analogy to mechanisms provided by section 311 of the South African *Companies Act.*

In respect of companies that are in the process of being wound up, the right to proceed against delinquent directors should rest with the liquidator. Should he refuse to take such action, creditors should be able to take action against the directors on behalf of the company in liquidation, provided that a certain majority of creditors are in support of this.\(^{1343}\)

Providing creditors with a mechanism with which to enforce directors’ duties will only partially protect their interests. Other deficiencies in the legal system will also have to be addressed in order to ensure that creditors are in a position fully to use the protective measure that is afforded to them by an extension of directors’ duties.\(^{1344}\)

8.5.4 Power of Ratification

The usefulness of section 309 of the British *Companies Act* as a source of guidelines on how the indirect duty to creditors should operate runs out at this point. Section 309(2) specifically provides that the “duty” to employees is to be enforced in exactly

\(^{1343}\) The insolvent company will probably have to foot the bill of such an action. An unsuccessful action will mean that there is even less money available for creditors. The body of creditors will therefore have to consider very carefully whether they are willing to proceed with such an action. In this respect it is once again submitted that a distinction should be drawn between the various classes of creditors. Secured creditors, eg, will not be interested in proceeding against directors, as their claims are covered by the security that they hold. They should therefore be excluded from voting at such a meeting to the extent that their claims are covered in full by the security that they hold, or, to put it differently, should be able to vote only to the extent that their claims are unsecured.

\(^{1344}\) The truth of this statement is recognised in the Department of Trade and Industry’s *South African Company Law for the 21st Century: Guidelines for Corporate Law Reform* (2004) 18, as indicated by the following statement:

Perhaps the most significant deficiency in the current law is that it does not provide effective mechanisms for the enforcement of even those duties prescribed under the present law. The result is that the directors and senior management of large companies are effectively immune from legal control, except perhaps in regard to the more outrageous criminal offences. The lack of enforcement and recourse is in part attributable to the disincentives to litigation created by the court system, such as the under developed nature of class actions and contingency fees and the costs of protracted litigation, which collectively diminish the practical effectiveness of the civil and criminal sanctions and remedies contained in law.
the same way as traditional directorial duties. This entails that a breach of the “duty” may be enforced or ratified by the company through the general meeting of shareholders. The judiciary indicated, however, that a breach of the indirect duty to creditors is not ratifiable by the company in general meeting.\footnote{It seems that the English legislature also subscribes to this view. The Company Law Review Steering Group \textit{Modern Company Law for a Competitive Economy} (Final Report Vol I) par 6.6 is clear on the point that a “ratification of a breach of duty in relation to creditors…should not be lawful”.} A clear divergence is thus created from section 309 and any uncertainties regarding ratification of a breach of directors’ duties to consider the interests of creditors will therefore not be resolved by relying on this statutory provision.

If one assumes for the moment that creditors are not entitled to ratify a breach of directors’ duties, it will mean that there is no mechanism to ratify the failure of directors to consider the interests of creditors in discharging their duties to the company, as shareholders as well as creditors will be precluded from doing so. This will be contrary to the general principles pertaining to fiduciary obligations.

One proposed solution, contrary to the thrust of the majority of cases on this point, is that the power to ratify a breach of directors’ duties should remain with the shareholders, but that their decisions must be more readily open to review by the courts.\footnote{Hannigan \textit{supra} 510; Payne \textit{supra} 625 – 626; and Sealy \textit{Directors’ “Wider” Responsibilities} 181.} This solution relies on the fact that “self-serving” or “phoney” votes by shareholders have been struck down on more than occasion by the courts, usually on the basis of particular decisions constituting a “fraud on the minority”.\footnote{Sealy \textit{Directors’ “Wider” Responsibilities} 174.} It is furthermore suggested that the company should be regarded as a corporate enterprise rather than a corporate membership.\footnote{\textit{Ibid}.} This will facilitate a shift in interpretation of “fraud on the company” to embrace the “enlarged constituency”.\footnote{Sealy \textit{Directors’ “Wider” Responsibilities} 182.}
This proposal shows progress in the direction of requiring shareholders to act in good faith towards the company, minority shareholders, or even creditors of the company when exercising their voting rights. However, the proposal that “phoney” votes by shareholders may be struck down by the court may create numerous problems.1350

A second solution lies in allowing creditors to ratify a breach of a duty to consider their interests. One may use the construction that was suggested with regard to the right of action1351 as a guideline as to how and when creditors should be able to do so.

In terms of the suggested method for enhancing creditor protection by way of directors’ duties, these duties are still owed to the company as a juristic person. The company, as beneficiary of directors’ duties, should therefore in principle remain entitled to excuse a breach of directors’ duties. The company will have to do so through the body of its creditors, however, once the duty to them is triggered. The mechanisms that are provided for creditors to act collectively in terms of section 311 of the South African Companies Act may furthermore provide an example of how creditors should act collectively in ratifying of a breach of directors’ duties.

This solution seems preferable, but leaves one with the situation that creditors are in effect becoming an organ of the company once it begins to experience financial or economic distress. This construction will probably be met with fierce resistance by proponents of traditional company law dogma.

However, it seems to be the only logical conclusion. This construction is also analogous to the voluntary winding-up of a company by creditors – shareholders initiate the winding-up of an insolvent company, upon which the primacy of their interests is displaced by those of the creditors. An indication of development in this

1350 See Wedderburn Derivative Actions and Foss v Harbottle 208 for a discussion on the difficulties inherent to such a solution. Wishart supra 340 also questions the practicality of this suggestion.

1351 See supra par 8.5.3.
direction is evidenced by the fact that some jurisdictions already provide a statutory derivative action to creditors.\textsuperscript{1352}

\section*{8.6 CONCLUSION}

Court cases in which the issue of directors’ duties to creditors was raised, indicated that the judiciary followed one of two approaches in extending the benefits of directors’ duties to creditors. The first was by way of recognition of a direct duty to creditors, while the second is modelled on existing legal principles, namely that the company remains the beneficiary of directors’ duties, but that directors, in compliance with their duties to the financially distressed company, have to consider the interests of creditors.

Both of these methods revealed a number of shortcomings. The major flaw of the direct duty method is that it does not provide guidelines in respect of enforcement and ratification of directors’ duties, as it is not based on existing legal principles. Another critical drawback is that application of the direct duty method may result in the principles of insolvency law regarding equitable distribution of assets being negated. This is a serious concern in light of the fact that directors’ duties to creditors are mooted for companies that are insolvent, or on the brink of insolvency.

The indirect duty method has an advantage over the direct duty method, in that the existing legal principles on which it is based provide some structure for the operation of the duty to creditors. Unfortunately the extent of an indirect duty to creditors seems to be restricted to a limitation on the power of the general meeting to ratify a breach of directors’ duties, where these duties are perceived to be aimed at the protection of creditors’ interests. This has led to the duty being termed a “duty of imperfect obligation”,\textsuperscript{1353} as creditors are not provided with the means to enforce the duty prior to the winding-up of the company. It also raises questions regarding the body that would be able to ratify a breach of directors’ duties, seeing that the general meeting is precluded from doing so.

\textsuperscript{1352} With reference to s 239(1) of the \textit{CBCA}.

\textsuperscript{1353} Heydon \textit{supra} 131.
It is therefore submitted that neither of the methods used by the courts provide a complete structure for the extension of directors’ duties to creditors. The indirect duty method is preferable to the direct duty method, however, in light of the fact that it does provide some guidelines for the operation of a duty to creditors.

In light of this fact the following method is envisaged for the operation of directors’ duties to creditors. The primary beneficiary of directors’ duties remains the company as a juristic person. Once the duty to creditors is triggered, however, creditors displace shareholders as the corporate constituent whose interests will give content to the phrase “interests of the company”. This substitution of creditors’ interests for shareholders’ interests will have important consequences with regard to the enforcement and ratification of a breach of directors’ duties.

As proposed by the judiciary, shareholders will no longer be in a position to enforce directors’ duties or ratify a breach thereof. It is submitted, however, that the effect of a duty to creditors should not be limited to this result, but that creditors should now be able to enforce these duties, or ratify a breach thereof on behalf of the company.

Enforcement of the duty by creditors may be facilitated by a derivative action for creditors, as is provided for in terms of section 239 of the CBCA, or through acceptance of a flexible definition of “membership”.1354

A mechanism to enable creditors to act collectively in enforcing directors’ duties, or in ratifying a breach thereof, may be developed by analogy with the mechanism that is statutorily provided to enable creditors to collectively assess the merits of a proposed arrangement.1355

1354 As proposed by Wishart supra 348 – 353.

1355 In terms of s 311 and s 312 of the South African Companies Act.
This method will retain the structure provided by existing legal principles, but it will go one step further in ensuring that the duty to creditors provides meaningful protection for their interests and that it is more than merely a “duty of imperfect obligation.”\textsuperscript{1356}

\textsuperscript{1356} Heydon \textit{supra} 131.
CHAPTER 9
RELIEF FROM LIABILITY

SUMMARY

9.1 INTRODUCTION
9.2 RELIEF BY THE COURT
9.3 INDEMNIFICATION
9.4 DIRECTOR LIABILITY INSURANCE
9.5 CONCLUSION

9.1 INTRODUCTION

It has been said that the “major corporate governance problem is the intricate balance between maximizing the efficiencies necessary to create wealth and ensuring that the controlling parties are accountable to those with a stake in the enterprise”. The balance between creating an environment conducive to wealth maximizing, while providing adequately for accountability, may be adversely affected by a duty to creditors. Such a duty may be perceived to expose directors to personal liability to such an extent that they become excessively risk averse. This in turn may lead to wealth creation being sacrificed in favour of accountability.

1357 Swanson “Corporate Governance: Sliding Seamlessly into the Twenty-first Century” (1996) 21 Journal of Corporation Law 417 418. In the same vein Finch “Personal Accountability and Corporate Control” (1994) 57 Modern Law Review 880 881 regards it as one of the purposes of the rules of corporate law to “encourage wealth creation yet discourage corporate wrongdoing”. Johnston “Corporate Indemnification and Liability Insurance for Directors and Officers” (1978) 33 The Business Lawyer 1993 defines the problem as balancing “the need for punishing faithless fiduciaries against the need to protect aggressive managers who are willing to take good-faith risks in the search for profits”. According to Ramsay “Liability of Directors for Breach of Duty and the Scope of Indemnification and Insurance” (1987) 5 Company & Securities Law Journal 129 “[a]ny regulation of the activities of companies and their directors must have as its twin objectives both the need to protect shareholders against mismanagement and self-dealing by directors through the threat of personal liability, and the need to encourage directors to take good faith risks when exercising their business judgment on behalf of the shareholders”.

1358 The pertinence of this concern is recognised by numerous authors. See eg Caraccio “Void Ab Initio: Application Fraud as Grounds for Avoiding Directors’ and Officers’ Liability Insurance Coverage” (1986) 74 California Law Review 929 943; Daniels & Hutton “The Capricious Cushion: The Implications of the Directors’ and Officers’ Insurance Liability Crisis on Canadian Corporate Governance” (1993) 22 Canadian Business Law Journal 182 229; Johnston supra 2035 who warns that eventually the “enterprise system itself will be the loser”; Spisto “D and O Insurance for Directors and Officers – What Is This and Is It a Viable Option in South African Law?” 1996 CILSA 61 (hereinafter
It is furthermore feared that increased exposure to personal liability will deter many competent persons from being willing to serve on the boards of companies,\textsuperscript{1359} which is contrary to one of the goals of company law of “fostering entrepreneurial talent, rewarding it, and then protecting it from untoward liability”.\textsuperscript{1360}

In defence of a duty to creditors it must be emphasised that the purpose of such a duty is not to hold directors liable for every corporate failure. Liability should ensue only in cases of a \textit{breach of duties} by directors. It is furthermore submitted that the goal of reaching and maintaining the balance between wealth maximization and accountability will not be attained through a reduction in director liability. Such a step will be undesirable, as it will increase the vulnerability of corporate creditors to the conduct of delinquent directors, who will in fact be provided with an opportunity to do as they please in the absence of a possible sanction of personal liability.\textsuperscript{1361}

As an alternative it is proposed that one should look to corporate law measures providing relief from liability under specified circumstances.\textsuperscript{1362} Measures such as

\textsuperscript{1359} Bradley & Schipani “The Relevance of the Duty of Care Standard in Corporate Governance” (1989) 75 Iowa Law Review 1 7, 34; Caraccio \textit{supra} 942; Ramsay \textit{supra} 132; Spisto \textit{supra} 69; Weiss \textit{supra} 638. Cohn “Demise of the Director’s Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule” (1983) 62 Texas Law Review 591 600 indicates that, though inappropriate, even the judiciary may base decisions on “the extent to which imposition of statutory standards would affect the selection process of directors”. In a comment on a paper by Menzies “Directors’ Duties” (1959) 33 Australian Law Journal 156 169, it was noted as early as in 1959 that:

\textit{The stage has been reached where, if a man is to become a director of a company, more particularly of a public company, he must either have as well as integrity, also great courage, or else be abysmally ignorant of the law surrounding the office he is to accept.}


\textsuperscript{1361} In this respect one is bound to agree with Cranston \textit{supra} 209 that “the law of directors’ duties is not only about whether particular breaches of duty are to result in monetary payments, \textit{but also about ensuring that directors adhere to certain fiduciary and management standards}” (own emphasis).

\textsuperscript{1362} Apart from corporate law measures providing relief from liability, directors are of course also free to take steps to provide some cover against personal liability (Spisto \textit{supra} 62). The most obvious example of such a step is professional liability insurance. Although this topic does not fall within the
these may play an important role in striking a balance between imposing liability on delinquent directors, thus ensuring accountability, while providing freedom to take calculated business risks without the threat of personal liability, should the corporation fail.\textsuperscript{1363} They may also serve to attract persons of the right calibre to serve on the boards of companies.\textsuperscript{1364}

Company law provides for a number of these measures,\textsuperscript{1365} for example relief granted by the court;\textsuperscript{1366} indemnification;\textsuperscript{1367} director liability insurance;\textsuperscript{1368} and ratification.\textsuperscript{1369} For these measures to achieve their aim with any degree of success it is important, however, that the right balance be struck between providing adequate defences for directors whose conduct can be shown to be beyond reproach, while ensuring that

ambit of this study, it not forming part of the general legal framework, a potential increase in personal liability could impact significantly on the cost of such insurance, making it unaffordable. Effective legal measures providing relief from personal liability could go some way towards ensuring that such personal measures do not become unavailable by reason of being unaffordable.

\textsuperscript{1363} Carhart & Thomson “Limiting Compromises of Director and Senior Officer Liability in CCAA Proceedings: NBD Bank, Canada v Dofasco Inc” (2000) 17 National Insolvency Review 38 observe that there are “few assignments in modern life more challenging than being a director…of a large company in financial distress”. The availability of relieving measures thus seems to be especially important in relation to directors of struggling companies.

\textsuperscript{1364} Cohn \textit{supra} 600 agrees that the resolution of conflict between enforcing acceptable standards of director conduct and ensuring competent people being willing to be appointed to the boards of companies lies “not in judicial negation of standards but in the legislative realm, where public policy conflicts are best resolved”.

\textsuperscript{1365} It must be noted that this section only deals with relief from personal liability in general. In some jurisdictions provisions imposing personal liability for insolvent or fraudulent trading contain their own measures specifically to provide directors with relief from the liability imposed in terms of those provisions. Measures providing relief from liability under those specific circumstances are discussed in the chapter pertaining to the statutory provisions imposing personal liability for fraudulent or insolvent trading. See \textit{supra} Ch 3 (Evaluation of Alternative Remedies) par 3.2.

\textsuperscript{1366} See discussion \textit{infra} par 9.2.

\textsuperscript{1367} See discussion \textit{infra} par 9.3.

\textsuperscript{1368} See discussion \textit{infra} par 9.4.

\textsuperscript{1369} The general meeting of shareholders is generally entitled to absolve directors from liability for a breach of their duties through ratification (\textit{Pavlides v Jensen} [1956] 2 All ER 518; \textit{Daniels v Daniels} [1978] 2 All ER 89). The way in which it is possible for shareholders to ratify a breach of directors’ duty to consider the interests of creditors, was discussed in a previous chapter (see discussion \textit{supra} Ch 8 (Beneficiary of the Duty)) and is not discussed again here.
these measures are not formulated so broadly as to allow delinquent directors to avail themselves thereof, thus escaping liability.\textsuperscript{1370}

In this chapter an attempt is made at answering the question whether the existing measures are successful in attaining the balance mentioned above by analysing each of the above-mentioned measures in various jurisdictions, upon which their efficiency and the possible impact on a duty to creditors are evaluated.

\section*{9.2 RELIEF BY THE COURT}

\subsection*{9.2.1 Introduction}

In the majority of jurisdictions referred to in this study, courts have the power to grant directors relief from possible personal liability. A court has this power either in terms of a business judgment rule,\textsuperscript{1371} or in terms of a specific statutory provision.\textsuperscript{1372}

For the purposes of the discussion of relief by the courts, the usual order in which jurisdictions are discussed in the comparative study is deviated from, grouping together those jurisdictions that use specific statutory provisions in terms of which courts have the discretion to grant relief\textsuperscript{1373} and those jurisdictions in which a business judgment rule applies.\textsuperscript{1374} There are no specific legal doctrines or statutory provisions exclusively dealing with the courts’ discretion to relieve directors from liability in Canada\textsuperscript{1375} and New Zealand.\textsuperscript{1376} This discussion therefore does not contain further reference to these jurisdictions.

\textsuperscript{1370} Or in the words of Spisto \textit{D and O Insurance} 60, one needs to balance “the need for punishing faithless fiduciaries against the need to protect aggressive directors willing to take good faith risks in the search for profits”.

\textsuperscript{1371} The business judgment rule is formally recognised and applied in the USA and Australia.


\textsuperscript{1373} Ie South Africa, Australia and England.

\textsuperscript{1374} Ie the USA and Australia. The USA, being the jurisdiction in which the business judgment rule originated, will be discussed before Australia.

\textsuperscript{1375} Rousseau “The Duties of Directors of Financially Distressed Corporations: A Quebec Perspective on the Peoples Case” (2004) 39 \textit{Canadian Business Law Journal} 368 374 makes the point, however,
Chapter 9                                                                                      Relief from Liability

9.2.2 Statutory Provisions Empowering Courts to Grant Relief

9.2.2.1 South Africa

Section 248 of the South African Companies Act provides that the court may exercise its discretion to relieve directors\textsuperscript{1377} from liability under particular circumstances.\textsuperscript{1378} This provision reads as follows:

(1) If in any proceedings for negligence, default, breach of duty or breach of trust against any director, officer or auditor of a company it appears to the Court that

that the Canadian courts could generally be seen to be reluctant to pass judgment on business decisions made in good faith and recognised an “implied rule of deference toward management decisions”, without formalising the rule as a doctrinal rule, as was done in the USA. Rousseau 374 – 375, quoting from Ziegel et al Cases and Materials on Partnerships and Canadian Business Corporations (1994) 478, furthermore indicates that numerous commentators argued that the end result is the same, leading to the conclusion that “the considerations underlying the [business judgment] rule have simply been imported into the formulation of the final standard of care that governs directorial conduct”. The Canadian courts have been leaning more and more towards articulating a standard of review that resembles the US type business judgment rule (see eg CW Shareholdings Inc v WIC Western International Communications Ltd (1998) 38 BLR (2d) 196 (Ont Ct (Gen Div)) 213 – 214, as referred to by Rousseau supra 375) to the point where the Canadian supreme court seems to have enshrined the business judgment rule. See Peoples Department Stores Inc v Wise 2004 SCC 68 par 64, where the court stated:

It might be tempting for some to see unsuccessful business decisions as unreasonable or imprudent in light of information that becomes available \textit{ex post facto}. Because of this risk of hindsight bias, Canadian courts have developed a rule of deference to business decisions called the “business judgment rule”, adopting the American name for the rule (own emphasis).

Sarra “Canada’s Supreme Court Rules No Fiduciary Obligation towards Creditors on Insolvency – Peoples Department Stores v Wise” (2006) 15 International Insolvency Review 1 10 is of the opinion that this statement has the effect of “moving Canada firmly towards the US standard in that respect”.

\textsuperscript{1376} According to Farrar “The Duty of Care of Company Directors in Australia and New Zealand” in Ramsay (ed) Corporate Governance and the Duties of Company Directors (1997) 81 90 (hereinafter Farrar Duty of Care), the only reference to the business judgment rule in New Zealand is in the long title of the 1993 Companies Act. In terms of par (d) of the long title, it is an object of the Act to “encourage efficient and responsible management of companies by allowing directors a wide discretion \textit{in matters of business judgment} while at the same time providing protection for shareholders and creditors against the abuse of management power” (own emphasis).

\textsuperscript{1377} This provision applies to directors, officers and auditors of the company. The position regarding directors of the company is the only aspect that is relevant for the purposes of this study and the way in which other parties are affected in terms of thereof is not discussed in any detail.

\textsuperscript{1378} The aim of this study is to assess whether provisions such as s 248(1) and the equivalent thereof in other jurisdictions are adequate in providing directors with some form of relief from civil liability. The question as to whether they provide relief from possible criminal liability falls outside the scope of this discussion and this matter is not dealt with in any detail. See Edmunds & Lowry “The Continuing Value of Relief for Directors’ Breach of Duty” (2003) 66 Modern Law Review 195 218 \textit{et seq} and authority there referred to for more information pertaining to relief from criminal liability.
the person concerned is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, the Court may relieve him, either wholly or partly, from his liability on such terms as the Court may think fit.

(2) Any such director, officer or auditor who has reason to apprehend that any claim will be made against him in respect of any negligence, default, breach of duty or breach of trust, may apply to the Court for relief, and the Court shall on any such application have the same powers to grant relief as are by subsection (1) conferred upon it with reference to proceedings referred to in that subsection.

Subsection (1) operates as a defence that may be advanced by directors in proceedings against them, whereas the proceedings under subsection (2) should be by way of motion.1379

9.2.2.2 Australia

The Australian courts are endowed with the power to grant relief in terms of section 1318 of the Corporations Act. Section 1318(1) is very similar to its South African counterpart1380 and reads as follows:

If, in any civil proceeding against a person to whom this section applies for negligence, default, breach of trust or breach of duty in a capacity as such a person, it appears to the court before which the proceedings are taken that the person is or may be liable in respect of the negligence, default or breach but that the person has acted honestly and that, having regard to all the circumstances of the case, including those connected with the person’s appointment, the person ought fairly to be excused for the negligence, default or breach, the court may relieve the person either wholly or partly from liability on such terms as the court thinks fit.

Subsection (2), nearly identical to section 248(2) of the South African Companies Act, provides for the possibility that a person to whom the provision applies may apply to


1380 S 248(1) of the South African Companies Act.
the court for relief should he have reason to believe that a claim will be made against
him in respect of negligence, default, breach of trust or breach of duty.  

9.2.2.3 England

Section 727(1) of the English Companies Act is the equivalent of section 248(1) of
the South African Companies Act. This provision is identical to section 248(1) of the
South African Companies Act in all material aspects and reads as follows:

If in any proceedings for negligence, default, breach of duty or breach of trust against
an officer of a company...it appears to the court hearing the case that the officer...is
or may be liable in respect of the negligence, default, breach of duty or breach of trust,
but that he has acted honestly and reasonably, and that having regard to all the
circumstances of the case (including those connected with his appointment) he ought
fairly to be excused for the negligence, default, breach of duty or breach of trust, that
court may relieve him, either wholly or partly, from his liability on such terms as it
thinks fit.

9.2.2.4 Evaluation

9.2.2.4.1 Applicability of Relieving Provisions in Case of Statutory Liability

There seems to be some uncertainties regarding particular aspects of the relieving
provisions. The first relates to whether directors who are involved in proceedings in
terms of provisions such as section 424(1) may avail themselves of the potential
relief offered by section 248.

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1381 Subsection (3) deals with instances where the case against the respondent is tried by a judge with a
jury. This scenario is irrelevant in a South African context and is not discussed further. Subsection (4)
contains information on the persons entitled to relief in terms of this provision. This study is
particularly concerned with possible relief for directors and further detail on parties other than directors
entitled to this type of protection is not provided.

1382 This provision has been described by some as the “principal protection for directors under English
compny law”. See Pasban, Campbell & Birds “Section 727 and the Business Judgment Rule: A
Comparative Analysis of Company Directors’ Duties and Liabilities in English and United States Law”

1383 Relief was granted under this provision in cases such as In re D’Jan of London Ltd [1994] BCLC
561 and In re Welfab Engineers Ltd [1990] BCLC 833. Relief was refused in Guinness plc v Saunders
[1990] 1 All ER 652 HL; Dorchester Finance Co Ltd v Stebbing [1989] BCLC 498; In re Produce
discussion on the meaning of the phrases “honesty”; “reasonableness”; and “fairness”.

1384 Providing for the personal liability for company debts of directors and others responsible for being
knowingly involved in managing the business of the company in a fraudulent or reckless manner. See
supra Ch 3 (Evaluation of Alternative Remedies) par 3.2.1 for more detail.
Section 248 provides that proceedings against directors must concern negligence, default, breach of duty or breach of trust. Some commentators are of the opinion that directors’ liability on the basis of a declaration in terms of section 424(1) is not liability in respect of negligence, default, breach of duty or breach of trust within the meaning of section 248(1). This entails that directors who are involved in section 424(1) proceedings are unable to make use of section 248. Others feel that relief in terms of section 248 will be available in the context of section 424.

A similar question arose in England. The first opportunity that the judiciary had to provide clarity on the relationship between section 727 and section 214 of the Insolvency Act presented itself in In re Produce Marketing Consortium Ltd. According to Justice Knox the wording of these provisions indicated that it was not the intention of the legislature that they should be used in conjunction. In a subsequent decision, In re DKG Contractors Ltd, relief was denied to the directors accused of wrongful trading in terms of section 214, not because relief under section 727 is not available in conjunction with section 214, but because the court found that the directors did not act reasonably. The decision in this case thus seems to have cleared the path for section 214 and section 727 to be used in conjunction.

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1385 Own emphasis.

1386 Eg Henochsberg 461.

1387 De Koker Die Roeklose en Bedrieglike Dryf van Besigheid in die Suid-Afrikaanse Maatskappereg LLD UOVS (1996) 251. He concedes, however, that the viewpoint on the ambit of section 248 relief is of theoretical importance, only, since it would be impossible for a defendant director to show that he acted honestly, where he participated in the management of the company’s affairs fraudulently. See Ex parte Lebowa Development Corporation Ltd 1989 3 SA 71 (T) 107. It would furthermore be very difficult for a defendant director to show that he acted reasonably where he took part in managing the business of the company recklessly.

1388 Insolvency Act 1986 (hereinafter English Insolvency Act). Section 214 could partially be regarded as the equivalent of section 424(1) of the South African Companies Act. See supra Ch 3 (Evaluation of Alternative Remedies) par 3.2.2.3 for more detail.


1390 Id 751.

1391 [1990] BCC 903 912 (Ch).
Chapter 9 Relief from Liability

This issue will probably not present a serious problem in Australia, as the Australian statutory provision on directors’ personal liability for insolvent trading has its own particular defences upon which directors may rely. Some commentators are of the opinion, however, that the defence in section 1318(1) will be available as an additional defence to those provided by section 588H of the Australian Corporations Act.

Lack of clarity as to whether these provisions may be used in conjunction with statutory liability provisions is not of much concern for the purposes of this study, as its focus is primarily on the extension of directors’ common law duties to creditors. Directors accused of breaching their duties to consider the interests of creditors should therefore be entitled to the relief in terms of these provisions, provided that they are able to convince the court that they acted honestly, reasonably, and ought fairly to be excused with regard to all the circumstances of the case. A codification or partial codification of directors’ duties may, however, result in this protection of directors becoming unavailable.

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1392 S 588G of the Australian Corporations Act. See discussion supra Ch 3 (Evaluation of Alternative Remedies) par 3.2.2.1 for more detail.

1393 In terms of s 588H of the Australian Corporations Act. See discussion supra Ch 3 (Evaluation of Alternative Remedies) par 3.2.2.1 for more detail.


1395 Eg s 424(1) of the South African Companies Act and section 214 of the English Insolvency Act.

1396 In terms of the wording of s 248(1) of the South African Companies Act; s 727 of the English Companies Act.

1397 Pasban, Campbell & Birds supra 207 argue that the fact that the introduction of a law against wrongful trading in terms of s 214 of the English Insolvency Act took place long after the enactment of s 727 of the English Companies Act, indicates that it was not intended that these provisions work in conjunction, as Parliament could not have intended to provide relief against a future statutory liability. Directors could thus be deprived of significant protection should the same argument be extended to the application of this type of relief in respect of non-compliance with statutory duties. A counter-argument is that subsequent legislation is enacted against the background of existing law and that the legislature, when promulgating new law, would assume that later provisions should slot in with existing provisions, thus creating the possibility that the type of relief offered in terms of s 248(1) of the South African Companies Act and equivalent provisions in other jurisdictions, will become available in cases of a breach of statutory duties.
In order to ensure that a codification of directors’ duties does not result in what would be an undesirable state of affairs, with directors potentially being exposed to increased liability while being deprived of an important protective mechanism, the safest route may be to amend the relieving provisions to bring them in line with a codification of directors’ duties. This may be done along similar lines as the proposed amendments to section 727 in England.

9.2.2.4.2 Uncertainty Regarding Proceedings to which Relieving Provisions Will Apply

It is uncertain whether relieving provisions are applicable in respect of all proceedings by anyone against directors, or whether their application is limited to proceedings against directors specifically instituted by the company.

The English judiciary seems to be of the opinion that section 727 relief is only available in respect of proceedings instituted against the director by the company and not in respect of third-party claims against the director.

Should the model for extending directors’ duties to creditors that was suggested in a previous chapter be accepted, this particular issue will not present a serious problem insofar as directors’ liability to creditors is concerned. If the model be accepted that creditors become the primary corporate constituents once the duty to

1399 According to Pasban, Campbell & Birds supra 202 a provision “permitting the exercise of judicial discretion, is the principal protection for directors”.

1400 As part of the major overhaul of English company law, a codification of directors’ duties is proposed. See supra Ch 5 (Protection Afforded by Fiduciary Duties) and Ch 6 (Protection Afforded by the Duty of Care and Skill) for more detail on this matter. The Company Law Review Modern Company Law for a Competitive Economy Final Report Vol I par 6.3 – 6.4 proposed that the detailed statutory formulation of breaches to which the relief applies be deleted and that relief be confined to those provided for in the statutory statement of directors’ duties.

1401 This is the viewpoint advocated by Henochsberg 460.

1402 The viewpoint adopted by Stegmann J in Ex parte Lebowa Development Corporation Ltd 1989 (3) SA 71 T 107.

1403 Customs & Excise Commissioners v Hedon Alpha Ltd [1981] 2 All ER 697 (CA).

1404 See discussion supra Ch 8 (Beneficiary of the Duty) par 8.5.
them is triggered,\textsuperscript{1405} any action against directors for failing to consider the interests of creditors will still be an action by “the company”. The relief provided for by section 248(1) of the South African \textit{Companies Act} and the counterparts thereof in other jurisdictions,\textsuperscript{1406} should thus still be available in respect of actions against directors on the basis that they breached their duties to the company for having neglected the interests of creditors at a certain stage.

\textbf{9.2.2.4.3 Anomaly in that Person who Acted Negligently Is Entitled to Relief if He Acted Reasonably}

A third problem regarding the application of section 248 of the South African \textit{Companies Act} is the apparent anomaly created by the fact that a person who acted \textit{negligently} may be relieved from liability if it can be shown that he acted \textit{reasonably}.\textsuperscript{1407} Usually a person is considered to have been negligent because he did not act reasonably.\textsuperscript{1408} A suggestion in this regard is that when a decision has to be made on whether relief should be granted in respect of negligence, “reasonably” should be interpreted to mean “understandably”.\textsuperscript{1409} Another view is that the degree

\begin{itemize}
\item \textsuperscript{1405} See discussion supra Ch 7 (Point in Time When the Duty Arises) for more detail on when the duty to creditors should be triggered.
\item \textsuperscript{1406} S 727(1) in England; s 1318 in Australia.
\item \textsuperscript{1407} Amongst other things. According to Henochsberg 461, with reference to \textit{Niagara Ltd v Langerman} 1913 WLD 188 202; \textit{Selangor United Rubber Estates Ltd v Cradock (3)} [1968] 2 All ER 1073 1155, a director wishing to avail himself of the relief offered in terms of s 248 will have to prove on a balance of probabilities that he acted honestly, reasonably and that he ought fairly to be excused.
\item \textsuperscript{1408} According to Neethling, Potgieter & Visser \textit{Law of Delict} (2001) 128 – 129 negligence is generally determined with reference to the objective standard of the reasonable person. It is indicated that the following statement by Holmes JA in \textit{Kruger v Coetzee} 1966 2 SA 428 (A) 430 is regarded as the most authoritative test for negligence:
\begin{quote}
For the purposes of liability \textit{culpa} arises if –
\begin{itemize}
\item \textit{a diligens paterfamilias} in the position of the defendant –
\begin{itemize}
\item \textit{(i)} would foresee the reasonable possibility of his conduct injuring another in his person or property and causing him patrimonial loss; and
\item \textit{(ii)} would take reasonable steps to guard against such occurrence; and
\end{itemize}
\item \textit{(b)} the defendant failed to take steps.
\end{itemize}
\end{quote}
\item \textsuperscript{1409} Henochsberg 462.
\end{itemize}
Relief from Liability

of negligence involved should determine whether a person may be held to have acted “reasonably”.1410

The English court used the opportunity to comment on the strange wording of section 727, which allows it to excuse a director who is guilty of negligence, provided that he acted reasonably, in In re D’Jan of London Ltd.1411 The implication of this apparent anomaly is that while the test for reasonableness is primarily an objective one for the purposes of negligence liability, it contains a subjective element in the context of an application for relief under section 727.1412

A possible solution to this problem is simply to remove the requirement of “reasonableness” from the relieving provision, as was done in section 1318 of the Australian Corporations Act. This also seems to be the route advocated by the Company Law Review Steering Group with regard to section 727(1).1413

Retaining the requirement of “honesty” may also be problematic, however, in that courts may be forced to pronounce upon the extent “to which honesty is or is not determined subjectively and/or objectively”.1414 In this respect it is proposed that “fairness” should be the only requirement that has to be satisfied for a director to be relieved from liability.1415 The notion of fairness is wide enough to encompass the

1411 Supra 564. In the words of Lord Hoffman:

[It] may be odd that a person found to have been guilty of negligence, which involves failing to take reasonable care, can ever satisfy the court that he acted reasonably. Nevertheless the section clearly contemplates that he may do so and it follows that conduct may be reasonable for the purposes of section 727 despite amounting to lack of reasonable care at common law.

1412 Pasban, Campbell & Birds supra 209.
1413 Developing the Framework DTI/Pub 4754/4k/3/00/NP, as referred to by Edmund & Lowry supra 212 n 91.
1414 Edmunds & Lowry supra 222.
1415 Id 223.
other two elements of the relieving provision and may also “balance the protection of the director with the needs of other constituencies, such as members and creditors”.\footnote{1416} Acceptance of this suggestion will also lead to the provision being more transparent, as the courts did not succeed in keeping a precise division between the three requirements.\footnote{1417}

\subsection*{9.2.2.4.4 Extent of the Court’s Discretion}

A further problem is that the power of the court to grant relief is discretionary and not mandatory.\footnote{1418} This is indicated by phrases granting a wide and flexible discretion to the court hearing the matter, for example that a director ought “fairly to be excused”; “having regard to all the circumstances...of the case”; and the absolute discretion contained in these provisions that a court “may relieve” a director under these circumstances.\footnote{1419} Consequently, even if a director acted honestly and reasonably there is no guarantee that he will escape personal liability.\footnote{1420}

In light of the fact that courts are reluctant to pronounce on the wisdom of managerial decisions, it is possible that directors may be in a more favourable position to obtain relief from liability where the relief depends on the discretion of the courts. A strict statutory framework pertaining to circumstances under which a court is under obligation to grant relief, which curtails the court’s discretion, may work against

\footnote{1416}Ibid.\footnote{1417}Ibid.\footnote{1418}Pasban, Campbell & Birds supra 211.\footnote{1419}The wording of s 248 of the South African Companies Act and of s 727 of the English Companies Act is identical in these respects.\footnote{1420}This has led Pasban, Campbell & Birds supra 212 to conclude that a great deal will depend on the attitude of the trial judge towards the exercise of the discretion vested to him. If a case is brought before a judge who applies a wide and general interpretation of the concepts, the respondent will likely be given the relief, whereas if a case is proceeded by a judge who interprets legal expressions in a strict way, an application for the relief may likely be rejected.

\begin{quotation}
\end{quotation}
directors. The courts may have been willing to go further in granting relief than a statutory framework would allow.

It is thus submitted that the fact that the relief granted by the courts is discretionary does not justify the conclusion that the protection afforded in terms of these provisions is inadequate. It is probable that this would rather lead to the exact opposite result, with the discretion in the hands of the courts potentially affording directors wider protection than would have been available had the court been obliged to grant relief within a strict regulatory framework.

9.2.3 The Business Judgment Rule

9.2.3.1 United States of America

The business judgment rule has its origin in the United States of America. In one of the classic cases on the business judgment rule, Aronson v Lewis, the business judgment rule was defined as a

presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.

At first glance, one may assume the business judgment rule to be a defence that directors may raise in cases where they are accused of having breached their duties to the company. The application of the business judgment rule clearly indicates, however, that the assessment of directors’ possible liability does not involve a two-step approach with directors first trying to show compliance with their duties and failing that, raising the business judgment rule as a defence.

1421 According to Johnson “The Modest Business Judgment Rule” (2000) 55 The Business Lawyer 625 639 the phrase “business judgment rule” was first used by the Delaware Chancery Court in 1959, in the case of Nadler v Bethlehem Steel Corporation 154 A 2d 146 149 (Del Ch 1959). The author indicates that the phrase “business judgment” and the concept of the rule had been in use for several decades, however, with reference to Gottlieb v Heyden Chemical Corporation 90 A 2d 660 663 (Del 1952); Davis v Louisville Gas & Electrical Company 142 A 654 660 (Del Ch 1928).

1422 473 A 2d 805 (Del 1984).

1423 Supra 812. According to Hansen “The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project” (1993) 48 The Business Lawyer 1355 1360, this is one of the best formulations of the rule.

1424 Hansen supra 1373 – 1374.
The business judgment rule is rather seen as a presumption that the directors have met various criteria in the decision-making context. These criteria constitute the essential elements of the business judgment rule, namely that the directors obtained the necessary information before making any business decisions; that they acted with the required degree of care in making the decision; that directors acted in genuine good faith; and that they ensured the absence of personal interest.

In other words, plaintiffs have to overcome the presumption that the directors complied with these criteria to be successful with an action against directors. If they fail to do so the action will fail, and the directors will escape liability. Directors will thus be considered to have complied with their duty of care in a decision-making context, if they took adequate steps to become informed before making certain decisions.

Should a plaintiff be successful in rebutting the presumption, the court’s inquiry is not whether the director acted with the necessary care, but whether the transaction was

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1425 The standard for determining whether a business judgment is an informed one, is gross negligence. See Radin “The Director’s Duty of Care Three Years After Smith v Van Gorkom” (1988) 39 Hastings Law Journal 707 711 and authority referred to in n 33.


1427 In this respect one is inclined to agree with Balotti and Hanks supra 1345 - 1347 that the so-called “procedural presumption” is in fact not a presumption at all, but a mere restatement of traditional rules of evidence that the plaintiff alleging director misconduct is saddled with the burden of proving “a lack of good faith, absence of due care, or action not in the best interests of the corporation”. At the end of the day it is thus only the substantive aspect of the rule which is of any importance, namely that the court will not second-guess the business merits of a business decision. § 8.31(a)(1) of the revised MBCA does seem to recognise the concept as unnecessary and avoids it when referring to procedural issues. The section reverts to traditional procedural principles and provides that the plaintiff carries the burden of proving that liability is not precluded by a provision of the MBCA and that challenged conduct is actionable. See Balotti & Hinsey supra for more detail.

1428 The business judgment rule does not only serve to protect directors from liability in this way, but also has a secondary function of protecting the decision itself from challenge. On this basis Hinsey supra 611 – 613 distinguishes the business judgment rule which protects directors, from the business judgment doctrine which protects the decision.

1429 Hansen supra 1361.
“intrinsically fair”. The burden of proving that the transaction was indeed fair to shareholders rests on the directors.

It should furthermore be noted that the business judgment rule only applies in respect of actions taken or decisions made by directors. Refraining from doing anything will therefore not entitle directors to the protection afforded by the business judgment rule, unless it was a positive decision, meeting all the standards for decision-making under the business judgment rule, to do nothing. The business judgment rule, therefore, on the face of it does not seem to be available in respect of directors’ oversight functions, although the possibility of extending the rule to directors’ oversight responsibilities is not excluded.

Application of the business judgment rule entails that the judiciary does not have to involve itself in an evaluation of the merits of the decision by directors. The role of the court will be limited to examining the process or procedure by which the decision was reached. As such the rule is a legal recognition of judicial reluctance to interfere with the internal affairs of corporations.

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1432 Hinsey supra 615.

1433 Hinsey supra 615, with reference to Aronson v Lewis supra 813 n 7, where reference is made to judgments in which questions of a director’s liability were decided upon concepts of business judgments, although the elements of business judgment were not actually present.

1434 Bradley & Schipani supra 24 view the business judgment rule as recognition of the fact that “it is in the best interest of the shareholders, that managers, rather than shareholders and courts, make business decisions”.


1436 Ubelaker “Director Liability under the Business Judgment Rule: Fact or Fiction?” (1981) 35 Southwestern Law Journal 775 791. The role may even be seen as a “judicial abdication of the court’s role” to determine whether a director acted in breach of his duties to the corporation (id 799).
The question arises whether the business judgment rule will offer protection to directors of companies operating in the “vicinity of insolvency”, or of companies that are already technically insolvent.

According to some commentators there are sound policy reasons for arguing that the rule should not be rendered inapplicable by a shift in directors’ duties upon the corporation experiencing financial difficulties, without being technically insolvent. This argument is based on the fact that the application of the rule is even more critical where the board has to make difficult decisions when the corporation is struggling financially. An adapted formulation of the business judgment rule is offered in this regard, namely that the expansion of directors’ duties should not “preclude risk-taking or entrepreneurship, provided the decision to pursue such activities is made in the informed, good faith belief that it is reasonably likely to enhance the long-term wealth-generating abilities of the firm”.

Whether the business judgment rule will protect board decisions made in insolvency, is uncertain. Some hold the view that the business judgment rule will be available under such circumstances, while others are of the opinion that such a conclusion is not supported by decisions that directors become trustees in a literal sense upon

1437 The phrase was used in Credit Lyonnais Bank Netherland, NV v Pathe Communications Corporation No 12150, 1991 WL 277613 (Del Ch Dec 30, 1991), reprinted in (1992) 17 Delaware Journal of Corporate Law 1099 1155, to indicate the point in time when a shift in directors’ duties will occur. See discussion supra Ch 7 (Point in Time When The Duty Arises) for more detail.

1438 See discussion supra Ch 7 (Point in Time When The Duty Arises) for more detail on these and other “triggers” for the duty to creditors.


1440 Ibid.

1441 Varallo & Finkelstein supra 243. Tompkins “Directors’ Duties to Corporate Creditors: Delaware and the Insolvency Exception” (1993) 47 Southern Methodist University Law Review 165 187 – 190, however, is of the opinion that directors who are seen to owe duties to creditors could be deprived of the protection afforded in terms of the business judgment rule, should the interpretation of the elements thereof as provided by the court in Credit Lyonnais Bank Netherland, NV v Pathe Communications Corporation supra be followed.

insolvency,\textsuperscript{1443} and are liable for damages based on simple negligence, and not gross negligence as per the business judgment rule.\textsuperscript{1444}

An argument is presented in favour of the application of the business judgment rule in the insolvency context, however, as the “traditional policies which are invoked to support the business judgment rule outside the insolvency context are equally applicable in the insolvency context”,\textsuperscript{1445} with specific reference to the court’s inability to make business decisions for directors.\textsuperscript{1446} A modified business judgment rule under such circumstances would, however, require some “threshold proof” by directors that they did indeed consider the interests of creditors.\textsuperscript{1447}

\textbf{9.2.3.2 Australia}

In 1995 already the Australian judiciary afforded some recognition to the legitimacy of a certain degree of risk taking in business judgment. The majority judgment in \textit{Daniels v Anderson}\textsuperscript{1448} stated:

\begin{quote}
\[\text{[w]}\text{hile a focus on and consideration of creditor interests is undoubtedly required, given the glaring and fundamental difficulty in determining when insolvency occurs and the corporate law mandate that the affairs of a corporation are to be managed under the direction of the board, courts or the state legislatures should provide directors with some form of business judgment rule protection...for decisions made in the ‘fourth quarter’ of a corporation’s life.}\]
\end{quote}

\textsuperscript{1443} In terms of the so-called trust fund doctrine.

\textsuperscript{1444} Varallo \& Finkelstein \textit{supra} 245.

\textsuperscript{1445} Varallo \& Finkelstein \textit{supra} 254. Also see Cieri, Sullivan \& Lennox \textit{supra} 422 who agree with this view in no uncertain terms, stating that

\begin{quote}
\[\text{this court must be able to rely on officers’ and directors’ actions, even for an insolvent corporation unless those seeking damages show that such actions are venal (}id 875).\]
\end{quote}

\textsuperscript{1446} Varallo \& Finkelstein \textit{supra} 253 indicate that a variant of the business judgment rule was applied by the court in \textit{In re Xonics Inc} 99 BR 870 (Bankr NDI II 1989), in which case action was brought against directors of the insolvent corporation by creditors, even though the court stated that its decision was based on the trust fund doctrine. This conclusion is derived from a statement by the court that

\textsuperscript{1447} Cieri, Sullivan \& Lennox \textit{supra} 421 for a similar interpretation of the specific case.

\textsuperscript{1448} (1995) 37 NSWLR 438.
The courts have recognised that directors must be allowed to make business judgments and business decisions in the spirit of enterprise untrammelled by the concerns of a conservative investment trustee. Any entrepreneur will rely upon a variety of talents in deciding whether to invest in a business venture. These may include legitimate but ephemeral, political insights, a feel for future economic trends, trust in the capacity of other human beings. Great risks may be taken in the hope of commensurate rewards. If such ventures fail, how is the undertaking of it to be judged against an allegation of negligence by the entrepreneur?1449

Statutory recognition of the above stance followed in 2001.1450 This was done through the adoption of section 180(2) of the Australian Corporations Act,1451 which provides for a statutory business judgment rule as a corollary to the statutory duty of care in terms of section 180(1). Section 180(2) reads as follows:

A director or other officer1452 of a corporation who makes a business judgment is taken to meet the requirements of subsection (1), and their equivalent duties at common law and in equity, in respect of the judgment if they:

(a) make the judgment in good faith for a proper purpose; and

(b) do not have a material personal interest in the subject matter of the judgment; and

(c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and

(d) rationally believe that the judgment is in the best interests of the corporation.1453

1449 Id 501.


1452 Parties who are thus afforded the protection of the business judgment rule would, apart from directors, include other people who manage the corporation; receivers; and liquidators, etc, as indicated by the extended definition of the term “officer” in s 9 of the Australian Corporations Act. This study is, however, only concerned with the protection that this rule offers to directors of the company.

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

Section 180(3) continues to define business judgment as “any decision to take or not take action in respect of a matter relevant to the business operations of the corporation”. In terms of this subsection it is clear that the Australian business judgment rule, like the American business judgment rule, is only applicable in respect of decisions to do, or not to do something, after judgment has been exercised in reaching the conclusion.\footnote{454}{Greenhow \textit{supra} 39.} It does therefore not extend to a failure to make a decision, or to the mere “rubber-stamping” of decisions.\footnote{455}{\textit{Ibid}.} The subject matter of the decision must furthermore be relevant to the operations of the company.\footnote{456}{Greenhow \textit{supra} 39; Langford “The New Statutory Business Judgment Rule: Should it Apply to the Duty to Prevent Insolvent Trading?” (1998) 16 \textit{Company \\& Securities Law Journal} 533 534.}

Compliance with the statutory business judgment rule only satisfies the duties under section 180(1) and the equivalent thereof at common law.\footnote{457}{S 180(2).} Not all decisions are therefore protected by the business judgment rule.\footnote{458}{A note to the provision makes it clear that it does not operate in relation to duties under any other provision of law.} Decisions that are not so protected are, for example, decisions made in the context of insolvent trading, or decisions with regard to misstatements in a prospectus or takeover document.\footnote{459}{Greenhow \textit{supra} 40; Kyrou \textit{supra} 561; Langford \textit{supra} 540.}
9.2.3.3 Evaluation

9.2.3.3.1 Arguments in Favour of a Statutory Business Judgment Rule

9.2.3.3.1.1 Judiciary’s Stance on Pronouncing on Business Decisions

The judiciary is well-known for its apparent reluctance to interfere with the management of the affairs of a company,\(^{1460}\) perhaps because it feels ill-equipped to deal with such matters,\(^{1461}\) or is desirous to adhere to the legal doctrine that the directors and not the courts are burdened with managing the affairs of the company.

Whatever the reason for the reluctance, the application of the business judgment rule seems to fit perfectly with the way in which the judiciary feels itself equipped to or permitted to judge business decisions of directors, in that it only has to examine process due care and not the actual merits of the decision itself.\(^{1462}\)

The legal recognition that the business judgment rule affords to this role adopted by the courts may provide plaintiffs beforehand with an indication of whether or not a particular action should be brought against directors. Directors, on the other hand, will not be subjected to a review of their decisions by persons who may not be equipped to do so and who may furthermore enjoy the unfair advantage of hindsight.

9.2.3.3.1.2 Encouragement of Risk-Taking

The importance of allowing directors to be bold and take business risks is emphasised on many levels.\(^{1463}\) The business judgment rule is seen as instrumental in encouraging

\(^{1460}\) See eg Howard Smith Ltd v Ampol Petroleum Ltd [1974] AC 821 832 where the court made clear its sentiments that it would be wrong for the court to substitute its opinion for that of the management, or to question the correctness of the management’s decision, as long as it was arrived at bona fide.

\(^{1461}\) A view shared by commentators. See eg Bradley & Schipani supra 24 who are of the opinion that courts “do not possess the requisite experience and expertise to make complex business decisions”.

\(^{1462}\) See discussion supra par 9.2.3.1.

\(^{1463}\) According to the American Law Institute’s Principles of Corporate Governance: Analysis and Recommendations (1994) 176, as referred to by Redmond “Safe Harbour or Sleepy Hollows: Does Australia Need a Statutory Business Judgment Rule?” in Ramsay (ed) Corporate Governance and the Duties of Company Directors (1997) 185 199, the business judgment rule would provide a stimulus for “risk taking, innovation, and other creative entrepreneurial activities”. In terms of the Australian Companies and Securities Law Review Committee Company Directors and Officers: Indemnification, Relief and Insurance Report No 10 (1990) par 76; as referred to by Redmond 199, a business judgment rule would “encourage business endeavour by assuring people who embark on business enterprises by specific legislation that if, acting honestly, they take risks there is some safeguard against personal liability flowing from tribunals reviewing with hindsight the merits of bona fide business decisions”.

352
directors to take business risks, without the fear of personal liability continuously hanging over their heads.1464 This, in turn, may attract directors of a high calibre to the office.1465

9.2.3.1.3 Need for Protection at the Moment When Directors Take Business Judgments

According to the Australian Institute of Company Directors, there is a need to give directors certainty “at the time when they take their decisions, that if specified prerequisites are met that their decisions will be beyond challenge”.1466 The business judgment rule may fulfil this function.1467

9.2.3.1.4 Arguments from Fairness and Expediency

The recognition of a business judgment rule is also propagated on the basis of fairness and expediency.1468 According to the “expediency argument”, shareholder welfare stands to benefit from encouraging risk taking,1469 and is closely related to a previous

Numerous commentators hold the same view. See eg Herzel & Katz “Smith v Van Gorkom: The Business of Judging Business Judgment” (1986) 41 The Business Lawyer 1187 1189 who emphasise the importance of allowing directors to be bold and warn that caution on the part of directors should not be regarded as a virtue, but rather a “costly vice”.

1464 Herzel & Katz supra 1189, in a critique of the decision in Smith v Van Gorkom 488 A 2d 858 (Del 1985), warn that an interpretation of the business judgment rule as in this case might not serve this purpose. Also see Greenhow supra 54 who emphasises the perceived importance of the business judgment rule in encouraging “responsible risk taking”.

1465 Greenhow supra 54.


1467 Greenhow supra 54 agrees that the business judgment rule will provide “enhancement and clarification” as well as “an awareness of the duties owed”. Also see Arsalidou “Objectivity vs Flexibility in Civil Law Jurisdictions and the Possible Introduction of the Business Judgment Rule in English Law” (2003) 24 The Company Lawyer 228 231 for similar arguments.


1469 In the words of Farrar Corporate Governance, Business Judgment and Professionalism 23 – 24:

The expediency reason recognises that shareholders’ welfare may be better advanced by encouraging rather than restricting risk taking. Making directors liable for mere errors of judgment will promote risk adverse behaviour which will stifle economic growth.

Greenhow supra 54 and Arsalidou supra 231 make the same point.
argument in favour of the importation of the business judgment rule.\textsuperscript{1470} The “fairness argument” is based thereon that directors are treated unfairly in the absence of a body of practice against which they are able to assess the acceptability of a business judgment.\textsuperscript{1471}

9.2.3.3.2 Arguments against a Statutory Business Judgment Rule

9.2.3.3.2.1 Superfluity of a Statutory Business Judgment Rule

It is rightly noted that much of the uncertainty surrounding the exact content of the business judgment rule is caused by the unfortunate misnomer thereof as a “presumption”.\textsuperscript{1472}

In this respect, one is inclined to agree that the so-called “procedural presumption” is in fact not a presumption at all, but a mere restatement of traditional rules of evidence that the party alleging director misconduct is saddled with the burden of proving this.\textsuperscript{1473} Should the plaintiff be unsuccessful with discharging the burden of proof, the defendant director will escape liability as a logical consequence of the application of these rules, and not because of some “presumption” that the director complied with his or her duties.

At the moment this is how the duty of care operates in South Africa and its current formulation allows ample scope for the judiciary to refrain from having to pass judgment on directors’ “business decisions”. In this regard there seems to be no

\textsuperscript{1470} Supra par 9.2.3.3.1.2.

\textsuperscript{1471} Farrar Corporate Governance, Business Judgment and Professionalism 23 – 24 states:

The fairness justification focuses on the difference between good decisions which turn out badly and bad decisions. All professionals are liable for the latter. However, in the case of most professionals there is a body of practice against which one can judge what is acceptable conduct. This is not the case with company directors. Many of the decisions taken are complex decisions made on the basis of incomplete information and necessarily involve risk.

\textsuperscript{1472} Balotti & Hanks supra 1339.

\textsuperscript{1473} Balotti & Hanks supra 1345 – 1347. Also see Johnson supra 627, who seems to agree that the “procedural burden-assigning function of the rule is rather trivial, and creating a doctrine simply to assign plaintiff a burden it already had is…unwarranted”.

354
reason to implement a statutory business judgment rule in South Africa. One has to agree, therefore, that there is a well-developed body of legal principle which “in function, if not in fact, embodies a business judgment rule”.1474

A final argument that may be raised in this regard is that sufficient protection exists in terms of other provisions that provide the court with a discretion to grant directors relief from liability.1475

9.2.3.3.2 Limited Application of and Protection Afforded by the Rule

The business judgment rule is also seen as not successfully providing directors with adequate protection. This is firstly because of the fact that it offers very limited coverage – it only protects directors against compensation liability which did not result from the exercise of corporate powers for an improper purpose, and does not protect them against possible injunctive relief, an account of profits or the declaration of a constructive trust.1476

A director is furthermore required to be informed to an extent that he or she reasonably believes to be appropriate in the circumstances. This may open the door to directors’ decisions being challenged.1477

In the third place, directors are only protected by the business judgment rule insofar as they actively exercised a business judgment. A major part of directors’ responsibilities, namely the supervisory process, is thus not covered by the protection offered by the business judgment rule.1478

1474 Redmond supra 202. Also see Redmond supra 185, where it is eloquently put that “there is no reason to believe that a statutory business judgment rule would offer superior protection to that provided by long established general law doctrines of directors’ duties which protect business judgments from inappropriate hindsight review, including review of the merits of the business judgment”. Arsalidou supra 231 refers to this as the “implied” or “unwritten” business judgment rule. Also see Havenga “The Business Judgment Rule – Should We Follow the Australian Example?” 2000 SA Merc LJ 25 37.

1475 Eg s 248(1) of the South African Companies Act; s 1318(1) of the Australian Corporations Act; and s 727(1) of the English Companies Act.

1476 Kyrou supra 561; Redmond supra 202.

1477 Redmond supra 203.

1478 Arsalidou supra 232.
9.2.3.3.2.3 Creation of Formalism

The business judgment rule, as applied in the United States of America, seems to protect directors against decisions that turn out badly, provided that the procedure involved in making the decision was acceptable. A decision that results from careful deliberation will thus be beyond reproach, even if the consequences of the decision were to the detriment of the company.

This may result in greater formalism on the part of the board of directors, when going about the business of “cultivating an aura of care, diligence, thoroughness, and circumspection”.1479 Such formalism will obviously involve an increase in costs for the company, as directors may deem it as necessary to involve experts of every kind in all decisions of the board, should the process by which the decision was reached be questioned at a later stage.1480

9.2.3.3.2.4 Realism About Shareholder Litigation Risk

There is a relatively small number of cases where proceedings were brought against directors for a breach of their duty of care. One of the reasons for this may be that shareholder remedies for enforcement of directors’ duties are inadequate and that this presents a “serious obstacle to their function of setting standards of conduct”.1481 In light of this fact one is inclined to agree that any further barriers to shareholder action, for example a statutory business judgment rule, will require “formidable justification”.1482

9.2.3.3.2.5 Effect of a Statutory Rule On the Content of a Duty of Care

The exact relationship between the business judgment rule and the duty of care is a source of great confusion,1483 with some seeing the business judgment rule as defining

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1479 Herzel & Katz supra 1191.

1480 Ibid.

1481 Redmond supra 203.

1482 Ibid.

1483 Hinsey supra 614; Johnson supra 636 describes the relationship between the duty of care and the business judgment rule as “one of the most important, but least understood relationships in corporate law.”
the contents of directors’ duty of care. Others, however, regard it as a “tool of judicial review rather than a standard of conduct”.

In some enquiries pertaining to director misconduct, however, the enquiry as to whether due care has been exercised was apparently subsumed by the presumption embodied in the business judgment rule.

One therefore has to disagree with those who see the business judgment rule as a “tool of judicial review rather than a standard of conduct”, as the business judgment rule, or the interpretation thereof, most certainly seems to lay down some standard of conduct. This standard of conduct, namely gross negligence, seems to justify concerns that a statutory business judgment rule will lower the risk of director liability, if not formally, at least substantially, thus compromising the standard of care required from directors.

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1484 Cohn supra 594. According to Johnson supra 642 “the Delaware business judgment rule both preceded articulation of the due care duty and later enveloped care…, thereby ‘triumphing,’ if you will, over the duty of care as the more pre-eminent and central corporate law precept in Delaware”.

1485 Cieri, Sullivan & Lennox supra 405.

1486 According to Cohn supra 594 the business judgment rule which “began as an adjunct to duty of care standards” has now “enveloped the primary inquiry”. He notes that the courts “frequently invoke the due care standard and then proceed to the business judgment rule with only a cursory due care analysis” (id 594 n 9). This leads him to question whether the reasonable care standard is still a viable means for corporate governance, seeing that it is “doubtful whether there still exists a sanction for lack of care, unadulterated by self-enrichment or other opprobrious behavior” (id 594 – 595). Johnson supra 625 ascribes this “conceptual misuse” of the business judgment rule to the “late emergence of, and still unformed contours of, the duty of care”, in contrast to the well-developed business judgment rule, which led to the business judgment rule becoming and remaining the pre-eminent legal precept in Delaware corporate law.

1487 Cieri, Sullivan & Lennox supra 405.

1488 Redmond supra 204. Also see Carrigan supra 219, who describes the business judgment rule as a “safe harbour device...directed at diluting the standard of care”; Johnson supra 644, who bemoans the “functional downgrading of due care” by the business judgment rule; and Ubelaker supra 791 – 792 who concludes that “the true function of the business judgment rule has been to shield directors from application of an ordinary care standard of conduct” and that the use of the business judgment rule “has weakened the negligence standard that is relevant to mismanagement issues” and even “excised the requirement that directors exercise ordinary care in the conduct of their offices”. See Johnson supra 639 – 644 for an explanation, with reference to the development of the business judgment rule and duty of care, of how the duty of care came to be subsumed by the business judgment rule.
Apart from the *standard* of the duty that is being compromised through the application of the business judgment rule, the *content* of the duty also seems to be under threat by the business judgment rule. Application of the rule results in the duty to be “thinned” to nothing more than a requirement that directors be “informed” before exercising judgment.\footnote{Johnson *supra* 643 states that it is unfortunate that the business judgment rule is able to “stunt the growth of a vigorous, all-encompassing duty of due care by delimiting that core duty to a duty to ‘be informed’”.} Eventually the only remnant of the duty of care might be the requirement to be diligent.\footnote{See discussion *supra* Ch 6 (Protection Afforded by the Duty of Care and Skill) par 6.3.1 for more detail on the elements of the duty of care, namely care, skill and diligence.}

9.2.3.3.2.6 Doctrinal Conflicts

With regard to the enactment of a business judgment rule in Australia, it was noted that one should be careful of “engrafting united States norms upon Anglo-Australian corporate jurisprudence, disregarding the potential pitfalls of such unreflective importation”.\footnote{Santow “Codification of Directors’ Duties” (1999) 73 *Australian Law Journal* 336 349. Also see Havenga *supra* 36 who cautions that “[t]ransposing only one aspect of directors’ duties can have unforeseen consequences”. Santow 348 furthermore warns that the unreflective importation of the rule resulted in the “so-called safe harbour” to have been “mined by statutory depth charges awaiting the unwary director”.} These fears are equally valid with regard to South African company law which is largely based on English law. Importation of the business judgment rule will not sit easily alongside many common-law principles and doctrinal conflicts between principles pertaining to the common-law duty of care and the duty of care in terms of the business judgment rule seem probable.\footnote{These fears do not seem unfounded in light of the statement of Johnson *supra* 636 that the relationship between “on the one hand, the far-reaching, always-applicable director duty of due care and, on the other hand, the more finely drawn policy of non-review housed in the business judgment rule, is one of the most important, but least understood, relationships in corporate law”.}

9.2.3.3.2.7 Uncertainty Regarding Parameters of the Business Judgment Rule

The exact parameters and application of the business judgment rule present problems even in its jurisdiction of origin.\footnote{Hansen *supra* 1360 refers to various cases in which formulations for the rule were advanced and concludes that these formulations “by and large, lack clarity and consistency”.

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1489 Johnson *supra* 643 states that it is unfortunate that the business judgment rule is able to “stunt the growth of a vigorous, all-encompassing duty of due care by delimiting that core duty to a duty to ‘be informed’”.

1490 See discussion *supra* Ch 6 (Protection Afforded by the Duty of Care and Skill) par 6.3.1 for more detail on the elements of the duty of care, namely care, skill and diligence.

1491 Santow “Codification of Directors’ Duties” (1999) 73 *Australian Law Journal* 336 349. Also see Havenga *supra* 36 who cautions that “[t]ransposing only one aspect of directors’ duties can have unforeseen consequences”. Santow 348 furthermore warns that the unreflective importation of the rule resulted in the “so-called safe harbour” to have been “mined by statutory depth charges awaiting the unwary director”.

1492 These fears do not seem unfounded in light of the statement of Johnson *supra* 636 that the relationship between “on the one hand, the far-reaching, always-applicable director duty of due care and, on the other hand, the more finely drawn policy of non-review housed in the business judgment rule, is one of the most important, but least understood, relationships in corporate law”.

1493 Hansen *supra* 1360 refers to various cases in which formulations for the rule were advanced and concludes that these formulations “by and large, lack clarity and consistency”.

358
business judgment rule results in attempts to quantify the degree of care that a director owes to his corporation being stifled substantially. 1494

In an attempt to clarify the parameters of the business judgment rule, some commentators suggest that a distinction is to be made between the business judgment rule, which shields directors from liability, and the business judgment doctrine, which protects the decision itself. 1495 It is conceded, however, that the elements of the rule and the doctrine are exactly the same, a fact which “undoubtedly contributed to the widespread tendency to overlook the distinction”. 1496

9.2.4 Application to a Duty to Creditors

The point was made that directors should have access to adequate measures that provide relief from liability, in order to address the concerns that a duty to creditors may impact detrimentally on directors’ risk-taking ability and that it may deter people from serving on company boards.

In light of the preceding discussion it is very doubtful, however, whether the business judgment rule could contribute in this regard and it is submitted that the statutory importation thereof should be considered with great circumspection.

This view is held because of two reasons, namely that the business judgment rule is doctrinally unsuitable in a South African company law context and, secondly, that the perceived value of the business judgment rule as a “safe harbour” is over-estimated and that there is actually no need for such a rule.

The first argument is supported by various factors.

1494 Ubelaker supra 775.

1495 See eg Hinsey supra 611 – 612 who ascribes the “misunderstanding and confusion” surrounding the business judgment rule to the fact that courts and commentators generally fail to make this distinction.

1496 Id 612.
It was indicated that the relationship between the business judgment rule and the duty of care is far from clear in its jurisdiction of origin, mainly due to historical reasons – specifically the development of the duty of care after the business judgment rule was already in full force. The duty of care has a very definite place in South African company law and the ill-considered grafting of a foreign concept onto a legal system based on a very dissimilar conceptual foundation may cause many unforeseen problems and uncertainties.\textsuperscript{1497}

The business judgment rule also seems to intermingle what is in South Africa regarded as two separate duties, namely directors’ fiduciary duties and their duty of care, further strengthening the argument that it is doctrinally unsuitable in the South African company law context.\textsuperscript{1498}

A last argument in this respect is that it is uncertain how the business judgment rule will function alongside a provision such as section 248(1) of the South African Companies Act, in terms of which the court may exercise its discretion to grant directors relief from liability for a breach of their duties under certain circumstances.\textsuperscript{1499}

\textsuperscript{1497} Santow \textit{supra} 350 refers to these problems as “statutory depth charges” with which the so-called “safe harbour” is mined.

\textsuperscript{1498} The elements of the business judgment rule are that directors are presumed to have made informed decisions and to have acted with the necessary care when doing so. This relates to what is known in South Africa as the duty of care and skill. The other elements, however, namely actions in good faith and the absence of personal interest fit more comfortably with directors’ fiduciary duties. In South Africa the basis of liability for a breach of each of these categories is totally different and a combination of the elements thereof in a business judgment rule may present serious problems. A codification of the common law duties will have the effect that the basis of liability will become statutory and will be similar for both categories of duties. It is doubtful, however, whether it will be possible to divorce such codified duties completely from their common law predecessors and the conceptual differences are likely to remain.

\textsuperscript{1499} The Australian legislature retained the equivalent of the South African s 248(1), namely s 1318 of the Australian \textit{Corporations Act}, as well as providing for a statutory business judgment rule. Australian commentators do not seem to be overly concerned with the way in which these two provisions will operate alongside each other. It is submitted, however, that two such conceptually different powers of the court may create more confusion than it does provide protection.
The second reason, pertaining to the superfluity of the business judgment rule, derives from the fact that the protection afforded by the business judgment rule is limited and that the substance thereof is in fact applied in an informal manner. It may also have the unforeseen result of increasing the burden that already rests on directors in terms of their duties to the company.

In relation to a duty to creditors specifically, there is doubt as to whether the business judgment is applicable, with authors holding conflicting views on its application in insolvency. Commentators also indicated that directors will be required to show that they considered the interests of creditors, even if it is accepted that a modified business judgment rule applies in insolvency.

Directors are furthermore afforded possible relief from liability in terms of specific statutory provisions to this effect.

It is true that these statutory provisions are not without problems and for them to fulfil the crucial role of ensuring a balance between allowing directors freedom to take

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1500 See discussion supra par 9.2.3.3.2.2.

1501 In the discussion supra par 9.2.3.3.2.1 it was indicated that the business judgment is merely a formal embodiment of the way in which the duty of care is approached by the courts, who are reluctant to pronounce on business decisions of directors, anyway. The current approach adopted by the courts may even offer better protection than a formal business judgment rule. In this regard one is inclined to agree with Davies “Self-Incrimination, Fair Trials, and the Pursuit of Corporate and Financial Wrongdoing” in Markesinis (ed) The Impact of the Human Rights Bill on English Law (1998) 50 – 58, as referred to by Santow supra 351, that ex post customising of the standard of care is likely to be of greater benefit to directors than ex ante fixing of identifiable safe harbours – because the former is feasible whilst the latter is not without producing an unacceptable rigidity in judicial decision-making.

1502 Farrar Duty of Care 90 – 91, with reference to the United States experience, warns that the introduction of a business judgment rule, without a concomitant “tightening up” on disclosure requirements and the effective regulation of self-interested transactions, may bode very ill for investors.

1503 See eg Coogan, Bermont & Glatt supra 1375; and Varallo & Finkelstein supra 245.

1504 Cieri, Sullivan and Lennox supra 421.

1505 S 248(1) of the South African Companies Act; s 727 of the English Companies Act; and s 1318 of the Australian Corporations Act.
calculated business risks without the fear of personal liability should these decisions turn out badly, and being held accountable for their actions, certain issues need to be addressed.\textsuperscript{1506} As indicated in the above discussion\textsuperscript{1507} these problems may be addressed without too much difficulty.

One can therefore not help but agree with various authors that the enactment of a business judgment rule is not only unnecessary, but also undesirable.\textsuperscript{1508}

9.3 INDEMNIFICATION

9.3.1 Introduction

One way in which directors may escape liability in case of a breach of their duties, is through exemption from or indemnification against liability.\textsuperscript{1509} Such indemnification or exemption may, for example, be provided for by a company’s articles of association, or in a contract between the director and the company.

Legislation in most jurisdictions draws a distinction between general indemnification and indemnification against liability for legal expenses. The extent to which exemption or indemnification may be granted is regulated to various degrees of strictness in the various jurisdictions. This section commences with a comparative

\textsuperscript{1506} Pasban, Campbell and Birds \textit{supra} 213 raised the issue that

the relief under section 727 has been an effective tool of protecting corporate directors. However, the courts have perhaps failed to resolve some of the problems and ambiguities inherent in this section. The section is in need of amendment.

\textsuperscript{1507} \textit{Supra} par 9.2.2.4.

\textsuperscript{1508} See eg Arsalidou \textit{supra} 233 who, after having weighed up various factors in favour of and against the introduction of a statutory business judgment rule, comes to the conclusion that “there is no pressing urgency to adopt a business judgment rule in the United Kingdom”. Also see Botha & Jooste “A Critique of the Recommendations in the \textit{King Report Regarding a Director’s Duty of Care and Skill}” 1997 \textit{SALJ} 65 67; and Havenga \textit{supra} 37.

\textsuperscript{1509} The terms “indemnification” and “exemption” are used in different ways in the various jurisdictions. In South Africa and England no clear distinction is made between the two concepts, whereas the Australian legislature decided to treat them in two separate subsections. New Zealand, on the other hand, has no provision regarding “exemption”, but “indemnification” is formulated widely enough to cover both concepts. See discussion \textit{infra} for more detail on the relevant statutory provisions in these jurisdictions. Where these terms are to be distinguished from one another regarding meaning and application, it will be clearly indicated.
study of how indemnity and exemption are regulated in various jurisdictions, after which the way in which it may be applied in respect of a duty to creditors is evaluated.

9.3.2 Statutory Regulation

9.3.2.1 South Africa

Section 247(1) of the South African Companies Act makes it clear that directors and others\textsuperscript{1510} may not be exempted from or indemnified against liability through private arrangements between themselves and the company, which would otherwise attach to them in respect of negligence, default, breach of duty or breach of trust.\textsuperscript{1511} The relevant part of this provision reads as follows:

\begin{quote}
[\text{A\text{\textsuperscript{ny}} provision, whether contained in the articles of a company or in any contract with a company, and whether expressed or implied, which purports to exempt any director or officer or the auditor of the company from any liability which by law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company or to indemnify him against any such liability, shall be void.}]
\end{quote}

Section 247(1), however, does not prohibit the ratification of such conduct by the company in general meeting.\textsuperscript{1512}

\textsuperscript{1510} This study is particularly concerned with directors, their duties and how they may be provided with relief from liability in case of a breach of these duties. The position in respect of other parties mentioned in terms of ss 247 and 248 and equivalent provisions in other jurisdictions, namely auditors and officers of the company, falls outside the scope of this contribution and is not discussed in any detail.

\textsuperscript{1511} A similar provision was first adopted in England on recommendation of the Greene Committee on Company Law, Cmd 2657, which was appointed partly as a response to the public scandal arising from the affairs of the City Equitable Fire Insurance Co, which resulted in \textit{In re City Equitable Fire Insurance Co} [1925] 1 Ch 407. See Baker “Disclosure of Directors’ Interests in Contracts” 1975 \textit{Journal of Business Law} 181 186 for an overview of the historical development of this provision. This provision was introduced in SA on recommendation of the Lansdown Commission \textit{Report of the Company Law Commission} 1935 – 1936 UG No 45 1936 par 135 to put a stop to the practice of providing for the indemnity of directors in the articles of association for all liability other than that based on dishonesty (see Blackman “Exemption of Directors from Liability and Section 247(1) of the Companies Act, 1973” 1993 \textit{THRHR} 537; and Cilliers & Benade \textit{Corporate Law} (2000) par 10.55).

\textsuperscript{1512} Du Plessis \textit{Maatskappypregtelike Grondsle van die Regsposisie van Direkteure en Besturende Direkteure} LLD UOVS (1990) 78 – 79.
Subsection (2) furthermore provides for the indemnification of a director by the company under very limited circumstances. These are where the director incurred liability in defending civil or criminal proceedings and judgment was given in his favour; or where he was acquitted; or in respect of proceedings that were abandoned; or in connection with an application under section 248\textsuperscript{1513} in which relief is granted to him by the court.

\textbf{9.3.2.2 Australia}

In Australia indemnities and exemption are provided for by sections 199A\textsuperscript{1514} and 199C of the Australian \textit{Corporations Act}.\textsuperscript{1515}

Exemption and indemnification are dealt with in separate provisions. In terms of the provision pertaining to \textit{exemption} a company or related body corporate is not allowed to exempt a person, directly or indirectly,\textsuperscript{1516} from a liability to the company incurred as an officer of the company.\textsuperscript{1517}

The provision dealing with \textit{indemnification} provides that a company or related body corporate is not allowed to indemnify a person by agreement, or by making a payment, whether directly or indirectly,\textsuperscript{1518} against particular liability incurred as an officer.\textsuperscript{1519} Liability includes “a liability owed to the company or a related body corporate”,\textsuperscript{1520} “a liability for a pecuniary penalty order under section 1317G”\textsuperscript{1521} or a

\textsuperscript{1513} See \textit{supra} par 9.2.2.1 for more detail on s 248.

\textsuperscript{1514} Titled “Indemnification and exemption of officer or auditor”.

\textsuperscript{1515} Titled “Certain indemnities, exemptions, payments and agreements not authorised and certain documents void”.

\textsuperscript{1516} Ie “[t]hrough an interposed entity” (s 199A(1)).

\textsuperscript{1517} S 199A(1).

\textsuperscript{1518} Ie “[t]hrough an interposed entity” (s 199A(2)).

\textsuperscript{1519} S 199A(2).

\textsuperscript{1520} S 199A(2)(a).

\textsuperscript{1521} In terms of s 1317G a court is authorised to order a person to pay a pecuniary penalty of up to AS$ 200,000, if the court makes a declaration that the person has contravened a civil penalty provision and certain other conditions are met. Civil penalty provisions include eg s 180(1), dealing with directors’ duty of care and diligence; as well as ss 181(1) and (2); 182(1) and (2); and 183(1) and (2), dealing
compensation order under section 1317H”; 1522 or “a liability that is owed to someone other than the company or a related body corporate and did not arise out of conduct in good faith”. 1524

The regulation of indemnity for legal costs is dealt with in a separate subsection. 1525 Section 199A(3) prohibits a company or related body corporate from indemnifying a person by agreement or by making a payment, directly or indirectly, against specific legal costs incurred as an officer of the company. The legal costs that such a person may not be indemnified against are those incurred “in defending or resisting proceedings in which the person is found to have a liability for which they could not be indemnified under subsection (2)”; 1527 “in defending or resisting criminal proceedings in which the person is found guilty”; 1528 “in defending or resisting proceedings brought by ASIC or a liquidator for a court order if the grounds for making the order are found by the court to have been established”; 1529 or “in connection with proceedings for relief to the person under this Law in which the Court denies the relief”. 1530

with fiduciary type obligations. See supra Ch 5 (Protection Afforded by Fiduciary Duties) par 5.4.4 and supra Ch 6 (Protection Afforded by the Duty of Care and Skill) par 6.4.2 for more detail on the operation of the civil penalty provisions.

1522 S 1317H provides that a court may order a person to compensate a corporation for damage suffered by it as a result of a contravention of a civil penalty provision by that person.

1523 S 199A(2)(b).

1524 S 199A(2)(c).

1525 S 199A(3). The fact that indemnity against particular liabilities and indemnity against legal costs are to be treated strictly separately, does not only follow from the treatment thereof in separate subsections, but also from the heading of subsection (2), which reads: “When indemnity for liability (other than for legal costs) are not allowed” (own emphasis) and from the fact that subsection (2) itself expressly provides that it is not applicable to a liability for legal costs.

1526 Ie “[t]hrough an interposed entity” (s 199A(3)).

1527 S 199A(3)(a).

1528 S 199A(3)(b).

1529 S 199A(3)(c).

1530 S 199A(3)(d). The proceedings for relief that are referred to here, are probably in relation to s 1318. See supra par 9.2.2.2 for more detail on this provision.
Anything that purports to indemnify a person against, or exempt him from a liability, is void insofar as it contravenes section 199A.\textsuperscript{1531}

A related provision, section 212, furthermore provides that any benefit to directors by way of an indemnity, exemption or insurance premium pertaining to a liability incurred as an officer of that company, or an agreement to that effect, is not subject to the approval of the members of the company,\textsuperscript{1532} provided that to give the benefit will be reasonable in the circumstances.\textsuperscript{1533} Member approval is also not necessary in respect of the making of, or agreement to make, a payment in respect of legal costs incurred by a director in defending an action for a liability incurred as an officer of the company,\textsuperscript{1534} provided that it will be reasonable to give the benefit in the circumstances.\textsuperscript{1535} The director will have to repay the amount if section 199A applies to the costs and the costs become costs for which the company should not have indemnified the director.\textsuperscript{1536}

\textbf{9.3.2.3 New Zealand}

The New Zealand \textit{Companies Act} does not permit a company to indemnify a director of the company or a related company in respect of “[l]iability for any act or omission in his or her capacity as a director”,\textsuperscript{1537} or in respect of “[c]osts incurred by that director...in defending or settling any claim or proceeding relating to any such liability”,\textsuperscript{1538} unless the Act expressly states otherwise. Any indemnity provided in breach of this provision, is void.\textsuperscript{1539}

\textsuperscript{1531} S 199C(2).
\textsuperscript{1532} S 212(1).
\textsuperscript{1533} S 212(1)(c).
\textsuperscript{1534} S 212(2). In terms of this provision, payment can be “by way of advance, loan or otherwise”.
\textsuperscript{1535} S 212(2)(d). S 212(3) lists factors that could be considered in order to determine whether the benefit was “reasonable in the circumstances”, for the purposes of ss 212(1)(c) and 212(2)(d).
\textsuperscript{1536} S 212(2)(c)(ii).
\textsuperscript{1537} S 162(1)(a).
\textsuperscript{1538} S 162(1)(b).
\textsuperscript{1539} S 162(2).
Section 162 lists the circumstances under which indemnity may be provided. Both of these “exceptions” to the general prohibition is subject to express authorisation granted in the company’s constitution.\textsuperscript{1540} In terms of the first exception a company may indemnify a director of a company or a related company for any costs incurred by him in any proceeding that relates to “liability for any act or omission in his or her capacity as a director”\textsuperscript{1541} and in which “judgment is given in his or her favour, or in which he or she is acquitted, or which is discontinued”.\textsuperscript{1542}

In terms of the second exception a director of the company, or a related company, may be indemnified in respect of “[l]iability to any person other than the company or a related company for any act or omission in his or her capacity as a director”,\textsuperscript{1543} as well as “[c]osts incurred by that director...in defending or settling any claim or proceeding relating to any such liability”,\textsuperscript{1544} provided that the liability is not criminal liability, or liability in respect of a breach of the director’s duty in terms of section 131\textsuperscript{1545} of the Act.\textsuperscript{1546}

Should indemnity be granted to a director of the company or a director of a related company, the board of the company is required to ensure that the particulars of the indemnity are entered into the interests register.\textsuperscript{1547}

The New Zealand \textit{Companies Act} does not expressly prohibit \textit{exempting} a director from liability. The statutory definition of “indemnify”, namely that it “includes relief

\textsuperscript{1540} Ss 162(3) and 162(4) commence with the phrase “A company may, \textit{if expressly authorised by its constitution}” (own emphasis).
\textsuperscript{1541} S 162(3)(a).
\textsuperscript{1542} S 162(3)(b).
\textsuperscript{1543} S 162(4)(a).
\textsuperscript{1544} S 162(4)(b).
\textsuperscript{1545} S 131 relates to directors’ duties to act in good faith and in the best interests of the company. See \textit{supra} Ch 5 (Protection Afforded by Fiduciary Duties) par 5.2.3 for more detail.
\textsuperscript{1546} S 162(4).
\textsuperscript{1547} S 162(7).
or excuse from liability, whether before or after the liability arises” is wide enough, however, to cover the concept of exemption as well.\footnote{\textit{S 162}(9). It is furthermore stated that “indemnity” has a corresponding meaning.} One issue that arises because of this wide definition is that it becomes questionable whether shareholder ratification itself will be effective to relieve a director from liability.\footnote{Jones \textit{Company Law in New Zealand: A Guide to the Companies Act 1993} (1993) 164. Cranston \textit{supra} 198 raises a similar concern in respect of \textit{s 310} of the English \textit{Companies Act}, the equivalent provision in England, should this provision be broadly interpreted. See \textit{infra} par 9.3.2.4 for more detail on \textit{s 310}.}

\textbf{9.3.2.4 England}

Section 310 of the English \textit{Companies Act}\footnote{\textit{Companies Act}, 1985 (hereinafter English \textit{Companies Act}).} is the equivalent of section 247 of the South African \textit{Companies Act}. In terms of section 310(1) and (2) “any provision, whether contained in a company’s articles or in any contract with the company or otherwise” which purports to exempt a director, officer\footnote{It is possible that the prohibition against indemnifying officers of the company, as opposed to directors, may be lifted. The Company Law Review \textit{Modern Company Law for a Competitive Economy: Final Report} Vol I (London, DTI, 2001) par 6.3 indicates that it is not believed that \textit{s 310} should apply to liability of officers, other than directors. The reason for this is that it is “ultimately a matter for the board to determine the conditions of employment of senior employees” (\textit{ibid}).} or auditor of a company from, or to indemnify him against “any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company” shall be void.

Subsection (3), however, provides that this prohibition does not prevent a company from indemnifying a director against liability incurred by him in successfully defending any civil or criminal proceedings\footnote{S 310(3)(b)(i).} or in connection with any application under section 144\footnote{Dealing with the acquisition of shares by an innocent nominee.} or section 727.\footnote{S 310(3)(b)(ii).}
9.3.2.5 Canada
Section 124(1) of the Canada Business Corporations Act\(^\text{1556}\) allows a corporation to indemnify a director against “all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment, reasonably incurred by the individual in respect of any civil, criminal, administrative, investigative or other proceeding in which the individual is involved because of that association with the corporation”.

This is subject, however, to the director having acted “honestly and in good faith with a view to the best interests of the corporation”\(^\text{1557}\) and to having had reasonable grounds for believing that his conduct was lawful.\(^\text{1558}\) The director should furthermore not have been judged by a court to have “committed any fault or omitted to do anything that the individual ought to have done”.\(^\text{1559}\)

9.3.2.6 United States of America
Concerns were raised that the decision in Smith v Van Gorkom\(^\text{1560}\) and the consequent insurance crisis, manifesting itself in high premiums and deductibles, reduced capacity, and the broadening of existing exclusions from coverage and drafting of new ones,\(^\text{1561}\) may deter directors from serving on corporate boards.\(^\text{1562}\) This prompted the Delaware General Assembly to amend its corporate code.\(^\text{1563}\)

\(^{1556}\) RSC 1985, cC-44 (hereinafter CBCA).

\(^{1557}\) S 124(3)(a).

\(^{1558}\) S 124(3)(b). S 124(3) is titled “Limitation”, but is referred to in other subsections, eg ss 124(2); 124(4); and 124(5)(b) as “conditions”.

\(^{1559}\) S 124(5)(a). S 124(5) is titled “Right to indemnity”.

\(^{1560}\) Supra.

\(^{1561}\) Caraccio supra 940.

\(^{1562}\) Weiss supra 638.

\(^{1563}\) The Delaware General Corporation Law Del Code Ann tit 8 (1991) (hereinafter DGCL). According to Veasey, Finkelstein & Bigler “Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance” (1987) 42 The Business Lawyer 399 401, the legislature extended indemnification rights principally in response to the insurance crisis that arose as a result of the decision in Smith v Van Gorkom supra. Also see Caraccio supra 930 who convincingly shows that there were numerous other factors also contributing to the insurance crisis and who is of the opinion that the D & O crisis itself is but a component of the larger liability insurance crisis affecting American society (id 998).
In terms of one such amendment, section 102(b)(7), a Delaware corporation may include in its articles of incorporation a clause eliminating or limiting directors’ personal liability to the corporation for a breach of their duty of care. This provision reads as follows:

(b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section the certificate of incorporation may also contain any or all of the following matters –

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director’s duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under section 174 of this Title, or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this subsection to a director shall also be deemed to refer to a member of the governing body of a corporation which is not authorized to issue capital stock.

It is clear that liability for a breach of the director’s duty of loyalty; acts or omissions not in good faith, involving intentional misconduct, or a knowing violation of the law; wilful or negligent conduct in stock transactions; or any transaction from which the director derived an improper personal benefit may not be limited or done away with. It is uncertain, however, whether this amendment exempts directors from liability from recklessness.

1564 Veasy, Finkelstein & Bigler supra 403 indicate that this provision does not have the effect of eliminating the duty of care, but only liability in respect thereof. The duty of care still has a role to play in remedial contexts, eg in injunction and rescission cases and may also be relevant in the context of elections, proxy contests, resignations and removals, but no longer in actions against directors for personal monetary damages.

1565 Weiss supra 644.

1566 Weiss supra 644 n 54.
This is an enabling provision, which means that a corporation will have to amend its certificate of incorporation to be able to grant directors the protection against personal liability envisaged in terms of this provision.\textsuperscript{1567} The power to amend the articles of incorporation in this way rests with the shareholders.\textsuperscript{1568} Weiss is in favour of this approach for three reasons. The first reason is based on the principle that it is “shareholders who own the corporation; the directors merely run it”.\textsuperscript{1569} It is furthermore shareholders’ money which is at stake and it will finally not interfere with the power of the shareholders to “approve or disapprove major changes in their corporation’s structure”.\textsuperscript{1570}

The end result of section 102(b)(7) is a “reduction in the overall sphere of liability to which a director is otherwise exposed”.\textsuperscript{1571}

Directors’ rights to indemnification were also expanded insofar as their involvement in actual or threatened litigation or an investigation by reason of the status of that person as director is concerned. In terms of section 145(a) a corporation may firstly indemnify a director “against expenses (including attorneys’ fees), judgments, fines and amounts paid in settlement...if he acted in good faith and in a manner he reasonably believed to be in...the best interests of the corporation”.\textsuperscript{1572} This subsection is not applicable to actions brought by the corporation and is therefore only relevant in respect of third-party actions.\textsuperscript{1573}

\textsuperscript{1567} Veasey, Finkelstein & Bigler \textit{supra} 402. This is called an “opt in” election. All states do not follow this option. See Weiss \textit{supra} 647 \textit{et seq} for a discussion of the way in which the various states amended their corporate statutes to limit directors’ liability for a breach of the duty of care, distinguishing specifically between enabling statutes, such as the \textit{DGCL}, and self-executing statutes, eg as in Indiana.

\textsuperscript{1568} Weiss \textit{supra} 647.

\textsuperscript{1569} \textit{Ibid}.

\textsuperscript{1570} \textit{Ibid}.

\textsuperscript{1571} Veasy, Finkelstein & Bigler \textit{supra} 403 – 404.

\textsuperscript{1572} S 145(a).

\textsuperscript{1573} Veasy, Finkelstein & Bigler \textit{supra} 404.
Section 145(b) applies to actions brought against directors by the corporation itself and provides for indemnification for attorneys’ fees and other expenses, but not for judgments or amounts paid in settlement.\textsuperscript{1574}

Mandatory indemnification against expenses and attorneys’ fees in respect of an action that was successfully defended by the director is provided for by section 145(c).\textsuperscript{1575} This provision reads as follows:

To the extent that a director...of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) and (b) of this section, or in defense of any claim, issue or matter therein, he shall be indemnified against expenses (including attorneys’ fees) actually and reasonably incurred by him in connection therewith.

In light of the phrase “successful on the merits or otherwise”, it is clear that section 145(c) provides for mandatory indemnification as a matter of right, irrespective of whether the director won judgment in his favour on the merits, or whether he successfully relied upon a technical defence.\textsuperscript{1576} What is not so clear, however, is whether this provision also applies in respect of a victory that is “less than total”.\textsuperscript{1577}

The indemnification referred to in subsections (a) and (b) does not occur automatically and must be duly authorized by the appropriate decision maker.\textsuperscript{1578} The “appropriate decision maker” may be the board of directors by a majority vote of a

\textsuperscript{1574} Weiss \textit{supra} 656 warns against the anomaly that would occur if a corporation was permitted to indemnify directors for amounts paid in settlement where an action was brought against the director by the corporation. This would entail that the corporation, as plaintiff, would receive money in damages, which it would then pay back to the delinquent director. On this point also see Bradley & Schipani \textit{supra} 32; and Veasy, Finkelstein & Bigler \textit{supra} 405 – 406.

\textsuperscript{1575} S 145(c).

\textsuperscript{1576} Veasey, Finkelstein & Bigley \textit{supra} 406.

\textsuperscript{1577} Veasey, Finkelstein & Bigley \textit{supra} 406. Johnston \textit{supra} 1998 is of the opinion that the phrase “to the extent that” indicates that a director who is partially successful will be entitled to be partially indemnified.

\textsuperscript{1578} S 145(d).
disinterested quorum; independent legal counsel should a quorum not be obtainable, or should a quorum of disinterested directors so direct; or the stockholders. Section 145(d) furthermore stipulates that indemnification shall be made “only as authorized in the specific case”, indicating that it will not be possible to authorise indemnification in advance on the basis of a purported blanket authority.

Attorneys’ fees and other legal expenses incurred by a director may be paid in advance by the corporation, provided that the director furnishes the corporation with a receipt and an undertaking to repay the amount advance if it is ultimately determined that the director is not entitled to indemnification.

It is also expressly provided that legislation is not the exclusive source of indemnity. It is thus possible to provide for more extensive protection through a by-law or an agreement specifically drafted for that purpose.

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1579 Veasy, Finkelstein & Bigley supra 409 note that these directors are required to exercise this authority in good faith and in the exercise of due care.

1580 Johnston supra 1999 suggests that independent legal counsel will be “special counsel appointed for this purpose only”.

1581 S 145(d).

1582 S 145(e).

1583 In terms of s 145(f), which provides:

The indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any by-law, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office.

1584 Johnston supra 1996. He warns, however, that there will undoubtedly be public policy limitations on how far such measures could go beyond the statutory formulation.
9.3.3 Application to a Duty to Creditors

9.3.3.1 General Indemnity and Exemption

9.3.3.1.1 General

It is clear that exemption from or indemnification against liability is regulated according to varying degrees of strictness in different jurisdictions. At the one end of the spectrum is Delaware, where it is permissible for a company to indemnify a director against any liability to the company resulting from a breach of the duty of care. At the opposite end of the spectrum are those jurisdictions, for example Australia and New Zealand, where exemption and indemnification are regulated very strictly and even to such an extent that the prohibition against it applies in a group context. South Africa and England lie somewhere in between, not being as liberal as Delaware, but allowing more room for exemption or indemnification than Australia and New Zealand, as indemnification by a subsidiary to a director of its holding company, for example, does not seem to be prohibited expressly.

At the outset of this chapter the importance of allowing directors room to take calculated business risks was emphasised. It was also indicated that it is not desirable to create this freedom by limiting directors’ exposure to personal liability for a breach of their duties. As an alternative it was suggested that mechanisms providing relief from liability, provided the circumstances warrant it, may play a crucial role in achieving the desired balance.

The question may rightly be asked which of the above systems will best serve to achieve the balance between providing directors with the much-needed freedom to take calculated business risks without the continuous fear of personal liability, while not allowing unscrupulous directors the opportunity to escape liability for a breach of their duties.

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1585 It is only liability to the corporation itself that may be limited or eliminated in this way. Liability to parties other than the corporation, as well as liability to a related corporation, should therefore not be influenced by this provision.
It is submitted that strict regulation in respect of companies’ ability to indemnify or exempt directors from their duties is advisable. This submission is based thereon that a liberal approach in terms of which directors’ liability for a breach of their duties may be excluded through a resolution by the members of the company may provide too much of an escape route for delinquent directors.\textsuperscript{1586} This will be especially relevant in the case of closely-controlled companies, where the directors are also the majority shareholders.

Furthermore, a very liberal system will operate unfairly towards creditors. The model that is proposed to facilitate the extension of directors’ duties to creditors is that the company remains the beneficiary of directors’ duties. The interests of the company are to be defined with reference to the interests of either its shareholders or its creditors,\textsuperscript{1587} depending on the financial situation of the company.\textsuperscript{1588} If it is assumed that creditors become the indirect recipients of directors’ duties at a particular point in time, they will not be able to enforce any rights they gained in this regard, as the shareholders, who are no longer considered to be the primary corporate constituents at this stage,\textsuperscript{1589} previously decided that they would be willing to excuse directors from any liability that might result from a breach of their duties, thus depriving creditors of any remedies against directors that they may have in future.\textsuperscript{1590}

\textsuperscript{1586} On the basis of empirical research undertaken by them, Bradley & Schipani supra 74 note that legislative provisions to reduce the liability of corporate officials, with specific reference to s 102(7)(b) of the \textit{DGCL} which provides for greater scope to indemnify directors, caused a decrease in the value of Delaware corporations. It also appears that firms who made use of the wider ability to grant directors indemnity, suffered statistically significant abnormal losses at that time as well. This leads them to conclude that “liability rules are a binding constraint on the behavior of corporate officials” and that “liability rules do matter”.

\textsuperscript{1587} See supra Ch 8 (Beneficiary of the Duty) par 8.5 for a more detailed explanation of the operation of this model.

\textsuperscript{1588} See supra Ch 7 (Point in Time When the Duty Arises) for more detail on the circumstances that may give rise to the duty to creditors being triggered.

\textsuperscript{1589} According to the model advocated in this study.

\textsuperscript{1590} This point was also made supra Ch 8 (Beneficiary of the Duty), par 8.5.4.
Section 247(1) and Modifying or Releasing Provisions in Articles of Association

There seems to be some uncertainty as to the precise scope of provisions such as section 247(1). A strict interpretation of section 247(1) leads to the conclusion that provisions such as these are aimed solely at prohibiting exemptions from liability.\(^{1591}\)

A large number of commentators are of the opinion, however, that it is also aimed at prohibiting provisions in the articles reducing or abrogating duties of directors.\(^{1592}\)

This interpretation is based on the viewpoint that a director is exempted from liability just as effectively by a provision which says that the rules do not apply to him, as by one which says that the consequences of a breach of the rules do not apply to him.\(^{1593}\)

Should the second viewpoint, namely that the prohibition extents to agreements purporting to relieve directors from their duties and not only from liability that may result from a breach of those duties, be accepted as correct, one encounters the problem of reconciling this prohibition with legal principles permitting what appears to be a relief from duties.\(^{1594}\)

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\(^{1591}\) Henochsberg 459 holds the view that only those provisions in the articles purporting to exempt a director from, or indemnify him against, liability that would exist in the absence of such a provision are prohibited in terms of s 247(1). It is indicated, however, that even should it be accepted as correct that provisions abrogating directors’ duties are not prohibited in terms of section 247(1), such provisions would still be invalid for being contra bonos mores.

\(^{1592}\) According to Baker supra 186 interpreting the provision to allow the abrogation or exclusion of directors’ duties will completely go against the intention of the Greene Committee supra in proposing the section. It will furthermore not be in line with a literal interpretation of the phrase that a director may not be relieved from liability “which would otherwise attach to him”, as an exclusion of duties will have the precise effect of relieving a director from liability which would have attached him, were it not for the provision excluding or abrogating his duties (id 187). Blackman supra 540; Birds “The Permissible Scope of Articles Excluding the Duties of Company Directors” (1976) 39 Modern Law Review 394 396; and Gregory “The Scope of the Companies Act 1948, Section 205” (1982) 98 Law Quarterly Review 413 414 – 415 are also of the opinion that provisions to reduce or abrogate directors’ duties are prohibited in terms of these statutory measures. Also see Spisto “Exemption from Liability under Section 247 of the Companies Act: To What Extent Does ‘The Prohibition’ in this Section Apply in the South African Context?” 1997 CILSA 60 for a discussion of the scope and effect of s 247(1).

\(^{1593}\) Gregory supra 414.

\(^{1594}\) Baker supra 190 justifies these clauses by arguing that breaches that are capable of being ratified after the event can be authorised in advance through clauses in the company’s constitution. He concedes, however, that certain breaches that are ratifiable after they have occurred are not capable of being authorised beforehand, for example a breach of the duty to act with care and skill or the duty to act in good faith.
This conflict seems to be more glaring in England in light of certain clauses contained in the model Articles. Especially relevant in this regard is article 85 of Table A, which reads as follows:

Subject to the provisions of the Act, and provided that he has disclosed to the directors the nature and extent of any material interest of his, a director notwithstanding his office—

(a) may be a party to, or otherwise interested in, any transaction or arrangement with the company or in which the company is otherwise interested;

(b) may be a director or other officer of, or employed by, or a party to any transaction or arrangement with, or otherwise interested in, any body corporate promoted by the company or in which the company is otherwise interested; and

(c) shall not, by reason of his office, be accountable to the company for any benefit which he derives from any such office or employment or from any such transaction or arrangement or from any interest in any such body corporate and no such transaction or arrangement shall be liable to be avoided on the ground of any such interest or benefit.

Numerous commentators grapple with this issue and various solutions have been proposed to resolve the apparent conflict. Although there are differences in

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1595 Own emphasis.

1596 The model articles provided by the South African *Companies Act* (Table A and Table B of Schedule 1) do not specifically contain clauses to this effect. Naude *Die Regsposisie van die Maatskappydirekteur met Besondere Verwysing na die Interne Maatskappyverband* (1970) 128 indicates that a contract between a director and the company of which he is a director would not be voidable, if authorised in terms of the articles of association. Directors could, however, still be held liable for any benefit obtained by way of concluding a contract with the company under certain circumstances (*id* 129 et seq).


1598 According to Baker *supra* 191 a distinction should be drawn between clauses that are *modificatory* and clauses that are *abrogatory*. An abrogation of directors’ duties would not be allowed, whereas a modification of directors’ duties, for example by substituting disclosure to the directors rather than the general meeting, would be permitted (*id* 193 – 194). Birds *supra* 400 distinguishes between various categories of directors’ duties, namely those that can be excluded, eg the duty to act for a proper purpose; duties that can be modified, eg the duty not to make secret profits and the duty to disclose interests in company contracts; and lastly duties that cannot be regulated in the articles at all, eg any
nuance, these solutions generally seem to provide for the fact that the general meeting plays a centre role in excusing directors from certain duties, or in granting directors permission for certain acts.  

The emphasis placed on the role of the general meeting in this regard may have undesirable consequences should a duty to creditors come into play. If it is assumed that the rule against self-dealing in effect provides that a director may not act in a matter in which he has an interest without the permission of the company, and that such permission may be granted in terms of the articles of association, creditors will be forced to accept contracts concluded by the directors with the company, even if these contracts were concluded after the creditors became the primary corporate constituents.

breach of a duty that involves wilfullness or fraud. Parkinson supra 337 – 338 disagrees with the solutions suggested by both Baker and Birds and suggests a distinction between duties that are “releasable” and those that are not, on the basis of whether breach of a particular duty is ratifiable, or not. This distinction is then further refined, as all duties that are ratifiable, are not necessarily releasable, eg the proper purpose duty (id 343 – 344). The judiciary, when confronted with this issue in Movitex Ltd v Bulfield [1988] BCLC 104, distinguished between “duties” and “disabilities”. According to the judiciary it is strictly speaking not correct to say that a director has a duty to avoid a conflict of interest (id 125). More accurate would be to state that, should a director place himself in a position where such a conflict arises, the court will set aside the transaction without inquiring whether the director acted in breach of his duties to the company. Modification of this principle in terms of the articles would thus not constitute exempting a director from liability for a breach of his duties, as this principle is not concerned with a duty (id 120). Blackman supra 549 acknowledges that the solution offered by the judiciary seems to have gained general acceptance, but criticises it for being contrary to accepted doctrine (id 550; with reference to Aberdeen Railway Co v Blaikie Brothers (1854) 1 Macq 461 471). As an alternative he suggests that the principle against “self-dealing” be distinguished from the principle prescribing “fair-dealing” (id 552). The crux of the rule against self-dealing is that a director may act in a matter in which he has an interest, provided that permission was granted by the general meeting after full disclosure by the director (id 552). The duty is therefore in fact a duty “not to act without the permission of his company in a matter in which he has an interest” (id 552). Permission granted in terms of the articles would therefore not be construed as exempting or releasing a director from the duty (id 552). The judiciary, in recognising the validity of such clauses, should thus be seen as making allowance for the fact that permission that can be granted by the company in general meeting, could also be granted in the articles (id 557).

1599 The solution provided by the judiciary in Movitex Ltd v Bulfield supra does not place the focus on the role of the general meeting, but operates to classify certain “duties” as “disabilities”, thus creating room for “releasing” provisions in the articles to co-exist with the statutory prohibition against an exemption from duties. One has to agree with Blackman supra 550 that this solution is doctrinally unacceptable. Cranston supra 208 has similar reservations.

1600 As suggested by Blackman supra 552.

1601 Blackman supra 557.
If it is accepted that the general meeting becomes powerless to ratify a breach of directors’ duties once creditors become the primary corporate constituents, any prior permission by the general meeting for directors to engage in self-dealing should also become void once the duty to consider the interests of creditors is triggered.

It is therefore submitted that releasing provisions in the articles of association, irrespective of how their co-existence with statutory provisions prohibiting exemption from directors’ duties is justified or explained, become void once the duty to creditors is triggered.

9.3.3.1.3 Application of Section 247(1) in a Group Context

At first glance a comparison between the South African section 247 and equivalent provisions in Australia and New Zealand reveals a number of differences with regard to the way in which these provisions are formulated. These differences are superficial, however. More critical is the fact that both Australia and New Zealand afford recognition to the group concept in their prohibition of exemption and indemnification.

Section 199A of the Australian Corporations Act prohibits exemptions and indemnifications by “a company or related body corporate”. In New Zealand a

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1602 As the judiciary generally seems to do. See discussion supra Ch 4 (Judicial Framework) par 4.6 and cases there referred to.

1603 Obvious examples are that the South African legislature deals with both exemption and indemnification in the same provision, whereas the Australian legislature makes a definite distinction between the prohibition on exemption and the prohibition on indemnification, treating them in separate subsections. New Zealand legislation, on the other hand, does not even contain a reference to exemption and deals exclusively with indemnification.

1604 Ss 199A(1); (2); and (3) (own emphasis). S 9 defines a related body corporate as a “body corporate that is related to the first-mentioned body by virtue of section 50”. S 50 provides:

Where a body corporate is:

(a) a holding company of another body corporate; or

(b) a subsidiary of another body corporate; or

(c) a subsidiary of a holding company of another body corporate;

the first-mentioned body and the other body are related to each other.
Chapter 9                                                                                      Relief from Liability

company is not permitted to indemnify a “director...of the company or a related company”

1605 The South African and possibly also the English provision, 1606 only applies in respect of an exemption or indemnity provided by “a company” to “any director...of the company”. 1607

In Australia and New Zealand it is therefore not possible for a subsidiary, for example, to indemnify a director of a holding company against liability, or exempt him from such liability. The prohibition against indemnification and exemption in section 247, as well as section 3101608, on the other hand, only seem to extend to indemnification or exemption granted by a company to its own directors. In South Africa and England it should for example be possible for a subsidiary to indemnify a director of a holding company against liability resulting from a breach of his duties.1609

1605 S 162(1); own emphasis. Also see ss 162(3), (4) and (7), where reference is made to directors of the company, as well as related companies. Although “related company” is not expressly defined in the New Zealand Companies Act, it is assumed that it also refers to companies operating in the same group.

1606 Due to the wording of the English s 310, with specific reference to the words “or otherwise” in the phrase declaring void indemnification in terms of “any provision, whether contained in a company’s articles or in any contract with the company, or otherwise” (own emphasis), it is uncertain whether contracts of indemnity with persons other than the company, for example its holding or subsidiary company, are prohibited by this provision. The view of the Company Law Review Modern Company Law for a Competitive Economy: Final Report Vol I (London, DTI, 2002) par 6.3 is that this prohibition should only apply to contracts of indemnity with the company and to such provisions in the company’s constitution, as these are the only matters which directors may influence unduly. The Company Law Review sees no objection to such contracts being negotiated with somebody other than the company itself. Application of the eiusdem generis rule may achieve the same result.

1607 S 247(1); own emphasis.

1608 As well as s 310, should the view held by the Company Law Review referred to supra n 249 be taken as correct.

1609 A further difference between the South African and English provisions and equivalent provisions in Australia and New Zealand pertains to the specific liability that a director may not be indemnified against. It seems that the South African and English legislature only prohibited indemnification against or exemption from liability to the company itself. The Australian prohibition on exemption reads like its South African equivalent in this respect, in that a director may not be exempted from “a liability to the company” (s 199A(1); own emphasis). The Australian prohibition on indemnification extends much further, however, in that a director may not be indemnified against a liability owed to the company or related body corporate (s 199A(2); own emphasis); a liability for a pecuniary penalty order or compensation order (s 199A(2)(b)); or a liability owed to someone other than the company or related body corporate and that did not arise out of conduct in good faith (s 199A(2)(c). The statutory provision in New Zealand is also concerned with the liability of a director to the company or a related company (s 162(4)(a)). In South Africa one may therefore encounter the result that a director of a holding company may be indemnified by the holding company against liability that the director may have to the subsidiary company. Examples of such liability include liability in terms of s 37, s 86(1) or
It is thus submitted that section 247(1) of the South African *Companies Act*, which applies only in respect of an exemption from or indemnification against liability to the company that resulted from a breach of the directors’ duties to the company, is formulated too narrowly, for failing to make provision for abuses that may occur in a group context – a situation in which creditors may be specially vulnerable. In this respect the Australian and New Zealand example should be followed, where indemnification against liability to a company or a related company is prohibited, as is indemnity provided by a company or a related company.

### 9.3.3.2 Indemnity against Liability for Legal Expenses

Insofar as indemnification against liability for legal expenses is concerned, all jurisdictions seem to adhere to the basic principle that directors may be indemnified against such liability, provided that the outcome of the case is in their favour.

This principle generally seems to be fair.

In principle directors should be afforded the same protection whether the action brought against them is with regard to their duties to the company to consider the

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1610 *Peoples Department Stores Inc (trustee of) v Wise* [1998] QJ No 3571 (QSC (Bankruptcy and Insolvency Division)) provides a prime example of how transactions between related companies may prejudice the interests of creditors of one of the companies in the group.

1611 Such indemnification is regulated more strictly in New Zealand, where it is allowed only if expressly authorised in the company’s constitution (s 162(3) and s 162(4)). The board of the company is furthermore under obligation to ensure that particulars of any indemnity are entered in the interests register (s 162(7)).

1612 One may even go so far as to suggest that protection afforded in this respect may be enhanced by providing for wider access to this type of relief than in Australia, where indemnification may be granted pending the outcome of a case through loans to the directors concerned, without having to adhere to normal requirements pertaining to shareholder approval (s 212). In a South African context the prior consent of all the shareholders or a special resolution for a loan to directors under such circumstances, normally required in terms of s 226(2), will thus not be required. The directors remain liable for any money so received, however, should it become apparent at a later stage that such indemnity should not have been granted.
interests of shareholders, or with regard to their duties to the company to consider the interests of creditors.

Provisions permitting indemnification under these circumstances may attain the desired balance between safeguarding creditors’ interests, by limiting such indemnification to instances where the outcome of the action is in favour of the directors, and not unnecessarily exposing directors to liability, by allowing non-delinquent directors to escape liability for legal expenses.

In order to maintain creditor protection, while providing directors with increased relief, provisions permitting indemnification against liability for legal expenses could limit such indemnification to legal expenses that was reasonably incurred.\(^{1613}\)

### 9.4 DIRECTOR LIABILITY INSURANCE

#### 9.4.1 Introduction

Another way in which directors may safeguard their own interests in the face of increased exposure to personal liability, is through director and officer liability insurance.\(^{1614}\) In light of statutory provisions prohibiting a company from indemnifying a director against liability for a breach of duties that attach to him,\(^ {1615}\) it was accepted that a company may not take out and pay for such insurance on behalf of its directors. Amendments to legislation in various jurisdictions, however, will now also make it possible for companies to take out and pay for such policies on behalf of their directors.\(^ {1616}\)

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1613 As provided for in Canada in terms of s 124(1) of the \textit{CBCA}.

1614 Often referred to as “D & O insurance”. Most of the statutory provisions applicable in the various jurisdictions in this regard do not limit such insurance to directors, but include officers and/or auditors of the company. The way in which the position of officers and auditors are affected by provisions regulating the taking out of insurance by the company on their behalf falls outside the scope of this study, however, and is not discussed further.

1615 As discussed \textit{supra} par 9.3.2.

1616 It must be kept in mind, however, that legislative amendments will only serve to allow a company to purchase and maintain insurance on behalf of its directors. Should increased director liability result in director liability insurance contracts themselves providing for even more exclusions or becoming too expensive, its attractiveness as a method to allow directors relief from liability will be greatly reduced, resulting in insurance eventually becoming unavailable. See Bradley & Schipani \textit{supra} 35; Radin \textit{supra} 745; and Ross “Protecting Corporate Directors and Officers: Insurance and Other Alternatives” (1987) 40 \textit{Vanderbilt Law Review} 775 776 – 782 for a discussion of the effect of increased litigation.
In this section statutory provisions in this regard are briefly referred to, followed by a
discussion of director liability insurance in the context of a duty to creditors.

9.4.2 Statutory Regulation

9.4.2.1 South Africa

Section 247(1), prohibiting a company from indemnifying directors against liability
resulting from a breach of duties, was amended in 1998\(^{1617}\) to make express provision
for a company to take out insurance on behalf of its directors. The relevant part of
section 247(1) reads:

Provided that this subsection shall not be applicable to insurance taken out and kept by
the company as indemnification against any liability of any director or officer towards
the company in respect of any negligence, default, breach of duty or breach of trust.

There is some uncertainty as to the effect of this amendment on the position of
directors. It is suggested that the purpose of amendments permitting the purchase of
insurance by the company on behalf of its directors, is to protect the company.\(^{1618}\) It is
uncertain, however, whether directors are protected in terms of the amendment to
section 247(1).

According to some the introductory part of section 247(1) will become meaningless
and directors’ common-law duties will in effect become useless, should it be accepted
that these policies also serve to protect directors.\(^{1619}\) It is therefore suggested that the

against directors on liability insurance. Weiss supra 643 refers to this as the “director and officer
insurance crisis”, which became a real threat after Smith v Van Gorkom supra. See authority referred
to in n 49. According to Manning “Reflections and Practical Tips on Life in the Boardroom after Van
Gorkom” (1985) 41 The Business Lawyer 1 6 such a deterioration in insurance coverage will result in
an exodus of independent directors from corporate boards. Also see Daniels & Hutton supra for a
detailed analysis of the insurance crisis of the mid-1980s in the USA and Canada; and Finch supra 892–897 for a general discussion on the availability of director liability insurance. Other mechanisms
providing some relief from liability, eg relief by the court, should therefore not be neglected. These
may play a role in influencing the way in which insurers view the risk of providing cover for director
liability, thus making director liability insurance more affordable. Bradley & Schipani supra 73 indicate that legislative measures to provide increased access to indemnity, with specific reference to s
102(b)(7) of the DGCL, resulted in premiums for director liability insurance beginning to level off.
Also see Finch supra 911.

\(^{1617}\) By s 12 of Companies Amendment Act 35 of 1998.

\(^{1618}\) Cilliers & Benade supra par 10.56.

\(^{1619}\) Id par 10.57. Botha & Jooste supra 69 – 71 also voice concerns regarding the effect of insurance
on directors’ duty of care and skill and the protection afforded in terms thereof and state that insurance
only purpose of the amendment to section 247(1) is to protect the company and not its directors.\textsuperscript{1620} The director will not be able to escape liability through the application of normal principles of insurance law, with specific reference to the principle of subrogation, in terms of which the insurance company should be able to recover the compensation paid to the company from the director.\textsuperscript{1621}

Should this interpretation of these amendments be accepted as correct, directors stand to benefit very little, if at all, from insurance taken out by the company. The current formulation of section 247(1), however, does not seem to allow for any other interpretation than the one suggested by the learned authors referred to in the previous paragraph, as it cannot be denied that the first part of the provision will be meaningless if another interpretation is followed.

\subsection*{3.8.2 Australia}

The \textit{Corporations Act} prohibits payment of insurance premiums by a company or related body corporate on behalf of a director of the company for certain types of liability. This leads one to conclude that the taking out of insurance by the company or a related body corporate for other liability that may be incurred by directors of the company, is allowed.

The exceptions, or liability for which a company or related body corporate may not maintain insurance for directors of the company, are conduct involving a wilful breach of duty in relation to the company;\textsuperscript{1622} or a contravention of section 182 or

\begin{itemize}
\item will “effectively remove such duty and such protection – the incentive to take care having been drastically diminished”.
\end{itemize}

\textsuperscript{1620} Cilliers & Benade \textit{supra} 10.57.

\textsuperscript{1621} \textit{Ibid}.

\textsuperscript{1622} S 199B(1)(a). Kyrou \textit{supra} 567 indicates that there has not been any judicial analysis of the phrase “wilful breach of duty” and suggests that the meaning of the phrase may be determined with reference to cases in which similar expressions had to be interpreted. According to him the meaning attached to the expression “wilful neglect or default” in \textit{In re City Equitable Fire Insurance Co Ltd} \textit{supra} may be helpful. In this case Romer J indicated that a director will not be guilty of a wilful neglect or default “unless he knows that he is committing, and intends to commit, a breach of his duty, or is recklessly careless in the sense of not caring whether his act or omission is or is not a breach of duty” (\textit{id} 434). This leads Kyrou \textit{supra} 567 to conclude that the phrase “wilful breach of duty” includes the situations where there is an intentional breach of duty as well as recklessness. An intentional breach of duty will
section 183. This indicates that directors may be insured against non-wilful breaches, other than breaches of sections 182 and 183, as well as the costs of defending civil or criminal proceedings, irrespective of the outcome of such proceedings. Farrar is of the opinion that the last-mentioned possibility seems too wide and that it should be limited to acquittal or a successful defence or settlement of a civil claim.

Section 199C furthermore makes it clear that section 199B should not be read to authorise anything that would otherwise be unlawful and that anything that purports to insure a director against a liability, would be void insofar as it contravenes section 199B.

9.4.2.3 New Zealand
The effecting of insurance by a company for a director of that company or a related company in respect of particular liability is regulated in more detail in New Zealand. Such insurance, for example, requires the prior approval of the board and express authorisation by the company’s constitution. Directors who vote in favour of authorising the effecting of such insurance are furthermore required to sign a certificate stating that, in their opinion, the cost of taking out the insurance is fair to the company. The board also has a duty to ensure that the particulars of the

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1623 S 199B(1)(b). In terms of s 182(1) a director may not improperly use his position to gain an advantage for himself or someone else, or cause detriment to the corporation. S 183(1) furthermore provides that a person who obtains information because he is or has been a director of the corporation may not improperly use the information to gain an advantage for himself or someone else, or cause detriment to the corporation. See discussion supra Ch 5 (Protection Afforded by Fiduciary Duties) par 5.2.2 for more detail.

1624 Farrar Duty of Care 164.

1625 Ibid.

1626 S 199C(1).

1627 S 199C(2).

1628 S 162(9) provides that the phrase to “effect insurance” “includes pay, whether directly or indirectly, the costs of the insurance”.

1629 S 162(5).
insurance effected for a director of the company or a related company, are entered in the interests register.\textsuperscript{1631}

The liability in respect of which insurance may be effected, is limited to liability incurred by the director for an act or omission in his capacity as a director, excluding criminal liability;\textsuperscript{1632} costs incurred by the director in defending or settling any claim or proceeding relating to such liability;\textsuperscript{1633} and costs incurred by the director in defending any criminal proceedings that have been brought against the director in relation to any act or omission in his capacity as a director and in which he is acquitted.

A director will be personally liable to the company for the cost of effecting the insurance if the provisions of section 162(5) or section 162(6) have not been complied with;\textsuperscript{1634} or if reasonable grounds did not exist for the opinion set out in the certificate required in terms of section 162(6),\textsuperscript{1635} except to the extent that the director is able to prove that it was fair to the company at the time when the insurance was effected.\textsuperscript{1636}

\textbf{9.4.2.4 England}

In terms of an amendment to section 310(3) of the English \textit{Companies Act},\textsuperscript{1637} a company is now allowed to purchase and maintain insurance for a director against liability under subsections (1) and (2). Subsection (3) expressly states that

[\textit{t}his section does not prevent a company from purchasing and maintaining for any such officer or auditor insurance against any such liability.]

\textsuperscript{1630} S 162(6).
\textsuperscript{1631} S 162(7).
\textsuperscript{1632} S 162(5)(a).
\textsuperscript{1633} S 162(5)(b).
\textsuperscript{1634} S 162(8)(a).
\textsuperscript{1635} S 162(8)(b).
\textsuperscript{1636} S 162(8).
\textsuperscript{1637} As per s 137(1)(a) of the \textit{Companies Act} 1989.
Chapter 9  Relief from Liability

If a company decides to take out such insurance, particulars thereof must be disclosed in the directors’ annual report.\textsuperscript{1638}

\textbf{9.4.2.5 Canada}

The \textit{CBCA} expressly provides that a corporation may purchase and maintain insurance for the benefit of a director against any liability incurred by the director in his capacity as a director of that corporation,\textsuperscript{1639} or in his capacity as a director of another entity, if he acts in that capacity at the corporation’s request.\textsuperscript{1640} The corporation is allowed to procure such insurance, even to cover those cases where the corporation itself is unable to indemnify the director because the misconduct constituted a breach of the standards set out in section 124(1) and section 124(2).\textsuperscript{1641}

\textbf{9.4.2.6 United States of America}

Section 145(g) of the \textit{DGCL} authorises a corporation to buy insurance on behalf of its directors for any liability arising out of their status in the corporation and reads as follows:

A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director...of the corporation, or is or was serving at the request of the corporation as a director...of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the corporation would have the power to indemnify him against such liability...under this section.

This provision is clear on the point that the corporation enjoys this power even though it may not be able to indemnify the directors against liability. Such policies may therefore provide cover against judgments against directors and amounts paid in settlement of derivative suits, even though indemnification in respect of these amounts would not be permitted if it violates public policy.\textsuperscript{1642}

\begin{flushright}
\textsuperscript{1638} In part I of Sched 7, par 5A, as is required in terms of s 137(2) of the \textit{Companies Act} 1989.
\textsuperscript{1639} S 124(6)(a).
\textsuperscript{1640} S 124(6)(b).
\textsuperscript{1642} Bradley & Schipani \textit{supra} 33. Johnston \textit{supra} 2000 acknowledges that many authors criticise this provision as too liberal, as it allows corporations to buy insurance covering all types of fiduciary
\end{flushright}
Director liability insurance thus serves an important role in providing access to relief from liability in cases where the corporation was not allowed to indemnify the director; in cases where the corporation refuses to indemnify the director, even though it is allowed; and in cases where indemnification is not possible due to the insolvency of the corporation.1643

Director liability insurance policies generally contain a very broad statement of coverage.1644 This broad statement is generally subject to numerous exclusions, however.1645 The ability of a corporation to procure director liability insurance is furthermore limited by public policy considerations.1646 These policies, for example, may not provide cover against wilful misconduct.1647

9.4.3 Application to a Duty to Creditors

9.4.3.1 General

Numerous advantages may flow from increased cover becoming available through company-funded director liability insurance,1648 the most important of which, for the

misconduct. He disagrees with this point of criticism, however, as the policies themselves contain exclusions on public policy grounds.

1643 Bradley & Schipani supra 33.

1644 Bradley & Schipani supra 33 indicate that these policies insure against losses resulting from wrongful acts occurring in connection with service to the corporation. Wrongful acts are defined as “any breach of duty, neglect, error, misstatement, misleading statement, omission or other act done or wrongfully attempted by the Assureds...or any matter claimed against them solely by reason of their being such Directors and Officers of the company”.

1645 Bradley & Schipani supra 34 n 214 list a number of common exclusions, eg claims against directors relating to libel and slander; illegal gains for personal profit or advantage; illegal remuneration; active and deliberate dishonesty with an actual dishonest purpose and intent; amounts covered by other policies; failure to maintain insurance; corporate indemnification; and environmental matters.

1646 Id 33.

1647 Ibid.

1648 Cranston supra 209 and Ramsay supra 154 indicate that increased access to director liability insurance may have the unforeseen advantage of courts imposing higher standards on directors. See Dent “The Revolution in Corporate Governance, the Monitoring Board, and the Directors’ Duty of Care” (1981) 61 Boston Law Review 623 653 who fears the exact opposite, namely that it may contribute to “judicial reluctance to impose stricter standards of care by instilling a feeling that more rigorous standards would only stir up more litigation for the benefit of lawyers with no corresponding benefit to shareholders”. Finch supra 888 – 891 lists a number of potential advantages of increased availability of director liability insurance, eg that it may improve monitoring of potential wrongdoers;
purposes of this study, is the fact that it may address the problem of unnecessary risk avoidance and delegation by directors fearing personal liability.\textsuperscript{1649} It is therefore submitted that directors, facing increased personal liability through a duty to creditors, should be offered the protection afforded in terms of insurance taken out on their behalf by the company.\textsuperscript{1650}

It seems, however, that section 247(1), in its present form, does not answer the need for increased access to such insurance. In order to achieve the objective of providing directors with some protection against personal liability, it is necessary to reconsider the way in which legislation allowing companies to purchase insurance against losses caused by a breach of directors’ duties is formulated.

A suggestion in this regard is that the provision allowing insurance to be taken out, should be dealt with in a separate subsection.\textsuperscript{1651} This will address the problem of the apparent contradiction between the first and the second part of subsection (1), which necessitates the conclusion that only the company, but not its directors, are protected in terms of such insurance.\textsuperscript{1652}

\textbf{9.4.3.2 Statutory Regulated Access}

It has been emphasised throughout this chapter, however, that a balance should be maintained between providing directors with relief from liability, while ensuring that delinquent directors do not escape liability.\textsuperscript{1653}

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assist the firm in wealth creation; and provide for a broadly-based fund which is made available to compensate company creditors as well as members, in case of wrongful acts by directors.
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\textsuperscript{1649} Finch \textit{supra} 891.

\textsuperscript{1650} Finch \textit{supra} 880 agrees that company-funded directors’ insurance could balance increased potential personal liability faced by directors.

\textsuperscript{1651} As was done by the English legislature in s 310 of the English \textit{Companies Act} – the provision most similar to s 247 of the South African \textit{Companies Act} – where the general prohibition is contained in subsection (1) and the exceptions, eg insurance to be purchased by the company, in subsection (3).

\textsuperscript{1652} As was indicated by Cilliers & Benade \textit{supra} par 10.57.

\textsuperscript{1653} Weiss \textit{supra} 659 warns that an imbalance, created by too many benefits being granted to corporate management at the expense of the corporation, will lead to “the term ‘corporate accountability’ [taking] on an oxymoronic lustre”.

389
Unregulated access to director liability insurance will not achieve this balance, as directors will be over-protected in that directors who are guilty of a breach of their duties will have a good opportunity of escaping liability in every instance. This will essentially remove a great part of the incentive to comply with directorial duties\textsuperscript{1654} and will clearly also impact negatively on the way in which directors conduct themselves insofar as their duties to consider the interests of creditors are concerned.

This concern is fuelled by the fact that the party who is supposed to be protected in terms of directors’ duties, namely the company itself and not even the director, has to fund such insurance.\textsuperscript{1655} Concerns that unregulated access to director liability insurance may reduce or even extinguish liability on the part of directors are not unwarranted and it is imperative that they should be addressed.\textsuperscript{1656}

Proper formulation of legislative provisions allowing the effecting of such insurance may play an important role in assuaging fears with regard to the negative effects of increased availability of director liability insurance. In this respect suggestions that directors should inform shareholders of the extent of cover obtained and the costs thereof, as well as the whole process be over-seen by non-executive directors, may prove helpful.\textsuperscript{1657}

\textsuperscript{1654} Cranston \textit{supra} 209 makes the point that the purpose of the law relating to directors’ duties is not only about “whether particular breaches of duty are to result in monetary payments, \textit{but also about ensuring that directors adhere to certain fiduciary and management standards}” (own emphasis). Also see Dent \textit{supra} 653; Ramsay \textit{supra} 154; and Weiss \textit{supra} 658 for similar viewpoints.

\textsuperscript{1655} Dent \textit{supra} 653. Finch \textit{supra} 887 states that company-funded insurance will result in the shareholder, consumer and the employee being the penalty payer, rather than the wrongdoer; Kennedy “The Standard of Responsibility for Directors” (1984) 52 \textit{George Washington Law Review} 624 644 refers to this as a “caricature of conventional loss-shifting”; while Weiss \textit{supra} 658 is of the opinion that this boils down to the company reimbursing a director for liability incurred by his conduct.

\textsuperscript{1656} At the same time one must warn against over-emphasising this concern. Corporate wrongdoing need not be addressed only in terms of director liability, but may also be prevented in ways other than the imposition of personal liability, eg the expansion of general duties of disclosure, as suggested by Finch \textit{supra} 912. Ramsay \textit{supra} 156 also makes the important point that there are also other forces that provide an incentive for directors to comply with their duties, eg the market for managerial services and the market for the company’s shares and that “deterrence is not deemed sufficiently important to outweigh the advantages of insurance” (\textit{id} 155).

Another suggestion is that all claims made under such cover should be disclosed to the general meeting, to ensure that shareholders are fully aware of directors’ doings in a company, giving them the opportunity to remove the directors from office should they deem it necessary. It is furthermore submitted that company creditors should also be provided with such information, to enable them to adequately protect their own interests in the company. This information should be provided in the directors’ report, along the lines of the requirement in England that the directors’ report contain information regarding insurance taken out by a company on behalf of its directors. Any such benefit for a director should furthermore be disclosed in a register of interests.

The New Zealand provisions may provide helpful guidelines for reformulation. In New Zealand such insurance has to be authorised in terms of the articles of association; and be approved by a resolution of the board, where the members signed a certificate specifically stating that the premiums are, in their opinion, fair to the company.

9.4.3.3 Consequences of Non-compliance with Statutory Requirements

In South Africa, England and Canada insurance contrary to the relevant statutory provisions will, by implication, be void and in Australia this is expressly provided for by section 199C(2). Non-compliance with the statutory requirements will thus result in the director not having the benefit of any insurance, should he decide not to take out personal insurance but to rely exclusively on insurance provided for by the company.

1658 Ibid. This suggestion presupposes shareholder activism, which may present a problem. See discussion supra Ch 2 (Conceptual Justification of a Duty to Creditors) par 2.4.5 for more information.
1659 In terms of s 137(2) of the 1989 Companies Act.
1660 As is required in New Zealand in terms of s 162(7) of the New Zealand Companies Act.
1661 In terms of s 162(5).
1662 Ibid.
1663 In terms of s 162(6).
In New Zealand non-compliance does not result in the insurance contract becoming void, thus depriving the director of any benefit in terms thereof. Instead provision is made that the director will become personally liable to the company for the cost of effecting the insurance, unless he is able to prove that it was fair to the company at the time that it was effected.\footnote{S 162(8).}

The latter option seems to be preferable. Granting the director the opportunity to make good to the company the expenses that it incurred with regard to the insurance policy, rather than voiding the whole transaction, will enable the director to obtain the insurance benefit without the company having to carry the financial burden thereof.

\section*{9.5 CONCLUSION}

The importance of providing honest directors with adequate relief against personal liability cannot be denied. It seems obvious, on the other hand, that a very liberal approach with regard to relieving directors from liability for a breach of their duties will significantly reduce the incentive for directors to comply with their duties. It is therefore of the utmost importance to maintain the critical balance between allowing relief in meritorious cases, while ensuring that delinquent directors do not escape liability.

The question remains whether the measures referred to in this chapter are successful in attaining the required balance.

It seems that general indemnification or exemption is regulated rather strictly in most jurisdictions,\footnote{Where it was considered not to be regulated strictly enough, e.g., in SA, it was submitted that the legal position should be revised. See discussion \textit{supra} par 9.3.4.1.} and that it offers limited protection to directors. It is submitted, however, that the scope of indemnification should not be broadened, as one must tread carefully when placing the power to relieve directors from liability for a breach of

\footnote{S 162(8).}
their duties in the hands of shareholders.\textsuperscript{1666} Such a step could nullify the potential protection that creditors may have in respect of a directorial duty for their benefit.\textsuperscript{1667}

Indemnification against legal expenses is provided for more liberally. The relief in this regard is also limited, however, in that it is only concerned with liability that directors may incur in respect of legal costs – escape from any other type of liability is not possible in terms of these provisions.

The two mechanisms of providing relief from liability may maintain the all-important balance referred to above, is the relief granted by the courts and director liability insurance. Relief granted by the courts is regarded as advantageous for two reasons. The first is that the court, through a proper exercise of its discretion, could ensure that deserving directors are relieved from liability, while delinquent directors are brought to book. Secondly, seeing that this form of relief from liability is dependent on a decision by the judiciary, it is clear that shareholders would not be able to deprive creditors of any protection they might enjoy by way of an extension of directors’ duties. Director liability could furthermore be judged on a case-by-case basis, providing for individual circumstances.

For this method to achieve its purpose, care must be taken, however, that statutory provisions in this regard are properly formulated and that all uncertainties be removed. A provision such as section 248, if properly formulated, seems to be adequate and it is submitted that there is no real need for a formalised business judgment rule in South African company law.

Director and officer liability insurance also seems to offer a reasonable measure of protection to directors. As was indicated, however, the current interpretation of the

\textsuperscript{1666} Whether it be a power that may be exercised before the breach actually occurred, eg by way of indemnification against liability for a breach of the duties, or after occurrence of the breach, eg through shareholder ratification of director conduct.

\textsuperscript{1667} Ramsay supra 155 also mentions other disadvantages of indemnification, compared to, eg director liability insurance, namely the greater prospect of abuse, as well as the fact that widespread indemnification may lead to directors enjoying “total immunity from the consequences of their actions” (\textit{id} 156).
South African provision allowing companies to take out director liability insurance does not protect directors at all. The suggested legislative reform should enhance the protection to be afforded in terms of director liability insurance. It must be kept in mind, however, that the success of such policies in protecting directors is not only dependent on the legislative framework in which they function – their effectiveness may greatly be reduced by exclusions in the policies themselves, as well as this type of insurance becoming too expensive because of the great risk imposed by increased director liability.

The existence of other effective measures of relief may greatly influence the way in which insurance companies view the potential risk that they would have to cover in terms of such policies. The fact that director liability insurance could play a crucial role in providing directors with relief from personal liability under particular circumstances, should thus not lead to the neglect of other possible means of relief, for example relief granted by the courts.

The importance of providing directors with relief from liability under suitable circumstances was emphasised in this chapter. It was shown that existing measures, if formulated and applied in the correct manner, may be quite adequate for providing directors with the required degree of relief from liability. In any reformulation of statutory provisions with regard to these measures care should, however, be taken to ensure that the balance between accountability and ensuring wealth maximization is not upset through measures that are so wide that they effectively grant directors total immunity from the consequences of their actions.

Ultimately, it is important to remember that directors, as corporate managers, “frequently occupy positions of significant responsibility and influence, and ways should not be devised to render them unaccountable to shareholders and society”\textsuperscript{1668} and, one may add, corporate creditors.

\textsuperscript{1668} Ramsay \textit{supra} 156.
PART IV

CONCLUSION

Chapter 10: Conclusion.......................................................................................................396
CHAPTER 10
CONCLUSION

SUMMARY

10.1 BACKGROUND
10.2 JUSTIFICATION OF A DUTY TO CREDITORS
10.3 FRAMEWORK FOR A DUTY TO CREDITORS
10.4 DEVELOPMENT OF A DUTY TO CREDITORS
10.5 CONCLUDING REMARKS

10.1 BACKGROUND

Creditors of the corporate business form are in a very vulnerable position. Their vulnerability is to a large part attributable to the unique nature of the company as a business vehicle, characterised by elements such as separate legal personality, limited liability, separation between ownership and control, and so forth.

Recognition of the plight of corporate creditors led to the implementation of various legal measures aimed at protecting their financial interest in the company. These measures proved disappointingly inadequate in many instances. This has led to the judiciary in some jurisdictions feeling compelled to develop existing legal principles pertaining to directors’ duties in such a way that they could facilitate the protection of creditors’ interests.

This development did not meet with universal approval. Those opposed to the extension of directors’ duties to protect creditors’ interests have three main arguments against it. The first is related to conceptual issues and policy concerns. The second argument is that existing remedies are more than adequate to protect creditors’ interests. A last argument against a directorial duty to creditors pertains to the practical implementation of this extended duty. It is argued that the existing legal framework with regard to directors’
duties cannot be interpreted in such a way as to provide protection for creditors’ interests in terms thereof.

In this study an attempt was made at proving that these arguments are not convincing and that the extension of directors’ duties to creditors is both justifiable and possible within the existing legal framework.

### 10.2 JUSTIFICATION OF A DUTY TO CREDITORS

#### 10.2.1 Conceptual Justification of a Duty to Creditors

It is firstly submitted that a duty to creditors is justifiable on a sound conceptual basis and that policy concerns raised in respect of the extension of directors’ duties could be addressed in a number of ways.

This submission is based on a number of grounds. Among these is the fact that the contractual protection upon which so much emphasis is placed, is often feigned. The basis of the emphasis on contractual protection, namely a predilection for the contractual theory of the company, as well as a view that a clear distinction exists, or should be drawn, between those holding equity and those holding debt in a company and the remedies that they are entitled to, is questioned. It was also shown that the reasons for awarding shareholders the position of primary, or exclusive, corporate constituents, such as the fact that they should always be regarded as the equitable owners and residual risk-bearers, that shareholders are more able to exercise effective control over management, and so forth, are unconvincing.

Policy concerns regarding the potential effect of extended directors’ duties on the behaviour of directors seem justified. It is suggested, however, that these concerns should be addressed by way of measures providing deserving directors with relief from liability, rather than through sacrificing accountability.

It is also feared that the extension of directors’ duties to creditors may erode the principle of limited liability. In this regard it is emphasised that limited liability in the strict sense
Chapter 10  Conclusion

refers to the liability of shareholders that are limited to the amount of their capital contribution to the company. Personal liability of directors would thus, strictly speaking, not encroach upon the principle of limited liability. It is furthermore argued that limited liability is not a right, but a privilege which should be enjoyed in a responsible fashion.

It is concluded that the extension of directors’ duties to protect creditors’ interests is indeed justifiable on a sound conceptual basis and that policy concerns regarding such an extension are either unfounded, or should be addressed in some other way.

10.2.2 Need for a Duty to Creditors

It is secondly submitted that those protective measures and remedies often referred to by opponents of an extension of directors’ duties, namely statutory personal liability of directors, traditional insolvency remedies, and the piercing of the veil doctrine, are not adequate and that there is a definite need for an alternative remedy that could be provided by way of the extension of directors’ duties to include creditors’ interests. These traditional remedies are inadequate for a number of reasons.

10.2.2.1 Statutory Personal Liability

Section 424(1) of the South African Companies Act, \(^{1669}\) which provides for the personal liability for payment of company debts by those who managed the affairs of the company fraudulently or recklessly, provides creditors with a powerful weapon. Both the case law and analyses by various commentators showed, however, that there are numerous uncertainties regarding the application of this provision.

Of particular importance, with regard to the position of corporate creditors, is the uncertainty regarding their locus standi to bring an application in terms of section 424(1). This uncertainty is caused by questions as to whether creditors’ claims should be quantified; how a compromise in terms of section 311 would impact on the rights of creditors to make use of the section 424(1) remedy; whether this remedy is only available

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\(^{1669}\) Act 61 of 1973 (hereinafter South African Companies Act).
in respect of directors of companies that are being wound up or under judicial management, and so forth.

In some respects this remedy also offers more limited protection of the interests of corporate creditors than directors’ fiduciary duties and duty of care and skill. Liability in terms of section 424(1) is dependent on the directors having engaged in reckless or fraudulent trading, both of which require creditors to prove fault on the part of directors. In case of liability based on a breach of fiduciary duties, on the other hand, creditors are not required to prove fault as this is typically strict liability.

In case of an application in which “reckless” trading is alleged, the creditors furthermore have to convince the court that the directors acted with gross negligence. However, if a delictual action is brought against directors for having failed to comply with their duty of care and skill, ordinary negligence would suffice.

It must be conceded that in some instances section 424(1) does offer wider protection than the traditional directors’ duties. It is, for example, possible for the protection offered by section 424(1) to be available despite the company in question being financially sound. The section 424(1) remedy is also more extensive as it contains a punitive element.

These factors give rise to policy concerns – the advisability of allowing creditors to proceed against directors of solvent companies, as well as the punitive element of the remedy, may impact negatively on directors’ risk-taking ability. This concern is exacerbated by the fact that relief that is typically available in respect of a breach of common-law duties, namely the relief offered by section 248 of the South African Companies Act, is not available in respect of section 424(1) liability.

A comparative study showed that equivalent provisions in jurisdictions such as Australia, New Zealand and England do not fare much better in providing protection to creditors’
interests. An amendment of section 424(1) to bring it in line with these provisions will therefore not have the same beneficial effect that a duty to creditors may have.

**10.2.2.2 Typical Insolvency Remedies**

Remedies that are typically provided for by the statutory principles of insolvency law, such as voidable dispositions, voidable preferences, and undue preferences cannot effectively protect the interests of creditors either. The same can be said in respect of common-law remedies, such as the *actio Pauliana*. This is largely the result of the fact that these remedies usually have very limited application and that their operation is often restricted by narrow time frames.

Apart from the fact that typical insolvency remedies enjoy very limited application, it must also be kept in mind that these remedies envisage company assets being recovered from the receiver thereof, whereas a duty to creditors would visit the consequences of preferential treatment of insider creditors upon the directors. This shift to director liability may have the added advantage of impacting positively on director conduct in general.

**10.2.2.3 Piercing the Veil**

The courts’ discretion to disregard the company’s separate legal personality under certain circumstances, as a result of which directors could incur personal liability for some of their actions, may be regarded by some as a better way to achieve similar results than those that could be achieved by way of the extension of directors’ duties. It was indicated, however, that the operation of this doctrine is fraught with uncertainty. Courts are very reluctant to exercise their discretion to disregard the separate existence of a company. Neither will a creditor relying on this type of remedy, apart from being uncertain as to whether his or her particular case might be an instance where the court will deviate from its well-known reluctance to “pierce the corporate veil”, be provided with the same solid legal structure that is provided for by a remedy based on traditional directors’ duties.
10.3 FRAMEWORK FOR A DUTY TO CREDITORS

A final and very critical submission is that the existing legal framework in respect of directors’ duties is indeed capable of being successfully adapted to include creditors’ interests.

Central issues in this respect, as was indicated by an analysis of the case law, include the point in time when creditors become entitled to the protection afforded by such a duty; the beneficiary of the duty, in other words who has locus standi in case of a breach of the duty; and the type of protection afforded to creditors’ interests by way of the traditional fiduciary duties and the duty of care and skill.

The duty to creditors is not seen as a continuous duty but as one that is triggered by a particular event related to the company’s financial state. On the basis of their ability to be defined; to be reconciled with a conceptual justification of a duty to creditors; and factors such as the need for precision; the need for protecting directors’ risk-taking ability; cost implications, and so forth, three “triggers” for the duty to creditors were identified, namely insolvency, doubtful solvency and actions causing insolvency.

It is furthermore submitted that “a duty to creditors” should not be seen as a duty running directly to creditors, but rather as a duty that is to be mediated through the juristic person of the company. Directors’ fiduciary duties and their duty of care and skill are thus still owed to “the company”. The fact that the duty to creditors is triggered will, however, necessitate a change in the way in which the company is perceived.

In this regard it is submitted that the interests of the company, which is traditionally equated with those of its shareholders, should now comprise those of its creditors. The advent of a trigger thus causes the interests of shareholders in a company to be displaced by those of creditors. This construction of a duty to creditors has the advantage that directors are not required to balance the competing interests of shareholders and creditors in a financially distressed company.
Chapter 10

Conclusion

This “shift” from shareholders being the primary corporate constituents to creditors becoming the primary corporate constituents has a number of important consequences. The first is that the shareholders in general meeting will no longer be able to ratify a breach of directors’ duties, as they are no longer the indirect beneficiaries of these duties. Once the duty to creditors has been triggered, any ratification of a breach of directors’ duties by the shareholders will thus be void.

Creditors should furthermore be allowed to exercise the power of ratification. It is true, however, that the South African Companies Act does not provide company creditors with a “general meeting” through which they may exercise this power. A similar mechanism may, however, be developed that is analogous to the meeting of creditors provided for by section 311 of the South African Companies Act for the purpose of approving a compromise.

Creditors collectively, and not shareholders, are also the proper body to enforce directors’ duties on behalf of the company. Locus standi for this purpose could be provided for in one of two ways.

The first is that creditors, who are regarded to have become the “members” of the company, may take action against directors on behalf of the company. Once again the section 311 type meeting can be used as a model to provide creditors with a mechanism to act collectively.

The second is that creditors could proceed by way of derivative action, similar to the derivative action provided for by section 239 of the Canada Business Corporations Act.\(^\text{1670}\) This method clearly requires legislative intervention, as the availability of the current derivative action in terms of section 266 of the South African Companies Act is limited to members.

\(^{1670}\) RSC 1985, c C-44.
Creditors furthermore seem vulnerable to a breach of particular fiduciary duties of directors, as well as a breach of the duty of care and skill. It is therefore also submitted that both directors’ fiduciary duties and the duty of care and skill may provide meaningful protection to the interests of creditors.

Elements of fiduciary duties that are particularly concerned with maintaining the balance of power between directors and shareholders, such as directors’ duty to exercise their powers for a proper purpose, do not seem to affect the position of corporate creditors to a large extent. The particular elements of fiduciary duties that may impact on the creditors’ position, however, are the directors’ duty to act in good faith in the best interests of the company; their duty to avoid a conflict of interests; and their duty to maintain an unfettered discretion. The latter element seems especially pertinent in a group context, where directors of a subsidiary may feel compelled to sacrifice the interests of the subsidiary in favour of the holding company, to the detriment of the creditors of the subsidiary.

The extension of these fiduciary duties is, however, only possible if it is accepted that the “interests of the company” should be defined with reference to the interests of its creditors, once the duty to them has been triggered.

As was indicated, acceptance of this submission has important consequences insofar as enforcement of these duties is concerned, but will not impact on the content of these duties, since the company remains the ultimate beneficiary of directors’ duties. The same conduct is therefore required of directors in compliance with their fiduciary duties to the company, whether it is shareholders’ interests or creditors’ interests which comprise the “interests of the company” – directors are still expected to refrain from self-dealing, from preferring insider creditors and to maintain an unfettered discretion.

Creditors also stand to benefit from an extension of directors’ duty of care and skill that is properly formulated and applied to include their interests. A discussion on the current legal principles regarding directors’ duty of care and skill indicated, however, that
nobody stands to benefit from the lax and very subjective standards imposed by the courts in this regard. It is submitted that the duty of care and skill, unlike fiduciary duties, should be codified. The way in which the duty of care and skill of directors of banks was codified in terms of section 60(1A) of the *Banks Act*\(^{1671}\) provides valuable guidelines in this regard.

Creditors stand to benefit from an extension of the duty of care and skill, especially in the case of a company that is not financially sound. In such instances directors could engage in a last desperate attempt to salvage the struggling undertaking. As was indicated, such a rescue attempt will be funded with creditors’ money as shareholders’ equity will probably be extinguished at this stage. Shareholders, unlike creditors, would therefore probably not be opposed to directors taking one last chance, even if the chances of success seem very unlikely, as they have nothing to lose in case of failure, but everything to gain in the unlikely event that the attempt is successful.

In light of this fact it is submitted that the *content* of the directors’ duty of care and skill, unlike the situation in case of an extension of fiduciary duties, will be affected under circumstances where the extension of directors’ duty of care and skill to creditors has been triggered by “insolvency” or “doubtful solvency”. This is so because the acceptable levels of risk-taking will be determined with reference to the fact that directors are effectively placing creditors’ money at risk in engaging in a last rescue attempt.

It must be emphasised that the purpose of the extension of the duty of care and skill under circumstances such as these is not to preclude all risk-taking. However, in case of failure directors must be able to show that the degree of risk that corporate assets were exposed to was acceptable, with reference to the tests that normally apply to determine whether the directors had complied with their duty of care and skill.

\(^{1671}\) Act 94 of 1990.
Chapter 10

The content of the duty of care and skill will not undergo a change, however, if the duty to creditors were triggered by “actions causing insolvency”. As was indicated, this trigger operates differently from “insolvency” and “doubtful solvency”, as it applies in respect of companies that are financially sound. Should a company become insolvent as a result of the fact that the directors did not comply with their fiduciary duties or duty of care and skill, a duty to creditors is recognised once the company becomes insolvent. This trigger is therefore not so much concerned with director conduct after a duty to creditors has been triggered, but with director conduct prior to the duty having been triggered and will consequently not impact on what is expected of directors in terms of their common-law duties.

However, the fact that the duty has been triggered will mean that shareholders are no longer able to ratify the breach of duties that caused the insolvency of the company. It will furthermore indicate that creditors are allowed to take action against the directors who did not comply with their duties to the company, which fact ultimately led to the insolvency of the company.

A final critical element of the legal framework that bears on the duty to creditors is the measures in terms of which directors may be relieved from liability, for example indemnification, relief granted by the courts and director liability insurance. The importance of these measures lies in the fact that they are seen as mechanisms that may achieve and maintain the essential balance between accountability and entrepreneurial freedom.

It is submitted that relief granted by the courts and director liability insurance could go a long way towards promoting the balance referred to above. The South African judiciary is statutorily empowered to relieve directors from liability by section 248 of the South African Companies Act.

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1672 See discussion supra Ch 7 (Point in Time When the Duty Arises) par 7.4.2.
This provision, if formulated correctly, seems to be adequate and it is therefore submitted that there is no need for the implementation of a formalised business judgment rule in South Africa. The unfortunate wording of the provision, namely that **negligent** directors may avail themselves of this relief if they acted **reasonably**, should be addressed, however. In this regard it is submitted the requirement of “reasonably” should be scrapped.

Director liability insurance may also offer a reasonable measure of protection to directors. Unfortunately the current interpretation of the South African provision allowing companies to take out director liability insurance does not protect directors at all. This interpretation seems to hinge on the fact that the prohibition against indemnification is contained in the same subsection that allows companies to take out insurance against losses that may result from a breach of directors’ duties. In order to remove this obstacle in the way of wider access to director liability insurance, it is submitted that these two aspects be dealt with in separate subsections.

### 10.4 DEVELOPMENT OF A DUTY TO CREDITORS

It is concluded that the extension of directors’ duties to encompass creditors’ interests is both justifiable and possible within the existing legal framework in respect of directors’ duties.

The legislatures’ response in those jurisdictions where the issue of directors’ duties to creditors was mooted during law reform was very lukewarm, however. From creditors’ perspective the cautious approach adopted by the legislature in respect of an extension of directors’ duties should not be seen as an obstacle in the way of the development of directors’ duties to include their interests. Company law abounds with examples of legal
principles that were developed on a common-law basis that were subsequently formalised in terms of statute, or complemented by statute.\textsuperscript{1673}

It thus seems to be up to the judiciary to develop directors’ duties to creditors in a meaningful way. Pioneering in this respect has already been done in Australia, New Zealand, England, Canada and the United States of America. It is hoped that the South African judiciary will follow suit when the opportunity to do so arises.

\section*{10.5 CONCLUDING REMARKS}

The duty to creditors may be criticised very clinically on the basis that it is theoretically and conceptually unsound; that the existing legal framework in respect of directors’ duties does not permit the extension of directors’ duties to include their interests and that such a development is unnecessary, as creditors’ interests are adequately protected through measures of insolvency law and provisions such as section 424(1) of the South African \textit{Companies Act}.

However, this study showed that the arguments against the extension of directors’ duties to include creditors’ interests are not convincing. On a purely theoretical level, there thus seems to be no good reason why creditors should not be afforded the protection that they could enjoy in terms of directors’ duties.

It is assumed, however, that the strong opposition against such a duty in some instances is not only based on conceptual concerns, or the questioning of the theoretical possibility or the necessity of such a duty, but also on fear for the continued existence of the corporate form itself.

\textsuperscript{1673} The development of the company as form of business enterprise could in itself be seen as such an example, with the legislature formalising to a large extent a structure that found expression in the common law “deed of settlement” company.
Chapter 10  Conclusion

It is true that the topic of this study seems contrary to the fundamentals of company law and that it may in fact be seen as an attack on the very basis of the existence of the company as a form of business enterprise.

It is trite that the corporate vehicle was provided to encourage entrepreneurship and thus to promote economic growth. In order to achieve this objective, those in charge of the business were given the assurance that they would not be held personally liable should the business venture fail. Unlike the unsuccessful sole proprietor, those managing the business of the company could rest easy in the knowledge that their personal estates would not be exposed to claims of creditors of the failed enterprise. A duty to creditors seems to go directly against this assurance.

It is submitted, however, that the pendulum has swung too far towards the protection of those managing the affairs of the company, in trying to promote entrepreneurship. Directors of a failed company are afforded the opportunity to hide behind the veil of separate legal personality and avoid personal liability even in those cases where they were directly responsible for its demise – albeit through negligence or conduct in bad faith. ¹⁶⁷⁴

The time seems to be ripe, therefore, to make an attempt at achieving a balance between providing an environment that is conducive to entrepreneurship and accountability. In an attempt to achieve this crucial balance, one must take care, however, that the pendulum does not swing too far in favour of accountability, thus sacrificing the opportunity for responsible risk-taking.

This may easily happen if the perception is created that directors should incur liability for all business failures, as would a sole proprietor. It should be emphasised, therefore, that

¹⁶⁷⁴ This gaping hole in accountability for those managing the affairs of the company was clearly recognised by the legislature, as indicated by the enactment of a provision such as s 424(1). It was shown, however, that this provision is not as effective as one would have wished it to be.
the purpose of this study is not to advocate general liability of directors to corporate creditors when their claims are not met, but only liability in cases where the directors did not comply with their fiduciary duties and their duty of care and skill. The consequences of corporate failure through no fault of their own should thus not be visited on directors.

The corporate vehicle as a tool of economic growth has proved invaluable and the importance of ensuring its continued existence cannot be over-emphasised. Unfortunately the corporate vehicle has also proved to be an instrument that could be grossly abused, which very fact could threaten its existence.

In this regard it is finally submitted that measures to promote accountability and responsible managerial behaviour, such as directors’ duties to creditors, may, apart from serving the short-term goal of protecting the interests of a particular company’s creditors, have the long-term benefit of contributing towards continued acceptance of the juristic person of the company as a form of business enterprise.
APPENDICES

Summary................................................................................................................................411

Opsomming............................................................................................................................413

Bibliography: Books and Theses ........................................................................................417

Bibliography: Law Journals ...............................................................................................423

Bibliography: Bills and Reports .........................................................................................441

Table of Cases........................................................................................................................445

Table of Statutes....................................................................................................................457
SUMMARY

Directors’ Duties to Creditors

by

Sulette Lombard

Promotor: Prof dr PA Delport

Department: Mercantile Law

Degree: LLD

Creditors of the corporate business form are in a vulnerable position. Recognition of the plight of corporate creditors led to the implementation of various legal measures aimed at protecting their financial interest in the company. These measures proved disappointingly inadequate in many instances. As a result the judiciary in some jurisdictions felt compelled to develop existing legal principles pertaining to directors’ duties in such a way that they could be used to facilitate protection of corporate creditors’ interests.

This development did not meet with universal approval. Those opposed to the extension of directors’ duties to protect creditors’ interests have three main arguments against it. The first is related to conceptual issues and policy concerns. The second argument is that existing remedies are more than adequate to protect creditors’ interests. A last argument against a directorial duty to creditors pertains to the practical implementation of this extended duty. It is argued that the existing legal framework with regard to directors’ duties is not suitable to provide protection for creditors’ interests.

However, it was shown in this study that the extension of directors’ duties to protect creditors’ interests is indeed justifiable on a sound conceptual basis and that policy concerns regarding such an extension are either unfounded, or should be addressed in some other way.
An analysis of existing protective measures and remedies often referred to by opponents of an extension of directors’ duties, namely statutory personal liability of directors, traditional insolvency remedies, and the piercing of the veil doctrine furthermore showed that these measures are inadequate. This leads to the conclusion that there is a definite need for an alternative remedy, such as the extension of directors’ duties to include creditors’ interests.

The existing legal framework in respect of directors’ duties furthermore proved to be capable of being successfully adapted to include creditors’ interests. Central issues in this respect, as was indicated by an analysis of case law, are the point in time when the duty to creditors is triggered, the beneficiary of the duty, in other words who would have *locus standi* in case of a breach of the duty, and the type of protection afforded to creditors’ interests by way of fiduciary duties and the duty of care and skill.

The existing legal framework also provides measures in terms of which honest and diligent directors may be relieved from liability, such as indemnification, relief granted by the courts and director liability insurance. These measures, if formulated correctly, may achieve and maintain the essential balance between accountability and entrepreneurial freedom.

The legislature appears to have adopted a cautious approach to the issue of directors’ duties to creditors. It thus seems to be up to the judiciary to develop directors’ duties to creditors in a meaningful way. Pioneering in this respect has already been done in Australia, New Zealand, England, Canada and the United States of America. It is to be hoped that the South African judiciary will follow suit when the opportunity to do so arises.

**Keywords:** beneficiary of directors’ duties; company’s interests; corporate creditor protection; corporate insolvency; corporate stakeholders; director liability; directors’ duties; directors’ duties to creditors; duty of care and skill; fiduciary duties.
OPSOMMING

Direkteurspligte teenoor Skuldeisers
deur

Sulette Lombard

Promotor: Prof dr PA Delport

Departement: Handelsreg

Graad: LLD

Korporatiewe skuldeisers is in ’n kwesbare posisie. Dit het geleidelik tot die implementering van verskeie regsmiddels geryk op die beskerming van hul finansiële belange in die maatskappy. Hierdie middels het in baie gevalle teleurstellend onvoldoende geblyk. As gevolg hiervan het dit die howe in sommige jurisdicties genoop om bestaande regsbeginsels met betrekking tot direkteurspligte uit te brei ten einde voorsiening te maak vir die beskerming van die belange van maatskappyskuldeisers.

Hierdie ontwikkeling dra nie almal se goedkeuring weg nie. Diegene wat gekant is teen die uitbreiding van direkteurspligte om skuldeiserbelange in te sluit, baseer hul teenkanting op drie hoofargumente. Die eerste hou verband met konsepsuele kwessies en beleidsbesware. Daar word tweedens aangevoer dat bestaande remedies meer as voldoende is om skuldeiserbelange te beskerm. ’n Laaste argument teen direkteurspligte teenoor skuldeisers hou verband met die praktiese implementering van so ’n uitgebreide plig en die standpunt word gehuldig dat die bestaande regsraamwerk met betrekking tot direkteurspligte nie geskik is om beskerming aan skuldeiserbelange te verleen nie.
In hierdie studie is egter aangedui dat die uitbreiding van direkteurspligte om skuldeiserbelange te beskerm wel konsepsueel regverdigbaar is en dat beleidsbesware rakende sodanige uitbreiding óf ongegrond is, óf op ’n ander wyse aangespreek behoort te word.

’n Ontleding van bestaande beskermingsmaatreëls en remedies waarna teenstanders van uitgebreide direkteurspligte dikwels verwys, naamlik statutêre persoonlike aanspreeklikheid van direkteure, tradisionele insolvensieregremedies en die ontsluieringsleerstuk, het verder getoon dat hierdie middels onvoldoende is. Dit lei tot die gevolgtrekking dat daar ’n definitiewe behoefte is aan ’n alternatiewe remedie, soos die uitbreiding van direkteurspligte om skuldeiserbelange in te sluit.

Die bestaande regsraamwerk met betrekking tot direkteurspligte is voorts geskik om suksesvol voorsiening te maak vir die beskerming van skuldeiserbelange. Kernaspekte in hierdie verband, soos aangedui deur ’n ontleding van die toepaslike regspraak, is die tydstep waarop die plig teenoor skuldeisers ontstaan, die bevoordeelde van die plig, met ander woorde die party wat *locus standi* sal hê in geval van nie-nakoming van die plig, asook die tipe beskerming wat aan skuldeiserbelange verleen word deur vertrouenspligte en die plig tot sorg en vaardigheid.

Die bestaande regsraamwerk maak verder voorsiening vir meganismes ingevolge waarvan eerlike en pligsgetroue direkteure teen aanspreeklikheid gevrywaar kan word, byvoorbeeld vrywaring, vryspraak deur die hof en direkteuraanspreeklikheidsversekering. Hierdie maatreëls, indien korrek geformuleer, kan die noodsaaklike balans tussen verantwoordbaarheid en entrepreneursvryheid bereik en handhaaf.

Dit kom voor asof die wetgewer ’n versigtige houding inneem ten opsigte van direkteurspligte teenoor skuldeisers. Dit word dus aan die howe oorgelaat om direkteurspligte teenoor skuldeisers op ’n betekenisvolle wyse te ontwikkel. Baanbrekerswerk in hierdie verband is reeds in Australië, Nieu-Seeland, Engeland en
Kanada gedoen. Daar word gehoop dat die Suid-Afrikaanse howe soortgelyke inisiatief aan die dag sal lê indien ’n geskikte geleentheid hom sou voordoen.

**Sleutelbegrippe:** begunstigde van direkteurspligte; belange van die maatskappy; beskerming van maatskappyskuldeisers; direkteursaanspreeklikheid; direkteurspligte; direkteurspligte teenoor skuldeisers; korporatiewe belangegroepe; korporatiewe insolvensie; plig tot sorg en vaardigheid; vertrouenspligte.
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