Directors' Duties To Creditors In South Africa

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1. Abstract

The traditional view of company law was that the interests of the company were closely identified with those of the shareholders. This meant that, in the past, directors would generally not consider the interests of anyone else having a stake in the company, such as the company's employees or its creditors.

It is argued, however, that many creditors cannot protect themselves adequately. Sometimes, creditors have no option but to extend credit and the debtor is either unwilling or unable to offer any security. This raises the question of whether it would not be unreasonable, in exchange for the benefit of limited liability, to impose a duty on directors to consider the interests of creditors when this becomes necessary. When the company's financial position was sound the main objective was to advance the shareholders' interest by maximizing the profits of the company. Thus, the creditors' interests only became significant when the company was in a state of insolvency. Much uncertainty and conflict remains as to whether directors' duties to the company extend to its creditors as well, or whether the interests of the creditors should only be considered during the period of insolvency.

There is no South African case law, which explicitly indicates that directors have a fiduciary duty towards creditors when a company is solvent and a going concern. Thus, if South African courts were to decide to eventually follow the trends in some foreign decisions and recognise a fiduciary duty towards creditors when the company is solvent and a going concern, the question arises as to the likely areas of conflict between the interests of shareholders and creditors. If our courts were to protect the interests of each group and legally recognise the directors' fiduciary duty towards creditors, the nature and extent of the interests of creditors, which could be prejudiced, would have to be determined.

2. Introduction

Ziegel argues that a duty should be placed on directors to consider the interests of creditors when this becomes necessary. [1] Additionally, as far back as 1939, it was stated in the US decision of *Pepper v Lutton* that directors owe a fiduciary duty to both shareholders and creditors. [2] Thus, it was noted,

> (t)he standard of fiduciary obligation is designed for the protection of the entire community of the interest in the corporation creditors as well as the stockholders.

There have been positive changes in the attitudes of the courts towards company "outsiders", such as creditors, consumers, employees and the State. The courts are taking social values into account and are therefore moving away from the traditional company law concepts enshrining maximum profits for shareholders. [3] Dawson, for example, notes that during the past twenty to thirty years, modern companies have been, to a greater extent, obliged to take into account the rights and interests of stakeholders other than the shareholders. This signals a greater concern regarding the "appropriateness" of a company law model that considers that its primary goals would be to only make profits for its

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1 JS Ziegel, "Creditors as corporate stakeholders: The quiet revolution – an Anglo-Canadian perspective", (1993) *University of Toronto Law Journal*, 43, 530.

2 *Pepper v Lutton* (1939) 308 US 295.

3 FT Newham, "Directors' duties to creditors: What are they and are they part of our law?" (1992) *UCT*, 20.

shareholders. [4] Hodes, therefore, notes that it is important to determine whether company legislation has developed to meet the new social demands, which are imposed by society. [5] Nowadays, directors are expected to take into account the interests and rights of all the stakeholders in a "socially useful" way. Then, the courts will not interfere. [6] Thus, it has been argued that, in developing principles in recent years, the courts have not considered the company as an entity distinct from its creditors or employees, but have included these groups within the definition of a "company". [7]

3. International court decisions

In the Australian High Court decision of *Walker v Wimbourne*, Mason J notes,

> it should be emphasised that the directors of a company, in discharging their duty to the company, must take account of the interest of its shareholders and its 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. [8]

This was the first case in Australia to establish that directors should consider the consequences of their actions towards creditors. Thus, it was stated in this case that directors must, when discharging their duty to the company, take into consideration the interests of its shareholders *and* its creditors. Failure by directors to take creditors' interests into account would result in unfavourable consequences not only towards the creditors, but to the company as well. However, Mason J did not indicate whether, what he had decided, applied only to insolvent companies, or whether it applied equally to solvent corporations as well. Had he intended his statement to apply only to insolvent companies, it is expected that he would have made this very clear. It can therefore be assumed (unless shown to be otherwise) that he intended the position to apply to solvent companies as well. This judgment would therefore extend the notion of fiduciary duties in such a manner that it would include the rights of creditors as well.

In *Lonrho Ltd & Another v Shell Petroleum Co Ltd & Another* the House of Lords also suggested that the company's interests could include those of the creditors. No prerequisite was mentioned that special circumstances, such as insolvency, would be necessary for such a duty to exist. [9] However, in England, in the case of *Multinational Gas and Petrochemical Co. v Multinational Gas and Petrochemical Services Ltd*, Dillon LJ indicated that a company does not owe a duty of care to creditors and neither do they owe a fiduciary duty to present or future creditors. [10] A later decision in New Zealand of *Nicholson v Permakraft* did not set out the duties of directors towards its creditors in such broad terms. [11] Cooke J held that the duties of directors might include a consideration of the interests of creditors. This is so, notes Cooke J, if the company is insolvent, nearly insolvent, doubtfully solvent, or if a payment would jeopardise its solvency. Cooke J *supra* restated the principle that the directors' duties are owed to the company, although this may require them to consider the interests of creditors. In addition, it was held that the duty to consider the interests of creditors arose only when the solvency of the company was in question. It was also indicated that this duty was owed to existing rather than future creditors. Thus, insolvency was a condition to be satisfied before directors could take the interests of creditors into account.

In the Australian Court of Appeal judgment of *Kinsela and Another v Russel Kinsela Pty. Ltd (in liquidation)* Street CJ held that in a solvent company the interests of the shareholders entitle them to be

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[4] Ibid. See also Dawson, "Acting in the best interests of the company – for whom are directors 'trustees'?", (1984) 11 *New Zealand University Law Review* 68.

[5] Ibid 21. See also L Hodes, "The social responsibility of a company", (1983) 100 *SALJ* 468.

[6] Newham, above n 3, 21.

[7] Ibid 21.

[8] Ibid 22. See also Mason J in *Walker v Wimbourne* (1976) 50 ALJR 446 at 449.

[9] *Lonrho Ltd & Another v Shell Petroleum Co Ltd & Another* (1980) 1 WLR 627 (HL), 634.

[10] *Multinational Gas and Petrochemical Co. v Multinational Gas and Petrochemical Services Ltd* (1983) 2 ALL ER 563.

[11] *Nicholson v Permakraft* (1985) 1 NZLR 242, 249-250.

regarded as the company when questions of the duty of directors arose. The directors could therefore authorise or ratify a particular action without any challenge to the validity of their actions. Where a company is insolvent, however, the interests of creditors become significant, as they become entitled, through liquidation proceedings, to deal with the company's assets. This is because the assets now belong to the creditors and not the shareholders. [12] Thus, Street CJ indicated that members could not validate an act, which amounted to a fraud on the creditors. Street CJ held that where the interests at risk are those of creditors, shareholders would not be able to authorise any breach of action against them. Thus, the shareholders do not have the power or authority to absolve the directors from breach against the creditors. Thus, the director' duty to a company as a whole extends, in insolvency cases, to not prejudicing the interests of its creditors. [13] Thus, although the court did not formulate a general test, which could be imposed upon directors to oblige them to consider the interests of creditors, the court did accept that, at the very least, the duty does arise when a company is insolvent, as it is the creditors money, which is now at risk in contrast to the shareholders' proprietary interests. Hence, this judgment identified that the duty to consider the interests of creditors arises, at the very least, in insolvent circumstances, which is to be seen as part of the duty of directors to act in the interests of the company.

However, in the English decision of *Winkworth v Edward Baron Development Company Ltd and Others* Lord Templeton noted,

> a company owes a duty to its creditors, present and future. … (T)he company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts. … 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 … exploited for the benefit of the directors … to the prejudice of the creditors. [14]

In this context, Lord Templeton noted that a company owed a duty to its creditors, both present and future. The court seemed to contemplate distinct duties owed by the directors to both the company and to its creditors. Hence, although the *dicta* in a decision such as *Walker v Wimbourne supra,* were expressed rather cautiously and narrowly, the *dicta* of Lord Templeton are, according to Sealy,

> couched in more extravagant terms, which strike at the very foundations of that policy. [15]

The "policy" referred to here are the principles of company law requiring directors to act in the interests of the company and the company alone. Therefore, the inference to be drawn is that a duty to creditors exists at *all* times and not only in insolvency circumstances.

The suggestion that duties are owed to present and future creditors is arguable. It may be impossible for the directors to take risks then. What would be the position if directors entered into a transaction resulting in a loss? Would this then imply that the directors had disregarded the interests of its creditors? It may well be unreasonable to place a burden on directors to maximise the profits of the corporation by undertaking risks, yet at the same time, cast a duty upon them "to keep its property inviolate and available for repayment of its debts". Consequently, it may well be quite difficult, if not impossible at times, for a director to strike a balance between the interests of its shareholders and those of its creditors.

In a further English decision of the Court of Appeal, Nourse LJ in *Brady and another v Brady and another* examined the expression "in the interests of the company" and held that this phrase may have different meanings in different contexts. [16] He noted that when a company is solvent, the interests and rights of the shareholders, both present and future, are to be considered first. Thus, in the situation where the company has many assets and the debts are few, "the interests of the creditors ought not to count for very much". However, where the company is insolvent, nearly insolvent or doubtfully

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[12] *Kinsela and Another v Russel Kinsela Pty. Ltd (in liquidation)* 1986 4 NSWLR 722, 730 per Street CJ.

[13] Ibid 732.

[14] Newham, above n 3, 29. See also *Winkworth v Edward Baron Development Company Ltd and Others* (1987) 1 All ER 114 (HL), at 118.

[15] LS Sealy, "Directors' duties – an unnecessary gloss", *The Cambridge Law Journal* (1988) 175, 176.

[16] *Brady and another v Brady and another* (1988) BCLC 20.

solvent, the interests of the company would then become solely the interests of existing creditors. [17] This decision is significant because it recognises the wider concept of the "company" as one that would include groups other than the shareholders. The decision also attempts to provide guidelines as to when the duty to creditors arises. [18]

As stated in the *Permakraft* case any proposed course of action, which would prejudice the company's solvency and thereby impact directly upon the interests of creditors, would require due consideration by the directors. [19] This may well have far-reaching implications for directors, as most ventures that are undertaken by them will be of some risk to creditors.

It is through the extension of the concept of the company to include those groups, which traditionally have been considered outsiders that the courts have been able to state that directors, when complying with their duties to the company, need to consider the interests of stakeholders other than the shareholders themselves. This indicates that there has been a movement away from identifying the interests of the company with the financial interests of its shareholders to a situation where the courts have ordered directors to consider the interests of other stakeholders. Thus, the duty to consider the interests of creditors is owed to the company. [20]

The decision of *Jeffree v National Companies and Securities Commission* considered the question of the duties towards creditors. [21] In this case, proceedings were brought against Jeffree on the basis of section 229(4) of the Australian Companies Legislation, which provides that

> (a)n officer or employee of a corporation shall not make improper use of his position as such an officer ... to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the corporation.

Jeffree was found liable on the basis of this section. The court also based its decision on *Walker's and Kinsela's cases supra* where it was noted that, in certain circumstances, especially where a company is in financial difficulties, directors owe an obligation to their creditors. The court *a quo's* decision was confirmed on appeal where it was noted that the duties of directors extend to both creditors and to prospective creditors. Hence, the learned judges did not restrict their statement only to companies, which were in the process of being liquidated, but adopted rather a more general approach as laid down by Lord Templeton in *Winkworth's case supra* where it was specifically noted that directors owe a duty to present and future creditors. The approach of the court in *Jeffree* was the same as that adopted by the Court of Appeal of New South Wales in *Ring v Sutton* where it was held that directors owe a duty to creditors *even* when the company is solvent. [22] However, the opposite view was held in *Re Horsley v Weight*, where the court held that the directors' duty to creditors arose *only* when the company is insolvent. [23]

In a more recent Australian decision of *Spies v The Queen* the court held per Gaudron, McHugh, Gummow and Hayne JJ that directors do not owe an independent duty to, nor is it enforceable by, creditors of the company. [24] This is so even though such creditors may also be directors of the company. [25] The court refers to the *Walker* decision and notes,

> (i)t is "extremely doubtful" whether Mason J "intended to suggest that directors owe an independent duty directly to creditors". To give some unsecured creditors remedies in an

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[17] Ibid at 40.

[18] Newham, above n 3, 31.

[19] *Nicholson v Permakraft*, above n 11, at 250.

[20] Ibid 45.

[21] *Jeffree v National Companies and Securities Commission* (1989) 15 ACLR 217, 7 ACLC 556.

[22] *Ring v Sutton* (1980) 5 ACLR 546.

[23] *Re Horsley v Weight* (1982) 3 ALL ER 1045.

[24] (2000) 201 CLR 603.

[25] Ibid at 604.

> insolvency, which are denied to others would undermine the basic principle of *pari passu* (my italics) participation by creditors. [26]

Thus, the court noted that any suggestion that directors owe an independent duty to creditors, by reason of their position as directors, "are contrary to principle and later authority and do not correctly state the law". [27]

Hargovan discusses the decision of *Spies v The Queen*. [28] He focuses on whether the majority judgment in *Spies* was significant in confirming whether directors owe an independent duty to creditors to consider their interests.[29] Hargovan submits,

> the context, explicit language and the strength of the majority's statements makes *Spies* the strongest authority on the Australian position concerning directors' fiduciary duties to creditors. [30]

Thus, Hargovan maintains that the decision in *Spies* affirmed the position that directors do not owe an independent duty directly to creditors. [31] He notes that the "deliberate and emphatic language used" clearly indicated that the *Spies* case was "an authoritative judicial statement", which rejected independent fiduciary duties to creditors. [32] He also notes that the judges *in casu* expressly rejected the decision in *Nicholson v Permakraft (NZ) Ltd*, which indicated that directors owe an independent duty to creditors. [33] However, Hargovan does note that the majority in *Spies* confirmed that directors owed a duty of imperfect obligations to creditors, which creditors cannot enforce except through the company itself or appointed liquidator. This recognises the rights of creditors in the interests of the company in insolvency situations. [34]

The term "imperfect obligation" was traditionally used in contract law to describe arbitration agreements. It was only used recently in company law to describe the relationship between directors and creditors. In describing imperfect obligations, this means that directors must take into account the interests of creditors, but creditors cannot seek action against those directors who act contrary to their interests. [35] Thus, rather than the directors owing a direct duty to creditors, an indirect duty is owed to creditors to consider their interests through the company. [36]

Thus, although the decision in *Walker* in its own right will remain influential for future cases, it can no longer stand alone as influential authority regarding the question of an independent fiduciary duty to creditors. It needs to be considered along with the decision in *Spies*. [37] Thus,

> the prospect of judicial development of an independent fiduciary duty to creditors is without strong foundation. [38] … Whilst a future Australian High Court is always free to depart from its previous judgments, it is submitted that based on the detailed analysis of *Spies* … it is unlikely to lightly

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26 Ibid at 636, paragraph 93.

27 Ibid at 636-7, paragraph 95.

28 A 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 *C&SLJ* 390.

29 Ibid 390.

30 Ibid 391.

31 Ibid 396.

32 Ibid 402.

33 Ibid 398.

34 Ibid.

35 J McConvill, "Directors' duties to creditors in Australia after *Spies v The Queen*", (2002) 20 *Company and Securities Law Journal*, 6.

36 Ibid.

37 Hargovan, above n 28, 404.

38 Ibid 405.

> disregard the unanimous and reasoned statements of four High Court judges and resuscitate the issue of independent fiduciary duty. [39]

McConvill, on the other hand, still believes that despite the decision in *Spies*, there is still "a degree of uncertainty" regarding the relationship between directors and creditors. More specifically, he writes that the decision in *Spies*, regarding the duties of directors towards its creditors, was "merely *obiter*". [40] Accordingly, he writes, "there is a possibility" that "Australian company law" would support the view that the directors owe a separate fiduciary duty to creditors. He notes that there are policy reasons for recognising this fiduciary duty. That is, if creditors are owed merely a duty of imperfect obligations, creditors would need to rely extensively upon the *Corporations Act 2001* to adequately protect their rights and interests. [41] Thus, McConvill maintains that the decision in *Spies* does not depart from the comments of Mason J in the *Walker* case. In this way, the decision in *Spies* "no way changes or clarifies" this relationship. If anything, he states that the *Spies* decision has encouraged "greater use of remedies under the (Australian) *Corporations Act 2001*". [42] However, he notes that whereas the insolvent trading provisions of the Australian *Corporations Act 2001* are only triggered when the company is insolvent, an independent fiduciary duty to creditors would become available even prior to insolvency. [43] Creditors, under section 588R(1), must first obtain the consent of the liquidator or be granted leave by the court before they can enforce the duty of directors under section 588G not to trade during insolvency. [44] Thus, the "utility" of section 588G and the other "insolvency trading provisions for creditors is not as substantial as some commentators (particularly Hargovan) have suggested recently".[45] Thus, McConvill sums up that

> (t)here is no question that following the High Court's decision in *Spies*, directors, when exercising their powers, owe a duty to consider the interests of creditors of the company when the company is insolvent or in the vicinity of insolvency. Despite the decision in *Spies*, however, the long-standing question concerning the nature and extent of this duty to creditors remains unresolved. … (T)he decision in *Spies*, unfortunately, raises more questions than it resolves. The High Court did not make any authoritative determination on … a director's fiduciary duties to creditors, and it cannot be said that the *Spies* decision provides any real indication of the approach, which the court may indorse if and when the issue is raised for determination in a future case. All that can be said for certain at present is that the … statement of Mason J in *Walker* … remains the strongest authority on the Australian position concerning directors' fiduciary duties to creditors. [46]

There are, as noted above, commentators that disagree with the reasoning and interpretation of McConvill regarding the *Spies* Case.

In a later article, McConvill again addresses the director's duty to company directors.[47] In this regard, he analyses the decision of *Geneva Finance Ltd v Resource & Industry Ltd*. [48] McConvill notes that the *Geneva Finance* case was the first decision in Australia since the case of *Spies* to deal with the nature of the directors' duties towards its creditors. Heenan J reaffirmed the principle in the *Spies* decision that directors' duties to creditors amounts to no more than an imperfect obligation. [49] Thus, the duty is not owed directly by directors to or enforceable by creditors. It is rather to be described as an indirect duty owed not to the creditors, but to the company to consider the interests of creditors. This imperfect obligation will "spring into action" on insolvency or when a director suspects this. In such

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39 Ibid 406.

40 McConvill, above n 35, 4.

41 Ibid 15.

42 Ibid 5.

43 Section 588G *et seq*.

44 McConvill, above n 35, 19.

45 Ibid.

46 Ibid 24.

47 J McConvill, "Geneva finance and the 'duty' of directors to creditors: imperfect obligation and other imperfections", (2003) 11 *Insolvency Law Journal*, 7.

48 (2002) 20 ACLC 1427.

49 McConvill (2003), above n 47, 7.

circumstances, the creditors "become the main stakeholders in the company" because they would then be entitled to those funds, which the company is using to trade. [50]

McConvill also believed that section 1324 of the Australian *Corporations Act 2001* remains "under-utilised". Section 1324 allows a person whose interests are affected by a breach of the Act to apply for injunctions and/or damages. [51] In this way, McConvill believes that creditors may take action against directors when their interests are affected. The parties in the *Geneva Finance* case did not use section 1324. [52] McConvill notes, however, that some writers, including Hargovan, believe that because the *Spies* decision states that the interests of creditors are not directly enforceable by them, the courts are likely to state that section 1324 would be unavailable to creditors as well. [53]

Keay has also recently pondered over the issue as to whether fiduciary duties should be extended to creditors. [54] From a British point of view, he writes that commentators "are sharply divided" as to whether such fiduciary duties should be extended to creditors as well. Thus, those commentators that adopt a contractarian approach believe that there are already sufficient factors in play, such as the market itself and freedom to contract, to protect the rights and interests of creditors. The communitarians, however, believe that creditors are amongst the stakeholders of companies and are therefore in as vulnerable position as anyone else. Thus, creditors should be protected by mandatory rules. [55] Keay submits that *fairness* must be considered and thus directors need to consider the interests of creditors when companies hit hard times. This is because creditors are in vulnerable positions (especially the employees, customers, involuntary creditors and trade creditors) and have expectations that their interests will be considered at this stage. [56] Also, a duty to creditors can be substantiated on the basis of *efficiency*. [57] Keay explains that whilst a duty to creditors might increase some transactions costs, other costs, such as those associated with drafting contracts, would be reduced. [58] Thus,

> … it seems fair that directors should be under a responsibility to consider creditor interests where financial difficulty exists, in order to reduce 'information asymmetries between companies and their creditors'. … (T)he contractarian arguments alone are not sufficient to reject the imposition of a duty to take account of the interests of creditors. [59]

Havenga, however, believes that the fiduciary duties of directors should only be "owed to the company as a whole and not to individual shareholders, creditors or other stakeholders". [60] She believes that legislation, which is aimed specifically at a particular stakeholder, provides "better protection" than a simple extension of a director's fiduciary duty. For example, in the South African context, she is of the opinion that section 424 of the South African *Companies Act* provides "substantial protection to company creditors". [61] In this section, the court may impose personal liability on any person who knowingly and in a fraudulent or reckless manner carried on business to defraud creditors or other persons. [62]

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50 Ibid 8.

51 Ibid 7.

52 Ibid 14.

53 Ibid 16.

54 A Keay, "Directors duties to creditors: Contractarian concerns relating to efficiency and over-protection of creditors", (2003) 66 *The Modern Law Review*, 665.

55 Ibid 666.

56 Ibid 698.

57 Ibid.

58 Ibid 699.

59 Ibid.

60 M Havenga, "Directors' fiduciary duties under our future company-law regime", Inaugural lecture (UNISA), (1997) 9 *South African Mercantile Law Journal*, 324.

61 No 61 of 1973.

62 Havenga, above n 50, 321.

4. Statutory protection of creditors and other interested stakeholders

The English *Companies Act* of 1948 contained a provision similar to section 424 of the present South African *Companies Act* 61 of 1973 except that the former was only applicable with regard to fraudulent conduct, whilst the latter was also applicable with regard to reckless conduct. [63] The subsequent recommendations of the Cork Committee led to the enactment of section 214 of the English *Insolvency Act*. [64] This section imposed liability on directors for conduct similar to negligence. [65] This Act provides that a director may, in certain circumstances, be held liable for a company's wrongful trading. Thus, the courts may declare a director liable to contribute towards a company's assets if

> (a) The company has gone into insolvent liquidation;
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> (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
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> (c) That person was a director of the company at that time.

This section is therefore clearly intended to benefit creditors. However, the court will not make a declaration of personal liability if it is satisfied that the director concerned, at the earliest opportunity, "took every step with a view to minimising the potential loss to the company's creditors as ... he ought to have taken". [66] Likewise, it needs to be noted that section 424 of the South African *Companies Act*, 1973 provides such a *powerful* statutory remedy for creditors that, because of it, the common law duty to creditors has not yet been developed in South Africa. [67]

Section 424 provides that,

> (1) When it appears, whether in the winding-up or judicial management of a company, or otherwise, that any business of the company concerned was or is being carried on recklessly or with the intent to defraud creditors of the company or any other person, or for any fraudulent purpose, the court may, on application, declare that any person who was knowingly a party to the carrying on of the business in such manner 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. [68]

The Master, the liquidator, the judicial manager, any member or creditor or contributory of the company may bring the application. It is important to establish the extent to which section 424, which is aimed at the protection of creditors and other interested parties, actually achieves this objective. In terms of South African law, a civil sanction applies to both fraudulent and reckless carrying on of the business of the company.

Havenga notes, [69]

> Du Plessis regards s424 (1) as one of the most powerful instruments in the hands of creditors. ... But its effectiveness will depend largely on cost implications and the likelihood that the particular

[63] EML Strydom (2005), *Company Legislation Handbook 2005 including the Close Corporations Act*, 18th edn, Butterworths, Durban, South Africa and Strydom (1998), *Company Legislation Handbook 1998 including the Close Corporations Act*, 11th edn, Butterworths, Durban, South Africa, 179.

[64] Cork Committee, Report of the Insolvency Law and Practise Review Committee (Cmnd 8558) June 1982, Ch.44.

[65] Section 214 of the English *Insolvency Act* of 1986.

[66] Newham, above n 3, 57. See also the English *Insolvency Act* of 1986, section 214.

[67] Ibid 58.

[68] Strydom, above n 53, 179.

[69] M Havenga, "Creditors, directors and personal liability under section 424 of the *Companies Act*", (1992) *SA Mercantile Law Journal* Vol. 4, 65.

> creditor's claim against the company will be settled if her application under the section is successful. [70]

Section 424, compared to section 214 of the English *Insolvency Act*, is a very powerful legislative enactment. In addition, the application of the section to circumstances other than those where the company is in the process of being wound up, are indicative that it is intended to provide a meaningful remedy. It can be argued that creditors are, as a result of section 424, "adequately protected against misuse of their powers by company controllers". Because of uncertainty as to whether fiduciary duties owed by directors to the company can be extended to creditors, creditors may well have to rely on section 424. However, uncertainty may arise because it is unclear to whom the court may order the payment under the section. Thus, the section should be interpreted or *amended* to permit payment directly to the applicant creditor if it would not prejudice other parties. [71]

South African law has accepted that section 424 confers a wide discretion on the court. The words "or otherwise" in this section are broad and are therefore not only applicable in liquidation or judicial-management proceedings. Thus, unlike the previous *Companies Act*, [72] which contained very restrictive wording, the present Act extends the scope of the section admirably. Thus, de Kok J in *Gordon No. and Rennie No v Standard Merchant Bank Ltd* noted,

> (t)he new *Companies Act* of 1973 ... expressly extends the section to apply to reckless, as well as fraudulent trading and it is made applicable to circumstances other than those where the company is in the process of being wound up. [73]

It can therefore be suggested that the section has been deliberately phrased in wide terms so that the courts may bring to account fraudulent and reckless directors for their actions towards their creditors even *before* the company becomes insolvent. The fact that the words "or otherwise" were adopted implies that, at all material times, creditors are entitled to expect that the affairs of the company are conducted properly. Thus, should directors commit fraudulent or reckless acts even prior to insolvency, the creditors would have the right to institute legal action against the directors. The provisions of section 424 provide a meaningful remedy against the abuse contemplated by the legislature. A creditor of the company may make the application or, where the company is being wound-up or has been placed under judicial management proceedings, by its liquidator or judicial manager.

However, creditors may decide not to use section 424 if payment, in the event of a successful application, is likely to be ordered to the company. There would be uncertainty as to whether they would actually receive payment, and whether they may have to make a contribution towards the costs of the application or even furnish security for it. Thus, the court should be able to order that payment be made directly to creditors. Thus, it is only through an amendment to this section, that the position, with regard to the order for payment, will be clarified. Only at that stage, would section 424 become a totally effective remedy for the creditors.

In addition to section 424 of the *Companies Act*, creditors' interests are also protected in terms of section 135 of the *Insolvency Act*, which provides that a director will be held criminally liable if he or she is found to have preferred one or more creditors above the other. [74] Thus, a possible argument may arise that, by virtue of these provisions, an extension of the directors' duties towards its creditors, is unnecessary because the interests of creditors are sufficiently safeguarded, both during and prior to the company becoming insolvent.

Section 354(2) of the *Companies Act* also allows the court to take into consideration the wishes of the creditors in all matters relating to the winding up of the company.[75] The purpose of issuing a

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[70] Ibid. See also JJ du Plessis, "Maatskappyregterlike Grondslae van die Regsposisie van Direkteure en Besturende Direkteure", unpublished LLD thesis, University of the Orange Free State (1990), 126.

[71] Havenga (1992), above n 59, 69.

[72] No 46 of 1926.

[73] *Gordon No and Rennie No v Standard Merchant Bank Ltd* (1984) 2 SA 519 (C).

[74] *Insolvency Act* 24, 1936, section 135.

[75] *Companies Act* 61, 1973, section 354(2).

provisional winding-up order is to afford creditors an opportunity to show cause why it would serve no benefit to them and why it should not be made a final order of liquidation. In this regard, Stegmann J in the decision of *Ex Parte Clifford Homes Construction (Pty) Ltd* noted,

> (t)he reason for the practice (of ordering a provisional winding-up order) would appear to be that the provision in the *Companies Act* empowering the court to have regard to the wishes of creditors as to all matters relating to a winding-up applies not only to matters arising after the winding-up has begun, but also to the question whether there should be a winding-up by the court at all. [76]

The court may further protect the interests of creditors by permitting an already insolvent company to continue trading, and the court does this by postponing the winding up order. Thus, in the decision of *SAA Distributors (Pty) Ltd v Sport en Spel (Edms) Bpk*, the respondent filed an affidavit in terms of which it was stated that the liquidation of the company would have an adverse effect on creditors. [77] The creditors, who were in the majority, supported the respondent and requested postponement of the winding-up order for financial reasons. The court held that the wishes of the creditors should be taken into consideration.

Finally, section 20(5) of the *Public Accountants' and Auditors' Act* also has the effect of protecting creditors. [78] This section provides that an auditor is required to intervene if he is satisfied or has reason to believe that a material irregularity has taken place in the conduct of affairs of the company, which has caused or is likely to cause financial loss to the undertaking or any of its members.

Shareholders, however, are deemed to have authorised the directors to expose the company's capital to risks when embarking upon trading ventures potentially in the interests of and for the benefit of the company. Thus, should a director's actions in these circumstances result in financial loss to the company, the same would not constitute an irregularity as contemplated under section 20(5) of the said Act since the actions of the director were lawfully authorised. However, had the company been insolvent at that time, and notwithstanding this, the directors decide to expose the company to further risks, this conduct would then constitute a material irregularity in terms of the said section.

5. The current position of duties towards creditors in South Africa

Newham notes that the duty to creditors has not been developed in South Africa because of the protection enjoyed by creditors under Section 424 of the Companies Act. [79] The basis for the proposition that there is no direct fiduciary duty relationship between directors and creditors is based upon the proposition that the company is a separate legal entity and therefore has its own rights and duties. Consequently, the director has a fiduciary relationship towards the company primarily and creditors must protect their interests "by bargaining with the company". When the company is being wound up, various statutory provisions ensure that creditors are treated fairly. [80]

In referring to the additional remedies arising from an application of the common law principles of fraud, Stegmann J in *Ex Parte Lebowa Development Corporation Ltd*, notes that for a company to obtain credit without it disclosing a known risk to the creditor or that payment may not be made, would amount to fraud on the creditor. Furthermore, the fact that the company director may not have intended to cause a loss and may have honestly believed that the debt would be paid, does not exonerate the actions of the director. Thus, any dishonest exposure to a known and undisclosed risk of loss would amount to fraud on the creditor. [81] The conduct of the company in taking goods on credit when it

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[76] *Ex Parte Clifford Homes Construction Pty Ltd* (1989) 4 SA 610(W), 612.

[77] *SAA Distributors Pty Ltd v Sport en Spel (Edms) Bpk* (1973) 3 SA 371 (C).

[78] *Public Accountants' and Auditors' Act* 80 (1991) section 20(5).

[79] Newham, above n 3, 65. See also HS Cilliers, ML Benade, JJ Henning, JJ du Plessis and PA Delport (1987), *Corporate Law*, 1st edn, 244, and OJS Fourie, "Die Plig van Direkteure Teenoor Maatskappy-Skuldeisers", (1992) 4 *SA Mercantile Law Journal* 25 at 47-8. See also HS Cilliers, ML Benade, JJ Henning, JJ du Plessis and PA Delport (1992), Corporate Law, 2nd edn, Butterworths, 156, and HS Cilliers, ML Benade, JJ Henning, JJ du Plessis, PA Delport, L de Koker and JT Pretorius (2000), *Corporate Law*, 3rd edn, Butterworths, 162.

[80] Cilliers et al (1992), above n 79, 156. See also Cilliers et al (2000), above n 79, 25.

[81] Newham, above n 3, 66. See also *Ex Parte Lebowa Development Corporation Ltd*, 1989, (3) SA 71 (T) at 105.

knows that it is, or is likely to become, insolvent, is labelled as a serious wrong and against public policy. Consequently, the extent to which the courts would be willing to protect the interests of company creditors would determine whether the courts recognise that fiduciary duties are owed to creditors. This could be achieved by including the rights of creditors within the concept of "the company" or in some other way. [82]

In addition, in the decision of *Ex Parte Lebowa Development Corporation Ltd*, Stegmann, distinguishing at length between claims, which creditors may enjoy against directors at common law arising from their fraudulent conduct and their statutory remedy contained in section 424, noted that there was a fundamental distinction between exposing a company's capital to the risks during the course of its business and exposing a company's creditors to those risks. The former exposure is authorised by the company's members and is therefore lawful. However, there is frequently no authorisation for the latter and is therefore unlawful. [83]

The decision of *Singer NO v M J Greeff Electrical Contractors (Pty) Ltd* Stegmann noted that trading in insolvent circumstances might not be always unlawful. Thus, an insolvent company might still be able to trade lawfully in insolvent circumstances by ensuring that it always pays cash for all goods and services it receives or by always disclosing its insolvency to a supplier before receiving any credit. However, such open and honest conduct of an insolvent company is not generally expected. Thus, to use an insolvent company to trade and bring risk to suppliers may result in either personal liability for the company's debts or in criminal liability or both. [84]Therefore, a court may recognise a possible claim by the creditors against the directors based either on negligence or fraud or both. Although Stegmann did not hold specifically that directors had a fiduciary duty towards the creditors, he did indicate what sanctions could result if directors unlawfully caused the creditors to expose themselves to risk. [85]

In the landmark decision of *Ex Parte De Villiers & Another N.N.O: In Re Carbon Developments (Pty) Ltd (in liquidation)* Stegmann J noted that if the directors permitted the corporation to trade whilst its liabilities exceeded its assets, then the directors neglected their duties either to restore its solvency or to wind it up. [86] Thus, directors, in this way, would have operated outside the legal framework of the *Companies Act* and the memorandum and articles of association and would, therefore, be unable to claim protection from personal liability, which would attach to those directors who conduct the business within the legal framework of the company legislation. Stegmann notes that there may be liability in terms of an Aquilian action. This is based on the fact that, in accordance with the reasonable man test, the directors negligently failed to perform their duties either to raise the capital of the company to restore its solvency or to wind it up. As a consequence, this has caused the trade creditors, who have remain unpaid, to suffer foreseeable loss. [87]

In *Re Carbon Developments* case, Stegmann, J suggested that the directors had a duty to either raise funds to restore the solvency of the company or to wind it up in the event of insolvency. If directors neglected their duty they would be operating outside the law and would therefore not be protected by the benefits of limited liability. This might indicate the possible "germination of the seed of a duty to creditors". However, it is clear that Stegmann J was referring only to a "duty of care" owed to creditors, and not the company, which, if breached, would give rise to a delictual action. This is nothing new in South African law. Thus, Stegmann J

> has not taken our law any further along the road ... in formulating and developing a common law duty to creditors. He has rather … examined … the various ways in which creditors have always been able to obtain relief from the directors of debtor companies. … This is not to say that there is no need or place for a duty to creditors in our law. ... [88]

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[82] Newham, above n 3, 66.

[83] *Ex parte Lebowa Development Corporation Ltd* 1989 (3) SA 71 (T), 106E-F.

[84] *Singer NO v M J Greeff Electrical Contractors Pty Ltd* (1990) (1) SA 530 (W), 538-539.

[85] Newham, above n 3, 70.

[86] *Ex Parte De Villiers & Another N.N.O: In Re Carbon Developments Pty Ltd (in liquidation)* 1992 (2) SA 95 (W), 136I-137B.

[87] Newham, above n 3, 75. See also Stegmann J in *Ex parte De Villiers*, above n 36, at 144.

[88] Ibid 76.

6. Conclusion

Until recently, little attention has been paid to the interests of creditors forming part of directors' duties because the duties of good faith and that of care and skill, were seen to be owed to the company *alone*. Consequently, the director is seen to be under a duty to exercise that degree of care and skill to the company that can reasonably be expected of a person with this knowledge and experience. The director therefore stands in a fiduciary relationship to the company embracing duties of loyalty, confidence and trust.

Prentice notes,

> (i)t has long been a central tenet of company law that directors owe their duties to the company and not the company's shareholders or its creditors. [89]

The philosophy and logic behind this submission was that when the company's financial position was sound, the main objective was to advance the shareholders' interest by maximizing the profits of the company. The creditors' interests only became significant when the company was in a state of insolvency. Hence, this reasoning takes cognisance of the fact that a heavy burden would be placed upon directors if they were bound to consider the interests of creditors when venturing into transactions. Directors might then be reluctant to take risks, which could affect the company's financial position. However, if directors needed only to consider the interests of shareholders when the company is solvent, they would be able to exercise an independent decision without fear of being sanctioned by the creditors should such decision prove to be erroneous or prejudicial to the interested parties. Thus, this submission argues that the interests of the shareholders and those of the creditors must be mutually exclusive and should not be reconciled to allow both groups to be entitled to duties of good faith and care and skill from directors. Moreover, the creditors' main concern is to receive payment for any debts incurred to them by the corporation (unlike the shareholders). It is further argued in this submission that should directors be obliged to show duties of good faith and care and skill to creditors, a conflict of interest and duties would then exist between the shareholders and creditors, which would thereby place directors in untenable positions, as they would not know which group's interests should take precedence when making a decision.

It is apparent from the various cases and discussions, that much uncertainty and conflict remains with regard to the question as to whether directors' duties to the company extend to its creditors as well, or whether the interests of the creditors should only be considered during the period of insolvency. There may well be room for the argument that there is no need for the fiduciary duties of directors to be extended to creditors because of the fact that the latter's interests are sufficiently safeguarded by the law as it currently stands. Thus, the extension of such duties to creditors may well create a conflict of interests between the shareholders and creditors - the former being interested in maximising its profits, while the latter interested in being paid by the company for its debts. The *Companies Act*, the *Insolvency Act* and the *Public Accountants' and Auditors' Act* may well be sufficient in safeguarding the interests of creditors. In addition, creditors may always resort to civil litigation while the company is solvent when payment of debts to them by the company is outstanding. Thus, arguably, the only period during which the company should be obliged to consider the interests of creditors, may be at that time when the company is insolvent or approaching a state of insolvency. Furthermore, one could argue that the interests of creditors could also be considered in a situation where directors embark upon a venture, which could threaten the solvency of the corporation. Thus, the interests of creditors should be primarily considered in insolvent circumstances and in solvent circumstances when the proposed transaction to be entered into by the directors may indeed affect the solvency of the corporation.

Furthermore, Sealy succinctly sums up the position when he notes,

> (c)reditors are more favourably placed, in that they have a statutory class available through their representative, the liquidator; and it is almost certainly only in a liquidation that any claim in

[89] DD Prentice, "Creditor's interest and director's duties", (1990) *Oxford Journal of Legal Studies*, 273. See also Blackman, MS, Jooste, RD and Everingham, GK (2002), *Commentary on the Companies Act*, Juta & Co, Ltd, South Africa, Volume 2, paragraph 208, 8-8.

> respect of their interests would arise. … For this reason, it is probably unsound … to formulate the directors' duty with reference to any stated category of creditor ... (as) the proper object of any duty ... should be the corporate estate. It would also run counter to established insolvency policy considerations if the law were to give remedial advantages to particular creditors. And if individual creditors are put by the law into a position where they may use threats to sue directors personally, as a form of pressure to have the company pay their debts in priority, the object of the insolvency law is undermined. In the light of these considerations there should be some resistance to any extension of the traditional directors' liability. … [90]

This is perhaps the reason why Stegmann J in *Carbon Developments'* case has decided not to take South Africa any further in formulating and developing a common law duty to creditors. [91] Thus, there is no South African case law, which explicitly indicates that directors have a fiduciary duty towards creditors when a company is solvent and a going concern.

Consequently, if South African courts were to decide to eventually follow the trends in the decisions in some of the foreign cases noted *supra* and thereby recognise a fiduciary duty towards creditors, the question arises as to the likely areas of conflict between the interests of shareholders and creditors. In other words, if our courts were to protect the interests of each group and, in this way, legally recognise the directors' fiduciary duty towards creditors, the nature and extent of the interests of creditors, which could be prejudiced, would have to be determined.

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[90] LS Sealy, "Directors' duties – an unnecessary gloss", *The Cambridge Law Journal* (1988) 178 et seq.

[91] *Ex Parte De Villiers & Another N.N.O: In Re Carbon Developments Pty Ltd (in liquidation)* (1992) (2) SA 95 (W).