

**A CRITICAL APPRAISAL OF THE CREDITOR PROTECTIVE MECHANISMS UNDER
THE SOUTH AFRICAN COMPANIES ACT 71 OF 2008**

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DECLARATION

I, **SIBANDA MANDHLAENKOSI (Student No. 15018554)**, hereby declare that the dissertation for the LLM degree at the University of Venda hereby submitted by me, has not been submitted previously for a degree at this or any other University and that it is my own work in design and execution, and that all reference material contained therein has been duly acknowledged.

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DEDICATION

I dedicate this work to my newly born bundle of joy, one Brandon Power Sibanda, who is my motivation to work hard and to my dearest wife, one Princess Mukhovhe Tshivhase, who encouraged me to work hard and complete this research work despite my several demanding commitments. I also dedicate this work to my beloved “mothers” who have always been pillars of support through it all.

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TABLE OF ABBREVIATIONS

- 1) CC : Companies Commission
- 2) CT : Companies Tribunal
- 3) DTI : Department of Trade and Industry
- 4) KCGP : King Code of Governance Principles
- 5) MOI : Memorandum of Incorporation
- 6) RPC : Research Publications Committee
- 7) SA : South Africa
- 8) UNIVEN : University of Venda
- 9) UK : United Kingdom
- 10) USA : United States of America

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ABSTRACT

This research examined the mechanisms that were employed by the Companies Act 71 of 2008 in order to protect the interests of creditors in company affairs. At the preamble of the aforementioned Act lies an undertaking from legislature to provide appropriate redress to investors and third parties/creditors. It was on that basis that the researcher sought to establish whether legislature had indeed fulfilled its commitment to provide appropriate redress to creditors. Traditionally, companies have been run to promote the interests of shareholders with little attention given to the interests of other stakeholders such as creditors. It is this research's findings that South African company law has moved from the traditional view, that is the shareholder value approach, to the enlightened shareholder value approach: a model of corporate governance which permits directors to have regard, where appropriate, to the interests of other stakeholders but with shareholders' interests retaining primacy. It is thus found that creditors cannot be protected by contract laws alone but that their protection should be enhanced by mandatory corporate laws which regulates the manner and conduct of company controllers in a way that ensures that the interests of all stakeholders, including creditors, are given due regard. Finally, it has been found that much work has been done by legislature in developing the re-enacted creditor protective mechanisms and also in statutorily adopting new mechanisms which are aimed at advancing creditor interests. Recommendations have thus been made to legislature for possible amendments to refine its corporate laws.

Keywords/ Concepts

Business rescue, Company, Company Controllers, Creditors, Creditor Protective mechanisms, Creditor Compromise, Corporate Constituencies or Stakeholders, Directors, Enforcement mechanisms, Investors, Liquidation, Piercing the corporate veil, Solvency and Liquidity test, Shareholder, *Turquand* rule.

CHAPTER 1

INTRODUCTION

1.1. BACKGROUND TO THE STUDY

The enactment of the South African (SA) Companies Act 71 of 2008¹ was a response to the much needed reform in SA Company law. The main objectives for the reform were to align SA Company Law with the new constitutional dispensation as well as to adapt to the ever changing international standards of corporate governance systems as advocated for by the King Code of Governance Principles (KCGP).² Prior to the enactment of the 2008 Act, SA`s company law was guided mainly by the South African Companies Act 61 of 1973³, a piece of legislation which was typical of archaic corporate law principles and burdened with the influence of the apartheid regime. In 2004, the Department of Trade and Industry (DTI) issued a policy paper which was meant to set guidelines for a more detailed technical consultation which was to provide for the drafting of a new Companies Act (the 2008 Act). In terms of the DTI Policy paper, SA Company law was to be reviewed in order to ensure that the new legislation would be appropriate for the legal, economic and social context of South Africa as a constitutional democracy and an open economy.⁴ Thus company law had to move from just being an instrument to advance economic goals to one that would also cater for socio-economic goals. The interests of various stakeholders were to be catered for in order to create a workable framework between corporate entities and their stakeholders.

An interesting question was posed by the DTI policy paper; “In whose interest should a corporation be run?”⁵ The question stemmed from an understanding of the law that one of the common law fiduciary duties of directors was to exercise their powers for the benefit of the company. In light of the preceding question, the 2008 Act also brought a provision which requires directors to exercise their powers as such and to perform their functions in the best interests of the company.⁶ That alone attracts another question; what is the meaning of the phrase “interests of a company”? The 2008 Act does not define what is meant by the phrase “best interest of the company”, however, at common law, directors owe their duties to the shareholders as a collective. In *South African Fabrics v Millman*,⁷ the court held that a company’s interests were only those interests of the company itself as a corporate entity and

¹Herein referred to as “the 2008 Act”.

²Institute of Directors ‘Southern Africa, King Code of Governance Principles for South Africa, King iv (2016).

³Herein referred to as the 1973 Act.

⁴ DTI ‘Policy Document: South African Company law for the 21st Century Guidelines for Corporate law Reform’ (2004) 7.

⁵ Ibid 19.

⁶ Section 76(3)(b) of the 2008 Act.

⁷ 1972 4 SA 592 (A).

those of its members. The ruling of such a nature reinstates the traditional shareholder centric view⁸ and that is a narrow interpretation of the law. A broader approach is needed in order to cater for other stakeholders who invest in the success of a corporate entity in different ways. A corporation cannot be successful with shareholders alone. It is imperative to make certain arrangements to ensure mutual benefit between the corporation and other corporate stakeholders such as its creditors, employees, consumers and the community at large. A broader meaning should be given to the phrase; “the best interest of a company”, in order to accommodate interests of various stakeholders.

The DTI policy paper asserted that it was imperative that much protection be afforded to shareholders who happened to bear the ultimate risk upon company failure.⁹ The reason for the assertion is based on an understanding that creditors enjoy their investment protection from contract law and that is an upholding of the contractarian theory.¹⁰ The researcher upholds the communitarian theory of the firm which suggests that creditors, amongst other stakeholders in the company, remain in a vulnerable position and should be protected more adequately by mandatory corporate rules.¹¹ Further, contract law does not help creditors in certain circumstances; for instance, where the company undergoes liquidation or business rescue proceedings or where directors commit certain acts which may prejudice the interests of creditors. This is because in such events, those with control powers may abuse the processes in order to suit themselves under the cover of the corporate veil and thus, mandatory rules from legislature should apply in order to specifically protect the interests of creditors.

According to Professor Nwafor ‘the law ensures that the interests of creditors are protected by imposing obligations on the directors to ensure that the affairs of the company are conducted in such a manner as would not jeopardize the recovery by creditors of the debts owed to them by the company’.¹² It is for this cause that the DTI had to ensure that a new Act (the 2008 Act) be enacted in order to replace the SA Companies Act of 1973¹³ so as to reform various areas of South African company law as they needed such reform. Now that the 2008 Act has been enacted, the researcher seeks to examine the way in which the 2008

⁸ A view that a company should be in terms of company law run in a profitable way for the benefit of its shareholders. See B. T CHOKUDA ‘Advancing and Protecting the Interests of Creditors and Employees under the Companies Act 71 of 2008’ unpublished LLM Dissertation, University of Cape Town, 2012, 17.

⁹ Ibid, 35.

¹⁰ The contractarian approach suggests that the market and freedom of contract are adequate factors to protect creditors. See D. Millon, ‘New Directions in Corporate Law: Communitarians, Contractarians and Crisis in Corporate Law’ (1993) 50 Washington and Lee Law Review 1373, 1378.

¹¹ Ibid

¹² AO Nwafor ‘Fraudulent Trading and the Protection of Company Creditors: the Current Trend in Company Legislation and Judicial Attitude’ (2013) Vol 42, *Common law World review*, 298.

¹³ Herein referred to as the 1973 Act.

Act was tailored to protect the interests of creditors and to make findings as to whether the provisions of the 2008 Act meet international standards in so far as it relates to protection of creditors.

1.2. PROBLEM STATEMENT

Creditors, unlike shareholders, do not enjoy control rights in corporate entities. They entrust their assets to corporate entities wherein they do not have the prerogative to closely monitor the manner in which their assets are utilised. All they do is waiting for the returns as per contractual agreements between them and companies. Creditors are therefore third parties who deal with companies from an outsider's position. Sometimes their interests might be at stake as agents of the company (directors and prescribed officers or those with controlling powers) abuse the legal personality of a company under the covering of the 'limited liability doctrine' and the 'separate legal existence doctrine'. Creditors have a financial stake in the company just as shareholders and therefore, their interests should as well be safeguarded in a similar manner as that of shareholders. The DTI policy framework proposed that a company should have as its objective the conduct of business activities with a view to enhancing the economic success of the corporation, taking into account, as appropriate, the legitimate interests of other stakeholder constituencies.¹⁴ The 2008 Act in response indicated the need to provide appropriate redress to third parties and thus protecting a group that does not have control rights in a company's affairs.¹⁵

Traditionally, corporate laws have been enacted to protect the interests of shareholders and creditors have been left out because it was believed that they were protected by contract laws (contractarian theory).¹⁶ From a communitarian theory's perspective and other various theoretical ideologies, it is acknowledged that contract law is not sufficient to cater for the interests of creditors in certain circumstances.¹⁷ Contract law enforces obligations and rights between parties but contract law may not restrict certain wrong acts that might be committed by shareholders and directors as they abuse their control powers. If the acts of those with control powers are not regulated by mandatory corporate rules, then there are high chances that they can run the affairs of the company in such a way that when creditors seek relief under contract they may find it impossible to obtain such relief. For instance, where the company becomes insolvent, directors may alienate the company's assets to unjustly enrich

¹⁴DTI, opcit note 4, 27.

¹⁵See the Preamble of the 2008 Act.

¹⁶ A Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' (2003) Vol 66 No. 5, *The Morden law Reform*, 666.

¹⁷ Ibid.

themselves at the expense of creditors who may not be relieved through contract when payment is due since their security, which is company assets, would have been alienated as a way to deny creditors their entitlements. Contracts are effective where obligations are capable of being fulfilled, that is, where there are sufficient assets to cater for the interests of company creditors in this case. The 2008 Act has laid some mandatory corporate rules that prohibit and restrict power controllers from committing certain acts that may affect the interest of other stakeholders. Thus, the extent to which those mandatory rules or mechanisms or measures, introduced by the 2008 Act, afford relief to the creditors was the subject of enquiry in this research work.

1.3. AIM AND OBJECTIVES OF THE STUDY

1.3.1. Aim

The aim of this research was to ascertain whether it is necessary for creditors to be protected under the 2008 Act and to evaluate the adequacy of creditor protective measures under the Act. This followed a notion that creditors are not supposed to be protected by corporate laws since it is presumed that contract laws give them sufficient protection.

1.3.2. Objectives

To achieve the above aim, the following objectives were pursued;

- The researcher had to determine whether it was justified to protect creditors by mandatory corporate laws. The researcher had to go through a critical analysis of theories behind the nature of the company as well as models of or approaches to corporate governance. Further, a comparative analysis was explored; hence comparing South Africa`s creditor protection laws with those of selected countries/jurisdictions.
- The researcher examined the protective mechanisms that were previously afforded to creditors by the 1973 Act in order to determine whether the 2008 Act developed them for a better protection of creditors.
- The researcher examined the innovative statutorily adopted creditor protective mechanisms and assessed their effectiveness in the advancing and protecting creditor interests.

- The researcher looked into whether the protection afforded to creditors by the 2008 Act is effective and sufficient. The researcher further suggested possible reforms and development of the company law for better protection of creditors.

1.4 RESEARCH QUESTIONS

To effectively carry out the aim and objectives detailed above, the following research questions were asked:

- What significance has been brought by the changes, if any, on the previously legislated protective mechanisms?
- What significance has been brought by the statutorily adopted creditor protective mechanisms in the South African company law?
- Are the mechanisms employed by the 2008 Act effective enough to secure the interests of creditors?
- Is it justified to protect creditor interests by corporate laws despite the protection from contract laws?

1.5. HYPOTHESIS

The research work was underpinned on the hypothesis that even though the 2008 Act had the interests of creditors at heart, a substantial revision of provisions that deal with certain creditor protective mechanisms still needed to be embarked on in order to improve the work that had already been done by legislature.

1.6. SIGNIFICANCE OF THE RESEARCH

This research work is novel in that it serves as a follow up endeavour to determine whether legislature had indeed delivered on its undertaking as contained on the preamble to the 2008 Act. The preamble to the 2008 Act proclaims the need to provide appropriate remedies to investors and third parties. Corporate creditors fall within both the categories of investors and third parties.¹⁸ Moreover, the DTI policy guidelines to the drafting of the 2008 Act had considered the need by corporate entities, where appropriate, to take into account the

¹⁸ DTI, opcit note 4, 37. Creditors are investors in that they enhance the company's capital to assist in the running of the company just as shareholders do although they differ in the nature of relationship with the company (Shareholders are insiders whereas creditors are outsiders).

interests of other corporate stakeholders other than shareholders.¹⁹ It is therefore important to deal with issues that are at the heart of South Africa's new corporate law regime in order to determine whether the new regime has dealt with past flaws and if so to determine whether or not there is still need for development of the new regime in so far as it relates to creditor protection.

Creditors are outsiders in corporate entities; protection of their rights is of essence as they may suffer prejudice as outsiders. Given the fact that the 2008 Act became effective in 2011, many had already looked into this field of study from different angles; the researcher therefore intended to contribute to what already existed. This research work is different from other research works in that it did not explore creditor protection from a general perspective but it examined various creditor protective mechanisms separately in order to determine their contributions towards the overall effectiveness of creditors' protection under the 2008 Act. To sum it up, this research is imperative in that it aimed at the possible reform and development of the South Africa's corporate laws *vis-à-vis* creditors' protection.

1.7. SCOPE OF STUDY

The study was limited to the protection afforded to creditors, amongst other stakeholders, by the 2008 Act and it did not address any issues that relate to protection of other stakeholders except where comparisons were to be made in order to clarify the subject matter. This research had its main focus on the 2008 Act; however references were made to other statutes and laws of other jurisdictions for comparisons. Further, the study had to separately scrutinise each creditor protective mechanism other than looking at creditor protection from a general perspective. Thus, what determined whether the protection afforded to creditors is effective or not was a combination of singular inputs of each creditor protective mechanism.

1.8. PRELIMINARY LITERATURE REVIEW

Marshall and Rossman define literature review as the process of relating a study to the larger, on-going dialogue in information and knowledge, filling in the gaps and extending previous studies.²⁰ Hart opines that the basic requirement for the research student is that they should understand the history of the subject that they intend to study, thus acquiring

¹⁹ DTI, Opcit note 4, 27.

²⁰ C Marshall, G Rossman 'Designing Qualitative Research: Thousand Oaks, CA: Sage Publications' (2006) 23.

sufficient knowledge of the subject area along with comprehending the significance of the work already done in the field.²¹ Hart acknowledges that it is the ideas and work of others that will provide the researcher with a framework for their own work; this includes methodological assumptions, data collection techniques, key concepts and structuring the research into a conventional academic thesis and further that the review distinguishes what has been done from what needs to be done.²² Having regard to the foregoing expositions, the following is an outline of the preliminary literature review in as far as the protection of corporate creditors is concerned.

In response to the debatable question that was raised by the DTI policy paper (in whose interest should a corporation be run?²³), scholars such as Van Der Linde argue for the shareholder primacy model which suggests that a corporate entity should be run in the interests of shareholders. Van Der Linde is of the view that shareholders, unlike other corporate constituencies (employees and creditors), do not contract to fixed returns but to uncertain returns in the form of dividends or in the increased value of shares and a return capital upon winding up when other claims have been paid and they consequently bear the ultimate risk of company failure.²⁴ The researcher agrees that indeed shareholders should be protected by corporate laws; however, other stakeholders should also be protected by mandatory rules to avoid the abuse of power by company controllers. The researcher's view is supported by Lynn and Margaret who are of the view that since all inputs necessary in corporate activities come inseparably and indivisibly from different corporate constituencies, it is difficult to attribute any proportion of the corporation's output to any particular group's contribution.²⁵ The latter view seemingly holds much water as it considers the joint efforts of all stakeholders for a successful corporate entity and for the benefit of all interested parties.

One of the protective mechanisms that have been employed by the 2008 Act is the embodying of the *Turquand* Rule in it.²⁶ Goitse and Ross acknowledge that under the new regime, protection has been afforded to both third parties and the company. They noted the fact that the *Turquand* Rule was legislated in a modified version and thus affording better

²¹ C Hart 'Doing the Literature Review' (1998) 27.

²² *ibid*

²³ DTI, Opcit note 4, 19

²⁴ KE. Van der Linde 'Aspects of regulation of share capital and distribution to shareholders' unpublished PHD thesis, University of South Africa, 2008, 9.

²⁵ AS. Lynn and MB. Margaret 'A team production theory of corporate law: Virginia law review' (1999) Vol. 85 No. 2, 249.

²⁶ See the definition of concepts section below for the description of the *Turquand* Rule at para 1.10.13

protection to creditors.²⁷ The *Turquand* Rule works hand in hand with the constructive notice doctrine²⁸ which was enshrined in the 1973 Act, but which has now been brought in a limited fashion for the advantage of the creditors. The researcher is of the view that legislature did well in limiting the application of the doctrine of constructive notice to ring-fenced companies²⁹ only because it was placing a burden on third parties regardless of the fact that they were dealing in good faith with the company. Third parties should therefore be duly informed when dealing with ring-fenced companies so that they will not fall prey of the rules governing ring-fenced companies.

The sanctioning of directors upon breach of their fiduciary duties is one of the protective mechanisms that have been used by the 2008 Act to protect the interests of creditors. This mechanism protects the interests of creditors in that it deters directors or power controllers from performing certain acts which if not restricted may result in the breach of their fiduciary duties and hence affect the rights of third parties. Cassim avers that under the 2008 Act, the fiduciary duties of directors are mandatory, prescriptive and unalterable and apply to all companies.³⁰ Directors cannot therefore contract outside these duties and the object of these duties is to raise the standards of corporate and directorial behaviour. In addition to that, Cassim³¹ acknowledges that for the first time in the SA Company law, a statutory provision has been enacted in the Companies Act that permits a court to disregard the separate juristic personality of the company which is similar to section 65 of the Close Corporations Act 69 of 1984 (CCA).³² Having had statutory provisions that support the lifting of the corporate veil, the researcher is of the view that directors should be more careful in the exercise of their duties for their commercial crimes may not be escapable since the veil can now be easily removed for the benefit of affected parties like creditors.

In addition to the paragraph above, the 2008 Act³³ strictly prohibits reckless trading and imposes sanctions against fraudulent trading or trading under insolvent circumstances. All

²⁷ P Goitse & F Ross 'A New age for the *Turquand* Rule and the Doctrine of constructive notice: Legal Magazine' (2010) available at <http://www.legalcity.net> (accessed 15 October 2015).

²⁸ See the definition of concepts section below for the description of the constructive notice doctrine at para 1.10.6. The doctrine of constructive notice now only applies to a special type of companies named ring fenced companies and those who deal with such companies should be careful enough to first read the company's memorandum of incorporation in order to identify any special provisions which are unalterable. The doctrine of constructive notice only safeguards the interests of the companies however it has now been dominated by the *Turquand* Rule which serves to creditors except for creditors that deal with ring-fenced companies.

²⁹ See the definition of concepts section for the description of ring-fenced companies at para 1.10.11.

³⁰ FHI Cassim 'The Duties and Liabilities of Directors' in FHI Cassim; MF Cassim; R Cassim; R Jooste; J Shev & J Yeats (eds), *The law of Business Structures* (Juta: Cape town: 2012) 284.

³¹ R Cassim 'The Concept of a Company' in FHI Cassim; MF Cassim; R Cassim; R Jooste; J Shev & J Yeats (eds), *Contemporary Company Law* (2nd ed, Juta: Cape town: 2012) 57.

³² Close Corporation Act 69 of 1984.

³³ Section 22 of the 2008 Act.

these are measures that are set in motion to protect the interests of creditors. It must however be noted that a company cannot operate without incurring debts sometimes as debts are a way of facilitating business. Nwafor asserts that incurring debts is not a reason for invoking provisions against fraudulent trading as there is absolutely nothing wrong with the incurring of debts by the company in the course of doing its business. The concern of the provision is on how such debts are managed by the directors while carrying on with the business of the company.³⁴ Thus, it is in the incurring of debts where the interests of creditors surfaces and the underlying resolution should be on proper management of such debts in order to strike a balance between the interests of the shareholders and those of other stakeholders such as creditors in this case.

Another interesting development in the South African company law is the introduction of the concept of business rescue which is also another envisaged creditor protective mechanism. Nwafor outlines that the underpinning approach of the statutory provisions relating to creditors of the company during business rescue process is essentially that as a result of the *moratorium* which freezes the rights of creditors, they should in return be formally given *quid pro quo*, a right to influence the manner in which the affairs of the company are regulated and a right to vote on the business rescue plan.³⁵ It must however be noted that the business rescue process is not an easy one, it is complex in nature and it is also prone to manipulation for the benefit of a particular group of the company's stakeholders and to the detriment of creditors in whose favour this concept originated. An examination shall be carried out to assess the viability of this concept in advancing the interests of creditors.

Another notable mechanism that was employed by the 2008 Act to protect the interests of creditors is the solvency and liquidity test *in lieu* of the capital maintenance rules. Van de Merwe asserts that the 2008 Act dramatically expands the scope of the application of the liquidity and insolvency test requirement and that the requirement presents itself as a critical protective device in transactions influencing the rights of creditors.³⁶ Thus, it was legislated in a broader way as compared to its previous existence in the 1973 Act; a deeper look into this subject will thus have to be embarked on in order to counter-check these assertions and above all to assess the effectiveness of this protective mechanism in so far as protection of creditors is concerned.

³⁴ Nwafor, Opcit note 12, 303

³⁵ AO Nwafor 'Moratorium in business rescue scheme and the protection of company's creditors' (2017) 13 (1) *Corporate Board: Role, Duties & Composition*, Virtus Interpress.

³⁶ C. P. van de Merwe 'Reconsidering distributions: A critical analysis of the regulation of distributions to shareholders in the Companies Act 2008, with special reference to the solvency and liquidity Requirement' unpublished dissertation, Stellenbosch University (2015) 51.

This research therefore builds on the various assertions that were made so far by various writers referred to in this literature review. Thus, the research paper extends its arms to a deeper and detailed examination of each of the creditor protective mechanisms that were employed by the 2008 Act in order to determine whether they are effective enough to advance the interests of corporate creditors.

1.9. RESEARCH METHODOLOGY

Rajasekar defines research methodology as a systematic way to solve a problem; it is a science of studying how research is to be carried out.³⁷ Methodology specifies the practical application of what is to be studied, how the researcher intends to practically go about the phenomena to be studied. A research method is a strategy of enquiry which moves from the underlying assumptions to research design and data collection.³⁸ Having grasped the meaning of research methodology, the researcher utilised the methodology of examining available data (doctrinal approach). The doctrinal approach entails rigorous study and analysis of law in detail. It is characterised by the study of legal texts hence 'black letter law'. In so doing, the researcher embarked on intensive library research and the use of internet sources in order to access both primary and secondary sources of law.

In order to process the acquired information, the researcher employed the descriptive, analytical, critical, comparative and prescriptive techniques. The descriptive technique was used in that there was an overall overview of the history or background of company law in as much as it relates to protection of creditors, thus a look into the evolution of various creditor protective mechanisms that have been employed by the 2008 Act. The analytical technique was used to evaluate and examine the effectiveness of various creditor-protective mechanisms that have been employed by the 2008 Act. The critical technique was used in conjunction with the analytical technique and it was mainly used to challenge the status *quo*, thus fault finding with intentions to address the flaws.

In addition to the techniques abovementioned, the comparative technique was used to compare the 2008 Act and the 1973 Act, as well as common law in so far as it relates to the protection of creditors. Further, the researcher used the comparative technique to compare South African company law with laws in other leading jurisdictions, thus assessing South

³⁷ Rajasekar S, Pitchai PN & Chinnathambi V 'Research Methodology' (2006) 5, Available at https://www.researchgate.net/publication/2174858_Research_Methodology/download (Accessed on 16 August 2015).

³⁸Ibid.

Africa`s creditor protection laws with international standards. Lastly, the prescriptive technique was utilised in order to propose recommendations for the development of creditor protection laws or for possible amendments to curb any flaws that were identified in the South African company law in so far as corporate creditors` protection is concerned.

1.10. DEFINITION OF KEY WORDS/ CONCEPTS

1.10.1. Business rescue

‘Business rescue’ in the 2008 Act entails proceedings to facilitate the rehabilitation of a company that is financially distressed by providing for the temporary supervision of the company, and of the management of its affairs, business and property; a temporary moratorium on the rights of claimants against the company or in respect of property in its possession; and the development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximises the likelihood of the company continuing to be in existence on a solvent basis or, if it is not possible for the company to continue being in existence, results in a better return for the company’s creditors or shareholders than would result from the immediate liquidation of the company.³⁹

1.10.2. Company

A company is a legal entity, allowed by legislation, which permits a group of people, as shareholders, to apply to the government for an independent organisation to be created, which can focus on pursuing objectives, and empowered with legal rights which are usually only reserved for individuals, such as to sue and be sued, own property, hire employees or loan and borrow money.⁴⁰ Section 1 of the 2008 Act defines a “company” as a juristic person incorporated in terms of the 2008 Act, or a juristic person that, immediately before the effective date (a) was registered in terms of the 1973 Act, other than as an external company as defined in that Act; or (ii) Close Corporations Act, 1984 (Act No. 69 of 1984), if it has subsequently been converted in terms of Schedule 2; and or (b) was in existence and recognised as an ‘existing company’ in terms of the 1973 Act and or (c) was deregistered in terms of the 1973 Act and has subsequently been re-registered in terms of the 2008 Act.

³⁹Section 128(1)(b) of the 2008 Act.

⁴⁰ ‘Duhaime’s Law Dictionary’ available at <http://www.duhaime.org/LegalDictionary/C/Company.aspx> (accessed on 18 October 2015).

1.10.3. Company Controllers

In this research, this refers to company directors who are vested with power to run companies, together with shareholders who indirectly control companies through their voting powers.

1.10.4. Creditor

Both the 1973 Act and the 2008 Act do not define the word “Creditor” hence the researcher resorts to other sources for such definition. A party to whom money is owed maybe as a result of having lent money to the person owing them (debtor) or as a result of having supplied goods and services on credit. The word ‘creditor’ as judicially defined, is not restricted to those who have present claims against the company, but extends to prospective creditors having future claims against it.⁴¹ Common classifications of creditors include;

- Secured creditor: a creditor who has a legal right to take a specific property of the borrower and sell it in case of a default.
- Unsecured creditor: a creditor who does not have any such right as a secured creditor and is at high risk should the debtor become insolvent.
- Preferential creditor: a creditor who takes precedence over other creditors in laying claim to a bankrupt borrower's property.⁴²

1.10.5. Creditor Protective mechanisms

In this research work, these are mechanisms, measures, doctrines, concepts or corporate principles that were employed by the 2008 Act to protect the interests of creditors. They are but not limited to; business rescue concept; compromise; liquidation; *Turquand* rule; the sanctioning/ liability of directors and prescribed officers; solvency and liquidity test; piercing the corporate veil; enforcement mechanisms.

1.10.6. Creditor Compromises

A compromise is an agreement that is entered into between a company and its creditors or any class of its creditors, whether or not the company is financially distressed, for there to be a compromise as to the company`s financial obligations towards its creditors. The

⁴¹Nwafor, opcit note 12, 312.

⁴² ‘Business Dictionary’ available at

<http://www.businessdictionary.com/definition/creditor.html#ixzz3ouvrhLG> (accessed on 18 October 2015)

compromise is sanctioned by the court when parties have reached consensus and the sanctioning is binding on the company's creditors concerned.⁴³

1.10.7. Corporate Constituencies or stakeholders

Corporate Constituencies are stakeholders of the corporate entity or people who have an interest in the affairs of the company. This includes Creditors; Debtors; Shareholders; Employees, Trade Unions etc.

1.10.8. Directors

In terms of section 1 of the 2008 Act, a director" means a member of the board of a company, as contemplated in section 66, or an alternate director of a company and includes any person occupying the position of a director or alternate director, by whatever name designated. Basically directors are vested with powers and authority to run companies on behalf of shareholders.

1.10.9. Doctrine of constructive notice

The doctrine of constructive notice entails that, a third party, when dealing with a company, is deemed to have knowledge of the contents of a company's public documents. As such, the third party, when contracting with the company, should appraise themselves with the contents of the Memorandum and Articles of association of that company in order to confirm that the individual representing the company in the contractual negotiations is, in fact, authorised to do so. Should that individual not be so authorised then the person would be acting beyond the scope of their authority, and as such the contract would be *ultra vires* the rules of the company and, as such, is not enforceable against the company.⁴⁴

1.10.10. Enforcement mechanisms

These are mechanisms that were created by the 2008 Act in a bid to ensure accessibility of justice by all people affected in way due to non-compliances with the 2008 Act. This includes the creation of the Companies Tribunal, the companies Commission, the Takeover Regulation Panel. Also, this includes the extension of *locus standi* to several stakeholders giving them a right to approach court either for themselves or on behalf of others or in a group, thus making legal proceedings convenient. In terms of the 2008 Act, "Companies Tribunal" means the Companies Tribunal established in terms of section 193. Section 195

⁴³Section 155 of the 2008 Act

⁴⁴ Van der Linde KE 'Aspects of regulation of share capital and distribution to shareholders' unpublished PHD thesis, University of South Africa, 2008, 4.

provides that the functions of the Tribunal are to (a) adjudicate in relation to any application that may be made to it in terms of the 2008 Act and make any order provided for in the Act in respect of such an application; (b) assist in the resolution of disputes as contemplated in Part C of Chapter 7 of the 2008 Act; and to (c) perform any other function assigned to it by or in terms of this Act, or any law mentioned in Schedule 4 of the 2008 Act.

The Companies Commission or commission means the Companies and Intellectual Property Commission (CIPC) and it is established by section 185 of the 2008 Act. Section 187 of the 2008 Act sets that, save for matters within the jurisdiction of the Takeover Regulation Panel, the Commission must enforce the 2008 Act, by, among other things (a) promoting voluntary resolution of disputes arising in terms of the Act between a company on the one hand and a shareholder or director on the other, as contemplated in Part C of Chapter 7, without intervening in, or adjudicating any such dispute; (b) monitoring proper compliance with the 2008 Act; (c) receiving or initiating complaints concerning alleged contraventions of the Act, evaluating those complaints, and initiating investigations into complaints; (d) receiving directions from the Minister in terms of section 190 of the Act, concerning investigations to be conducted into alleged contraventions of this Act, or other circumstances, and conducting any such investigation; (e) ensuring that contraventions of this Act are promptly and properly investigated; (f) negotiating and concluding undertakings and consent orders contemplated in section 169(1)(b) and 173 of the 2008 Act; (g) issuing and enforcing compliance notices; (h) referring alleged offences in terms of this Act to the National Prosecuting Authority; and (i) referring matters to a court, and appearing before the court or the Companies Tribunal, as permitted or required by the 2008 Act.

The Takeover Regulation Panel is a panel established in terms of section 196 of the 2008 Act. Section 201 of the 2008 Act sets that the Panel is responsible for (a) regulating affected transactions and offers to the extent provided for, and in accordance with, Parts B and C of Chapter 5 and the Takeover Regulations; (b) investigating complaints with respect to affected transactions and offers in accordance with Part D of Chapter 7; (c) applying for a court order to wind up a company, in the manner contemplated in section 81(1)(f); and (d) consulting with the Minister in respect of additions, deletions or amendments to the Takeover Regulations.

1.10.11 Investor

An investor is a person who commits capital in any form with the expectation of financial returns. In this research corporate investors refer to shareholders, employees and creditors as depicted in the DTI Policy paper.⁴⁵

1.10.12. Liquidation

Liquidation is the procedure under which a company is dissolved (or wound up). Liquidation maybe voluntary (where the company is solvent but where the purposes for which it was set up have been achieved or no longer exist) or compulsory (usually where the company is insolvent). The function of a liquidator is to convert the assets of the company into cash, which is then distributed among the creditors to pay off (so far as possible) the debts of the company. Any surplus is then distributed among the members.⁴⁶

1.10.13. Piercing the corporate veil

When the veil of incorporation is pierced or lifted, the court acts to strip the protective covering of the limited liability presented by the company structure such that shareholders/ or directors can be held personally liable for the actions influenced by them in the company`s affairs.⁴⁷

1.10.14. Solvency and Liquidity test

Basically the concept entails that the company`s assets must exceed its liabilities, and it must appear that the company will be able to pay its debts as they become due for a period of twelve months. Generally, the test will be an accounting exercise as the 2008 Act stipulates how the various values are to be calculated and what assets and liabilities are to be taken into account.⁴⁸

1.10.15. Shareholder

Subject to section 57(1) of the 2008 Act, a shareholder means the holder of a share issued by a company and who is entered as such in the certificated or uncertificated securities register, as the case may be.⁴⁹

⁴⁵ DTI, opcit note 4, 37

⁴⁶Farlex 'The Free Dictionary' available at <http://legal-dictionary.thefreedictionary.com/liquidation> (accessed on 25 October 2015)

⁴⁷ See chapter 4; paragraph 4.3.

⁴⁸Tomlinson Mnguni James Attorneys 'Solvency and Liquidity' Law talk: Newsletter (2011) Available at <http://www.tmj.co.za> (accessed on 15 October 2015)

⁴⁹ Section 1 of the 2008 Act. See also section 57(1) of the 2008 Act which restricts the definition of shareholder to part F of the 2008 Act.

1.10.16. *Turquand* rule

The *Turquand* rule states that it is permissible for the third party contracting with the company to presume that such internal procedures have been complied with. Where such internal procedures have not been followed, and the person contracting on behalf of the company does not, in fact, have the authority to do so, such a contract is referred to as a limping contract and is enforceable, and capable of being cancelled at the instance of the third party.⁵⁰

1.11. ETHICAL CONSIDERATIONS

The researcher honestly used acquired information, without distortion of the truth or misrepresentation thereof. The researcher did not fabricate data to support his conclusions, and he acknowledged all sources, thus he avoided plagiarism or academic shoplifting.

1.12. LIMITATIONS OF THE STUDY

This research work was limited in that it relied mainly on primary and secondary sources of law or the use of already existing information. The findings were therefore limited to information that was already available. A direct physical engagement with directors of companies could have helped answer the research questions from a practical point of view rather than a theoretical point of view. In order to assist addressing this limitation, decided case laws were therefore invoked. This follows that case laws are practical and they reflect a true position of the courts` interpretation of legislative provisions to give meaning to the true intention of legislature. The researcher was also limited as he could not access reports from the Companies Commission and Takeover Regulation Panel and decisions of the Companies Tribunal, to date hereof, which are related to creditors` protection for the development of paragraph 4.4 in this research. This has thus been left for further research where one would be expected to approach these institutions in person to access such records if any.

1.13. STRUCTURE (OVERVIEW OF CHAPTERS)

1.13.1. Chapter 1: Introduction

This chapter outlines the background, problem statement, aim and objectives of the study, significance of the study, hypothesis; scope of the study, methodology, definition of terms/concepts, ethical considerations and limitations of the study.

⁵⁰Section 20 (8) of the 2008 Act.

1.13.2. Chapter 2: Theoretical Basis for Creditor Protection

This chapter justifies creditor protection through looking at issues pertinent to creditor protection other than creditor protective mechanisms. It answers certain relevant questions such as; in whose interest should a corporate entity be run? What is the meaning of the phrase “best interests of the company” as in section 76(1)(b)? Which view is envisaged by 2008 Act, Shareholder centric view, shareholder enlightened value approach or team production theory/stakeholder approach? This chapter looks into other legal systems in so far as creditor protection is concerned such as English law where most of SA’s corporate law draws its basis. In *toto*, this chapter provides a theoretical debate on creditor protection related issues.

1.13.3. Chapter 3: Re-enacted Creditor-Protective Mechanisms

This chapter deals with creditor protective mechanisms that were previously employed by the 1973 Act and which have been re-enacted by the 2008 Act. Thus it is a comparative examination that determines whether the respective creditor-protective mechanisms have been improved and/or developed to provide effective creditor protection.

1.13.4. Chapter 4: The Innovative Statutorily Adopted Creditor-Protective Mechanisms

This chapter deals with Statutorily Adopted creditor-protective mechanisms as provided for in the 2008 Act, thus, an examination of their effectiveness in affording creditor protection.

1.13.5 Chapter Five: Conclusions and Recommendations

This chapter gives a brief overview of the whole thesis, conclusions of the research and recommendations which may influence future directions and possible amendments to South Africa’s corporate law in this regard.

1.14. CONCLUSION

Having introduced the subject of enquiry in this research work, the researcher shall therefore propound in detail his findings in succeeding chapters. What follows henceforth is chapter two which seeks to justify creditor protection by mandatory corporate laws which is contrary to the views that creditors need no protection from mandatory corporate laws as they are protected by contract laws. It is then after justifying creditor protection by corporate laws that the researcher will explore the various creditor protective mechanisms that have been employed by the 2008 Act in order to assess their effectiveness in advancing creditors’ interests in company affairs.

CHAPTER 2

THEORETICAL BASIS FOR CREDITOR PROTECTION

2.0. INTRODUCTION

Corporate entities are sometimes compelled to procure assets on a credit basis. What propel them to incur debts are such situations which can be best dealt with by procuring debts to the advantage of the business. It is trite that credit transactions are recognised aids in the ordinary course of running businesses. Thus, it is normal for a company as a going concern to incur debts in the ordinary course of carrying on its business.⁵¹ When such debts have been incurred for the benefit of the company, the question that arises is whether the interests of creditors are to be protected. If such interests are to be protected, the question that follows is, “who bears the burden to protect such interests?” Is it the creditors themselves who bear such a burden or directors who control the company?

Granted that the creditors may make use of available remedies such as contract enforcements, they however do not have direct access to control the manner in which directors administer their assets. The moment creditors invest assets in an entity, certain rights and obligations are created between them and the company, hence establishing contractual agreements where parties hold interests ensuing from such transactions. Initially such interests are protected by the terms of the contract. In other words, the creditors are safe to the extent that contract law covers them; put differently, they are safe as long as the matter that arises between them and the companies falls within the ambits of the terms of the contractual agreements.

The problem arises in instances where a matter that is not covered by contractual terms arises between parties or where such contracts become incapable of being enforced. A contract sometimes becomes unenforceable where the subject matter of the contract is rendered inaccessible. For instance, where directors have intentionally alienated assets that could secure the interests of creditors and hence creditors find nothing to rely on upon enforcing their claims. In such situations, creditors’ interests should be protected by mandatory corporate laws that bind those with direct control over the affairs of the company. Thus, the rules would prevent directors from engaging in transactions that would prejudice the interests of creditors. They could be held personally liable for engaging in such

⁵¹ Nwafor, opcit note 12, p 297-8.

transactions.⁵² In the premises, one would want to know whether directors owe a duty to creditors or whether section 76(3)(1)(b) includes creditors' interests in the phrase "best interests of the company".⁵³ Thus, the researcher shall endeavor to find answers to various questions raised above and to explore various angles pertinent to creditor protection in an attempt to justify creditor protection by mandatory corporate laws.

2.1. EFFECTS OF INCORPORATION OF A COMPANY ON CREDITOR PROTECTION

2.1.1 Separate legal existence

The doctrine of separate legal existence of a company is a cardinal principle in company law. The doctrine is affirmed by section 19(1)(b) of the 2008 Act as it provides that, from the date and time the incorporation of a company is registered, the company has all the legal powers and capacity of an individual, except to the extent that a juristic person is incapable of exercising any such power or having any such capacity, or except to the extent that the company's memorandum of incorporation provides otherwise.⁵⁴ In the leading case on this principle, Lord Macnaghten held that the company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of its subscribers or a trustee for them.⁵⁵ Even though the juristic person is merely a legal fiction and as such has no physical existence, the principle endows a company with powers to acquire rights and obligations which are distinct from those of its directors and shareholders. Thus, the company exists separately from its shareholders, its assets and liabilities are separate from those of its members; the company becomes the so called 'artificial/ juristic/ juridical/ fictitious/ legal person'.

The doctrine of separate legal existence of a company could be subjected to abuse by directors and shareholders. Company controllers sometimes engage in conducts which negatively affect the interests of certain stakeholders. These controllers do so under the shield of the doctrine of separate legal existence of the company. They know that their acts are attributed to the company itself and they are treated as having been committed by the company as the principal to its agents who are directors. In some instances such abuses prejudice the interests of creditors who are outsiders in company affairs. This has been recognised by both courts and legislature, hence the need for exceptions to this principle in

⁵² See section 22 & 214 of the 2008 Act.

⁵³Section 76(3)(1)(b) of the 2008 Act.

⁵⁴Section 19(1)(b) of the 2008 Act.

⁵⁵*Salomon v Salomon & Co Ltd* [1897] AC 22 (HL) at 51.

order to curb extreme cases of abuse, in the form of the machinery of piercing or lifting the corporate veil.⁵⁶ Thus several remedies are availed by the 2008 Act to the creditors against hardships that may be caused by the company`s directors or any controlling shareholders in the conduct of the company`s affairs.⁵⁷

2.1.2. Limited liability principle

According to Cassim, limited liability means that the liability of the company`s shareholders is limited to the amount they have subscribed for shares.⁵⁸ In general, this means that should a company be insolvent, the shareholders will only loose to the extent of the value of their share subscription amounts and not anything beyond that. In the premises, a creditor will only be entitled to claim any balance of the amount used for subscription of shares by shareholder (which forms capital) provided there is any outstanding amount, without which creditors can only resort to assets of the company and not individual assets of shareholders. Thus, in *Airport Cold Storage (Pty) Ltd v Ebrahim*⁵⁹ it was held that with limited liability, shareholders are as a general principle not liable for the debts of the company. Shareholders are therefore protected by this principle from any claims that arise against the company; such claims are confined to the company`s assets and not personal assets of the shareholders. A person is not, solely by reason of being a shareholder or director of a company, liable for any liabilities or obligations of the company, except to the extent that the Act, or the company`s MOI provides otherwise.⁶⁰ This however does not apply to personal liability companies where directors tacitly undertake personal liability.⁶¹ Save for personal liability companies, directors and shareholders of companies find the limited liability principle to be of paramount importance as it encourages them to invest in business ventures knowing that their personal assets are safe and treated separately from those of the company itself and thus averting the harsh effects of insolvency or bankruptcy law in the event of business failure.⁶²

The limited liability principle is one of the core principles of company law. This principle limits the risk of investing funds in a business venture and thus encourages the growth and

⁵⁶R Cassim 'The Concept of a Company' opcit note 31, 28.

⁵⁷ See section 20(9) of the 2008 Act dealing with the principle of piercing the corporate veil; section 22 preventing reckless trading; section 214 imposing criminal sanctions on participants to fraudulent activities against third parties and section 218 imputing civil liability thereof.

⁵⁸R Cassim, opcit note 31, 35.

⁵⁹ 2008 (2) SA 303 (C) para 6.

⁶⁰See section 19(2) of the 2008 Act.

⁶¹See section 19(3) of the 2008 Act where it is stated that in a personal liability company directors and past directors of a personal liability company are jointly and severally liable, together with the company, for any debts and liabilities of the company that were contracted during their respective periods of office.

⁶²See *Salomon v Salomon & Co Ltd* [1897] AC 22 (HL) at 52.

expansion of companies, which is of crucial importance to the economy because successful companies generate wealth and employment.⁶³ The general essence of this principle is economically of sound benefit to the business world. On the other hand, this principle has been abused by company controllers. Several cases arise where the original notion of the principle is lost and directors or shareholders engage in conducts which affect the interests of creditors knowing that they are covered by the limited liability principle.

According to Corkery, limited liability was supposed to encourage investment in commercial endeavors but with time it became clear that some of the investors in limited liability companies, in particular unsecured creditors, had lost much; limited liability was often enjoyed at their expense.⁶⁴ Grundfest argues that there is concrete evidence to the fact that limited liability perpetuates a notable increase in a corporation's willingness to engage in risky behavior.⁶⁵ If directors were personally liable for debts and liabilities of a company then even their conduct could be of great caution. Mandatory corporate laws are therefore needed to control the risky behavior that company controllers may engage in order to further their personal interests at the expense of creditors. This therefore justifies the need for legislative provisions such as sections 20(9), 22, 214, etc of the 2008 Act in order to protect interests of creditors. In the succeeding chapters, a detailed exploration of remedies availed for creditors by mandatory corporate laws shall be expounded.

2.1.3. Other consequences of incorporation of a company

In addition to separate legal existence and limited liability principles, one of the consequences of incorporation of a company is the continued existence of a company even after death of its members, or changes in its membership, or transfer of shares or any other cause, that is, perpetual succession.⁶⁶ The importance of this attribute to the interests of creditors is that there is security of pursuing one's claim in an entity. A creditor will not be surprised to find that he has nowhere to claim since a company has been closed by virtue of death of its members or any other reasons. A company's existence is therefore separate from the personal lives or choices of its shareholders.

Another consequence of incorporation of a company is the assertion that the property and assets of the company belongs to the company itself and not to its members. In

⁶³R Cassim, *opcit* note 31, p 35.

⁶⁴Corkery JF 'Defaulting Director/Guarantors – Recovering Money from Company Officers for Creditors' (1986) *Vol 10, Adelaide Law Review*, 492.

⁶⁵Grundfest JA 'The Limited Future of Unlimited Liability: A Capital Market Perspective' (1992) *Vol 102 Yale Law Journal* 387.

⁶⁶*Maasdop v Haddow* 1959 3 SA 861 (C) 866.

Stellenbosch Farmers Winery Ltd v Distillers Corporation SA Ltd,⁶⁷ it was held that the fact that the shareholder is entitled to a proportional share in the distribution of surplus assets when the company is wound up proves that he is financially interested in the success of the company but not that he has any right or title to any assets of the company. This attribute is crucial to creditors in that in most cases they secure their interests on assets of a company which is indebted to them and as such no shareholder can claim personal ownership of company assets. Thus, creditors' claims are therefore secured as they are preferred over shareholders in the event of business failure (liquidation) or in sequestration proceedings upon insolvency.

In addition to the above discussed consequences, the debts and liabilities of the company belong to the company and not to the members of the company. This consequence is applicable to limited liability companies. Positively, this places creditors at ease in that they know who exactly they are contracting with and who is liable, that is, the company. This consequence is however a defence that maybe raised against creditors' claims by shareholders and directors should creditors wish to claim directly from the company controllers. The position is however different with personal liability companies where both present and past directors are jointly and severally liable, together with the company, for any debts and liabilities of the company that were incurred during their respective periods of office.⁶⁸ Thus, creditors can freely claim their interests against both the company and its controllers in a personal liability company but not in a limited liability company where they are required to claim against the company's assets.

The incorporation of a company also entails that the profits of a company belong to the company itself and not to its members. It is regarded as theft for a shareholder to appropriate for him/herself the company's profits or funds for personal gain.⁶⁹ Shareholders are only entitled to dividends when declared by the company. In *S v De Jager*,⁷⁰ the court held that an act of misappropriation of funds offends the principles underpinning the concept of separate legal existence doctrine as it asserts that a company is a separate legal person and owns the funds of a company; the directors manage the affairs of the company in a fiduciary capacity and shareholders' general right over the assets of the company surfaces only at winding up, subject to claims of creditors. In line with the separate legal personality concept, allowing shareholders and directors to take company assets for themselves would

⁶⁷ 1962 (1) SA 458(A), 472, See also *Dadoo Ltd v Krugersdorp Municipality Council* 1920 AD 530.

⁶⁸ Section 19(3) of the 2008 Act.

⁶⁹ *S v De Jager* 1965 (2) SA 616 (A).

⁷⁰ *Ibid*, 625.

be offending this principle. All it therefore means is that the concept has a restraining effect on how directors and shareholders should deal with the company property because the property and assets are not theirs. Thus, the distribution of the company's profits should be in a way that, in addition to the benefit of shareholders, promotes fair returns for third parties who risk their financial assets for the company's benefit.

Moreover, a shareholder has no right to manage the company's business or to enter into transactions on its behalf. A shareholder is not an agent of the company. Only authorized persons are supposed to act on behalf of the company. Shareholders may only act on company's behalf when authorized to do so or when a shareholder is employed by a company under a contract of service. The contracts entered into by the company are for the company itself and not shareholders.⁷¹ Thus, creditors know exactly who to approach when dealing with the company and thus avoiding dealing with unauthorized persons.

Lastly, another attribute ensuing from incorporation of a company is the fact that a company may sue or be sued in its own name. Where creditors have dealt with a company, they have right of recourse against the company itself if the company breaches its obligations in terms of such agreements. The company in its own capacity may as well institute action against a creditor/ supplier who fails to abide by the contractual terms or obligations under such contracts.⁷² This attribute therefore ensures convenience for creditors in their dealings with companies as they do not have to be burdened with the cumbersome work of suing individual shareholders or directors but specifically the company itself.

It could therefore be said that the consequences of incorporating a company are designed in such a way as to protect the interests of both controlling and non-controlling stakeholders, such as creditors in this case, whilst at the same time promoting good relationships with the company and its stakeholders in a way that benefits the company and all its stakeholders. On the other hand, it should be noted that some of the consequences of incorporating a company only benefit shareholders at the expense of other stakeholders such as creditors, for instance, the limited liability principle which is prone to abuse. Thus, South Africa's corporate laws are to a considerable extent designed to protect the interests of creditors beyond the protection afforded by contract law.

⁷¹*Kuwait Asia Bank EC V National Mutual Life Nominees Ltd* [1990] 3 All ER 404 (PC) 423.

⁷²Cassim, *opcit* note 31, pp 39, 40, 41.

2.2. SCHOOLS OF THOUGHTS UNDERLYING THEORIES OF CORPORATE GOVERNANCE

There are different schools of thoughts that underlie theories of corporate governance. There are three main theories of corporate governance which are the shareholder value approach, the enlightened shareholder value approach and the Pluralist approach. A predisposition of any of these theories in a particular jurisdiction depends on a school of thought that would have been accepted therein. For instance, a jurisdiction that favours the shareholder value approach would have drawn its basis from ideas advanced by contractarian scholars. The contractarians suggest that creditors need no protection from mandatory corporate laws as it is believed that creditors are protected by contract laws.⁷³ A school of thought of such a nature considers shareholders as the only stakeholder constituency deserving protection from the duties of a director. It is therefore important to explore these schools of thoughts that influence theories of corporate governance before examining the actual theories of corporate governance. The various schools of thoughts to be discussed below are the contractarianism, communitarianism, dual-concessionarism and associativism.⁷⁴

2.2.1. Contractarianism

Contractarianism is a school of thought that focuses on the contractual relationships that exist between stakeholders of a company and thus holds to the principle of the ultimate importance of contract.⁷⁵ Many contractarians regard the company as almost a number of complex, private and consensual contract-based relations, either express or implied consisting of many different kinds of relations that are maintained by those willingly associating in a company.⁷⁶ The parties involved in these contracts are regarded as rational economic actors and thus including all stakeholders of a company. It is accepted that each of these stakeholder constituencies endeavour in their dealings to ensure that they secure desirable returns for themselves.⁷⁷

This school of thought is usually termed as ‘a nexus of contracts.’ The school of thought, while allowing that implied contracts may be incomplete and that discrepancies may be articulated by corporate laws, is against the mandatory application of corporate laws and

⁷³ Keay A, *Opcit* note 16.

⁷⁴ J Dine, *The Governance of Corporate Groups*, (Cambridge: Cambridge University Press, 2000) 1. For the associative theory see D Wishart ‘Models and Theories of Directors’ Duties to Creditors’ (1991) *Vol. 14 New Zealand Universities Law Review*,323.

⁷⁵Keay, *opcit* note 16, 672.

⁷⁶ F. H. Easterbrook and D. R. Fischel ‘The Corporate Contract’ (1989) *Vol. 89, Columbian Law Review*,1416, 1426.

⁷⁷ H. N. Butler ‘The Contractual Theory of the Corporation’ (1989) *Vol. 11, George Mason University Law Review*,99.

suggests that parties must be free to “opt out” of the rules where they are not comfortable.⁷⁸ The nexus of contracts theory has been criticised by many scholars as they are against the idea of regarding a company as a nexus of incomplete contracts.⁷⁹ Contractarianism however has been quite influential in shaping company law doctrines of corporate governance. It is thus argued by some scholars that the contractarian school of thought as developed by law and economics scholars dominates the theory of corporate law.⁸⁰

There are two forms of contractualism ideologies namely legal contractualism and economic contractualism.⁸¹ Legal contractualism creates an entity that is free from mandatory corporate laws and upholds the view that an entity is a result of consensual contracts between the corporate entity and its members to the exclusion of other stakeholders.⁸² Other scholars beg to differ as they suggest that there is scope for recognition of contractual terms between the company and non-shareholder constituencies within contractarianism.⁸³ The latter is a wider view of Contractarianism as it is based on this school of thought that creditors cannot be protected by corporate laws since they enjoy protection from contract laws. On the other hand, economic contractualism avers that the nature and form of the corporation is explained on the basis of bargaining issues, rather than legislation, which is considered to have only limited impact on any corporation.⁸⁴ Thus, an entity is seen as an association of shareholders with a view to pursue economic gain and thus contracting with the corporate entity.

Contractarianism opposes the protection of creditors by corporate laws as it asserts that protective measures for creditors’ interests are limited to terms in the actual contract

⁷⁸Keay, *opcit* note 16, pp 672-3.

⁷⁹See S. Deakin and A. Hughes ‘Economic Efficiency and the Proceduralisation of Company Law’(1999) *Vol. 3 California Law Review*,169; W. Bratton Jr ‘The “Nexus of Contracts Corporation”’: A Critical Appraisal’ (1989) *Vol 74 Cornell Law Review*,407, 412.

⁸⁰ Whincop “Painting the Corporate Cathedral: The Protection Entitlements in Corporate Law” (1999) *Vol. 19, Oxford Journal of Legal Studies*, 30.

⁸¹Dine, *opcit* note 74, pp 3-12.

⁸² *Ibid*, 6. For a statutory manifestation of this concept see section 65(2) of the repealed 1973 Act which states that 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. Same applies with 15 (6) of the 2008 Act which states that a company's Memorandum of Incorporation, and any rules of the company, are binding between the company and each shareholder; between or among the shareholders of the company; and between the company and each director or prescribed officer of the company; or any other person serving the company as a member of the audit committee or as a member of a committee of the board, in the exercise of their respective functions within the company.

⁸³ J Dean ‘Stakeholding and Company Law’ (2001) *Vol. 22 No. 3, The Company Lawyer*, 66, 67.

⁸⁴ B. R. Cheffins ‘Company Law: Theory, Structure and Operation’ (1997) *Vol. 41, Canadian Business law Journal*, 233.

between them and the company.⁸⁵ In other words, creditors enjoy protection from contract laws and they are therefore entitled to make use of contractual remedies should their rights in terms of the contract be infringed. The contractarian school of thought is therefore an inspiration to the shareholder value approach as it recognises the contractual relationship of shareholders and the corporate entity to the exclusion of other stakeholders. Thus, stakeholders, other than shareholders, are expected to derive their protection from separate laws other than corporate laws.

2.2.2. Communitarianism

This school of thought is an opposite of contractarianism which primarily values the rights of shareholders of the company. Under this school of thought, directors' duties are redefined as being in the interests of various corporate stakeholders. This school of thought suggests that mutually benefiting and productive relationships will only be optimised where directors are allowed to balance shareholders' interests with those of other important but non-shareholder constituencies.⁸⁶ A company should therefore have as its objective the conduct of business activities with a view to enhancing the economic success of the corporation, taking into account, as appropriate, the legitimate interests of other stakeholder constituencies.⁸⁷

This school of thought is criticised mainly because the granting of the company's status is modelled by the state and thus creating an instrument for the state to utilise for its own ulterior motives. The aims of the company should therefore be identified with those of the society and that is a misdirection of the company from commercial goals in favour of politically diffused goals.⁸⁸ When it comes to protection of stakeholders by corporate laws, it must be noted that creditors deserve as much as shareholders because they also have a financial stake in the company. Employees at least are protected by both contract and statute in South Africa which gives them much security. The society is protected by different laws such as environmental laws as well as policies of social responsibility and sustainable development related measures. It is thus argued that since the company is more of an economic oriented vehicle than a social orientation more and better protection should be given to stakeholders with a financial stake in the company.

⁸⁵ Keay, *opcit* note 16, 673.

⁸⁶ DTI, *opcit* note 4, 25.

⁸⁷ *Ibid.*

⁸⁸ Dine, *opcit* note 74, 17.

Communitarianism however has its arms wide open to accommodate protection of all stakeholders of the company. A company in a jurisdiction that is inspired by this school of thought may be prone to diffusion of goals and thus losing the economic essence of a company. Holding directors accountable to all stakeholders may be a burdensome duty which may be incapable of being fulfilled.⁸⁹ Although this school of thought has a positive impact on protection of creditor interests, it still proves not to be ideal for business and thus not investor friendly. Thus, save for shareholders and creditors, other stakeholders should be protected by different laws other than corporate laws which are, according to the researcher's view, prescribed for those stakeholders with a direct financial stake in the company.

2.2.3. Dual-Concessionarism

With this school of thought, a company is regarded as an economic arena where contractors convene for business adventures yet conceding to the fact that a company has a separate legal identity. The wishes of the original owners can no longer be considered paramount.⁹⁰ Proponents of this school of thought recognise the separate legal existence status of a company and the operation and existence of the company is viewed as a concession by the state wherein the company's shareholders enjoy limited liability subject to terms and conditions.⁹¹ The difference between communitarianism and concessionarism is that supporters of the latter accept that the state has a limited role to play in ensuring that corporate governance structures equally cater for all stakeholders but do not force the company to realign its aims to reflect the social goals of the state.⁹²

This school of thought has influence on the enlightened shareholder value approach as it suggests that the interests of the company can no longer be assumed to be those of the original contracting partners, thus creating the opportunity for shareholders, as well as other stakeholders, to have their interests considered.⁹³ The other difference between this school of thought and communitarianism is that the company still maintains its commercial goals unlike in communitarianism where commercial goals are diffused with state driven political goals. In other words, the original notion of a company realising profits for the benefit of shareholders is maintained while at the same time catering for interests of other stakeholders although subjected to shareholder interests. The flaw in this school of thought

⁸⁹ B. Chapman 'Corporate Stakeholders, Choice Procedures and Committees' (1995-6) *Vol. 26 Canadian Business Law Journal*, 211-213.

⁹⁰Dine, *opcit* note 74, p 26.

⁹¹*Ibid*, 22.

⁹² *Ibid*, 21.

⁹³*Ibid*, 28.

are such that it does not determine the extent to which interests of various corporate constituencies are to be considered. This therefore leaves creditors uncertain as to the degree to which their interests may be regarded.

2.2.4. Associativism

According to Wishart, this school of thought considers a company as an association of members who aim at contributing capital and the capital that they contribute determines the purpose, organisation and criteria of membership.⁹⁴ Of crucial importance to the protection of creditors is the notion behind this school of thought; it asserts that contributors of capital are not limited to shareholders but also creditors who provides the debt capital in times of need and hence they form part of the company`s membership.⁹⁵ These ideologies therefore place creditors and other stakeholders on an equal footing with shareholders to the extent their contribution allows them to form part of the company`s membership.

The issue of creditors being part of members by virtue of their capital contribution however remains unclear as each particular association should determine whether to include any stakeholder as a member upon their contribution. It is however suggested 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 financially distressed.⁹⁶ Corporate governance benefits should therefore 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.

Having explored the various schools of thoughts, the researcher notes the different influences that each school of thought has on the interests of creditors. Further, one may come to the realisation of the source or schools of thoughts that inspire a choice of a particular theory of corporate governance in a particular jurisdiction. As earlier observed, a jurisdiction that is predisposed to the shareholder value approach certainly derives its strength from the contractarian school of thought. Also, a jurisdiction that follows the pluralist approach would have drawn its impetus from possibly the communitarian and associative school of thoughts. Finally, a jurisdiction that is predisposed to the enlightened shareholder value approach could be aligned to the dual concessionarism school of thought.

⁹⁴Wishart, opcit note 74, p 348.

⁹⁵Ibid.

⁹⁶ Ibid.

2.3. THEORIES OF CORPORATE GOVERNANCE AND THEIR EFFECTS ON PROTECTION OF CREDITORS` INTERESTS

This section discusses the effects of the three main theories of corporate governance which are the shareholder value approach, the enlightened shareholder approach and the pluralist approach. A predisposition of a particular model of corporate governance depends on what a particular jurisdiction adopts as its preferred model or approach of corporate governance. These models define relationships between the company and its stakeholders. They determine the extent to which interests of certain corporate constituencies may be regarded by the company`s directors. Traditionally, corporate entities have been run in such a way that only the interests of shareholders were regarded; directors were fiducially bound to serve the best interests of shareholders.⁹⁷

It must be noted that there is a gradual global shift from the above-mentioned tradition to a model that takes into consideration the interests of other stakeholders. For instance, the 21st century came with new spheres of corporate governance which called for companies in different jurisdictions to start considering sustainability issues as part of the companies` goals. Nature, society and business are interconnected in complex ways that need decision makers to pay attention so as to understand these current business dynamics for the benefit of their companies.⁹⁸ In South Africa, the King III Report adheres to the “triple bottom-line” or “integrated approach” which acknowledges that companies should operate within the framework of their economic, social and environmental responsibility concerns.⁹⁹ The company directors should take into account the interests of all stakeholders when managing the company`s affairs. Thus, a corporate governance system which as well values interests of non-shareholder constituencies is a turn away from the traditional view that corporate entities should pursue only economic goals for the sole benefit of shareholders.

2.3.1. Shareholder value approach

The shareholder centric approach is a model of corporate governance which obliges directors to act in the best interests of shareholders.¹⁰⁰ This model values the interests of shareholders above interests of any other corporate constituencies. Traditionally company law seeks to protect the interests of shareholders hence directing directors to maximise

⁹⁷ M.P. Spisto ‘Legal Aspects of Corporate Governance in the Republic of South Africa: Towards a Possible Model for Improved Stakeholder Relations within the Corporation’ Unpublished PhD Thesis, University of the Witwatersrand, 2011, 87.

⁹⁸ King iv report, opcit note 2. Although the King Reports are not binding in law, their influence should not be understated given their impact on South Africa`s corporate laws; the code has a notable mark on inspiring the 2008 Act to extend its arms to accommodate certain good standards of corporate governance.

⁹⁹ Ibid, 22.

¹⁰⁰DTI, opcit note 4, p 24.

profits for the benefit of shareholders. Company law has therefore been reluctant to extend the protection afforded by directors' fiduciary duties to non stakeholder constituencies.¹⁰¹ The notion behind this model is an orientation to encourage investment. Generally, shareholders are the ones who initiate the existence of a company by investing their assets in the corporation and as such their investment cannot go unnoticed. It is believed that they mostly deserve protection from directors' fiduciary duties and as such directors should serve their best interests.

The legal precedent that endorsed this approach is the case of *Dodge v Ford Motor Company*.¹⁰² In that case it was held that the business corporation is organized and carried on primarily for the profit maximization for the benefit of stockholders. Thus, until recently, the main goal of business in the USA was mainly to maximize profits for a higher earning of dividends by stockholder of the company. According to Spisto, corporate governance in the USA involves a unitary board structure with shareholders being the owners of the corporation.¹⁰³ Thus, in the USA, companies are therefore not obligated to regard the interests of even key stakeholders such as creditors and employees.¹⁰⁴ Shareholders retain primacy even to this present day although there is a slight change that minimally accommodates interests of other stakeholders subject to those of shareholders.

Critics of this model suggest that directors' duties should be extended to other corporate constituencies given that shareholders, although they initiate formation of a company, are not the only investors in the success of a company. Creditors invest through debt finance and thus complement what shareholders cannot achieve alone. The employees invest in the form of labour capital whilst at the same time the society and the environment within which a corporation is situated deserve protection from any acts that may be of a prejudicial nature.¹⁰⁵ These conflicting views refer back to the 1930's when a well-known debate arose between Professor A Berle and Professor E Merrick Dodd Jr. It was Berle's view that powers bestowed upon company controllers are only exercised for the sole benefit of shareholders. He asserted that the sole function of a company is to maximise profits for better shareholders returns.¹⁰⁶ On the contrary, Dodd was of the view that a company has more objectives than merely profit maximization. He was of the opinion that a company is an

¹⁰¹Spisto, opcit note 97, pp 87-8.

¹⁰²170 N.W. 668 (Mich. 1919).

¹⁰³ Spisto, opcit note 97, p 88.

¹⁰⁴S. M. Jacoby 'Corporate governance in comparative perspective: prospects for convergence' (2000)22(1) *Comparative Labour Law & Policy Journal: Employees and Corporate Governance*, 13.

¹⁰⁵ DTI, opcit note 4, p 25.

¹⁰⁶ A Berle "Corporate powers as powers in trust" (1931) 44 *Harvard Law Riview* 1049.

economic institution that pursues economic goals such as profit maximisation as well as social services.¹⁰⁷ Sommer Jr concurring with Dodd asserted that;

No doubt it is to a large extent true that an attempt by business managers to take into consideration the welfare of employees and customers (and under modern industrial conditions the two classes are largely the same) will in the long run increase the profits of stockholders.¹⁰⁸

Professor Nwafor in agreement with the latter contended as follows;

Any argument that emphasizes a preference for profit maximisation against the genuine societal concerns on corporate operations is rather myopic. It overlooks the long term benefit which the recognition of other stakeholders' interests would confer on the company.¹⁰⁹

It is therefore the arguments of the opponents of the shareholder value approach that the approach impacts negatively on the long term goals of the company which may be more beneficial compared to short term pleasures.

The DTI policy paper noted the rationale behind this approach as the following;¹¹⁰

- ❖ It is the shareholders who invested their capital in the company and so they should be entitled to its profits after other claimants are satisfied.
- ❖ The shareholders are residual claimants of whatever is left over after all other claims have been paid, and are consequently best positioned to police the efficiency of the company.
- ❖ The survival and economic success of a company will deliver social benefits to many stakeholder constituencies which will not be delivered if the company is a financial failure.

From the foregoing arguments, firstly, it must be noted that what differentiates shareholders from other corporate investors such as creditors and employees is that shareholders, although the company exists on its own after incorporation, are the ones who, beforehand, would have gone through the whole lot of developing their ideas into something economically feasible. In other words, their pre-incorporation efforts and risks associated thereto should not go unnoticed; they have to benefit from what they initiated. Secondly, shareholders unlike the other main corporate constituencies, that is, the creditors and employees, do not contract for fixed returns but to uncertain returns in the form of dividends

¹⁰⁷ E Merrick Dodd, Jr "For whom are corporate managers trustees?" (1932) *45 Harvard Law Review* 1145, 1147-8.

¹⁰⁸ Sommer AA Jr 'Whom should the corporation serve? The Berle-Dodd debate revisited sixty years latter' (1991) *16 Delaware Journal of Corporate Law*, 33.

¹⁰⁹ Nwafor AO, 'Shareholders Profit maximisation and Stakeholders Interests in Corporate Governance' (2014) *Vol 11 No. 4, Corporate Ownership & Control Journal*, 670.

¹¹⁰ DTI, opcit note 4, pp 20-1.

or in the increased value of the shares and a return of capital on winding up after all other claims have been paid and consequently bear the ultimate risk of the failure of the company.¹¹¹ Thirdly, the company indeed must pursue its economic goals to ensure continued success and benefit of all shareholders. However such a goal should be pursued with interests of all important stakeholders in the business for a mutual benefit of all participants. This issue has already been settled both in the UK and USA as it is now accepted that non-shareholder interests may be taken into account but only if, in so doing, the interests of the company (interpreted to mean interests of shareholders as a collective body), is thereby served.¹¹² Thus, where a conflict of interest arises between the interests of shareholders and other stakeholders then it is the interests of shareholders that must prevail.

In terms of section 76(3)(b) of the 2008 Act, a director of a company, when acting in that capacity, must exercise the powers and perform the functions of a director in the best interests of the company. This provision codifies the common law duty of a director to act in the best interests of a company and hence the wording of section 76(3)(b) removes any doubt that directors of a company owe their duty to the company and the company alone. The problem however arises when the word “company” has to be defined. Since the 2008 Act has not defined the word “company” for purposes of section 76(3)(b), the common law meaning of the word is therefore adopted.¹¹³ There is common law authority that suggests that the word “company” in this context refers not to the legal entity itself, but rather to the interests of the collective body of present and future shareholders.¹¹⁴

In *Greenhalgh v Ardene Cinemas Ltd*¹¹⁵ it was stated that the phrase “company as a whole” does not mean the commercial entity as distinct from the shareholders; it means the shareholders as a general body. The word “company” is therefore a synonym for shareholders. Thus directors should balance between short-term considerations that affect present shareholders against long-term considerations that affect future shareholders.¹¹⁶ Directors are therefore not obliged to maximise profits to satisfy short term demands for dividends at the expense of growth and profitability in the long run. Thus, directors have a discretion concerning the time period over which existing shareholders may benefit.¹¹⁷ In

¹¹¹ Van De Linde, *opcit* note 27, 9.

¹¹² See section 172 of the UK Companies Act 2006 and also Sommer AA Jr, *opcit* note 108, 33.

¹¹³ *Ibid*, 467.

¹¹⁴ The genesis of this legal principle is the case of *Re Smith & Fawcett Ltd* [1942] Ch 304; it was stated that the directors are bound to exercise the powers conferred upon them bona fide in what they consider – not what the court may consider – is the interests of the company.

¹¹⁵ [1951] Ch 286, 291.

¹¹⁶ Cassim, *opcit* note 31, p 468.

¹¹⁷ *ibid*

*Shuttleworth v Cox Bros & Co Ltd*¹¹⁸ the court stressed that the best interests of a company are not assessed by the court itself; instead, the test is whether a reasonable man would have regarded the act of the directors to be in the best interests of a company. The court in *Charterbridge Corporation Ltd v Lloyd's Bank*¹¹⁹ formulates the test to be whether an intelligent and honest person in the position of a director could in the whole of the circumstances have reasonably believed that he or she was acting in the best interests of the company. The discretion therefore lies on the directors to act within the ambit of what they believe to be in the best interests of the company. For instance, a reasonable, honest and intelligent director would not disregard certain principles of good governance that accommodate the interests of other stakeholders in order to secure long term benefits for the company's shareholders.

Of importance are the King Reports in attributing a preferred meaning of 'the best interests of the company'. In South Africa, the King IV Report adheres to the "triple bottom-line" or "integrated approach" which acknowledges that companies should operate within the framework of their economic, social and environmental responsibility concerns.¹²⁰ It is noted that the 2008 Act states as one of its purposes, to promote compliance with the Bill of Rights as provided for in the Constitution as well as to provide for the welfare of all stakeholders in appropriate circumstances.¹²¹ According to King IV Report, this purpose, as stated, constitutes a departure from the traditional narrow interpretation of the best interests of the company. The JSE Limited (JSE) requires listed companies to comply with King Codes. The requirement is however not mandatory; companies may either comply with the codes or explain their failure to do so. Either way, directors must ensure that acting in the best interests of the company is the overriding factor, subject always to proper consideration for the legitimate interests of all stakeholders, including actual and potential investors and creditors.¹²²

In the premises, one could argue that the 2008 Act has expanded the meaning of 'the best interests of the company' to include not only shareholders but also other stakeholders. While this argument appears attractive, it is submitted that section 76(3)(b) of the Companies Act has not been framed in a way that clearly indicates that directors must now take cognizance

¹¹⁸ [1972] 2 KB 9 at 23.

¹¹⁹ [1970] Ch 62 at 74.

¹²⁰ King IV, opcit note 2.

¹²¹ See section 7 of the 2008 Act as well as the preamble to this Act which seeks to provide appropriate legal redress to investors and third parties.

¹²² King IV Report, OpCit note 2.

of the interests of stakeholders when managing their companies.¹²³ In light of section 76(3)(b), the duty of directors to act in the best interest of the company has become mandatory but still in line to its common-law foundation. It therefore leaves the 2008 Act with flaws in this regard. Section 76(3)(b) has not developed this common law duty of directors to specifically include non-shareholder constituencies yet the preamble of this Act advocates for addressing third-party issues. This is further evidenced by a range of creditor protective mechanisms entrenched in the 2008 Act which are, *inter alia*, the *Turquand Rule*, business rescue, the prohibition of reckless trading and the intensive application of the solvency and liquidity test on many fundamental transactions.¹²⁴ Another trait of a turn away from the traditional meaning of “best interests of a company” is the mandatory requirement for a social ethics committee for public limited entities so to cater for the social concerns of these large entities.¹²⁵ Thus, it is deduced that South African company law confusingly prefers the shareholder value approach despite the fact that there are various provisions that extend protection to non-shareholder constituencies in the 2008 Act. The result of this is that whereas shareholders have received recognition, the interests of stakeholders have received no formal or express recognition. It is therefore argued that the interpretation of ‘best interests of a company’ should not only derive meaning from common law but also consider the purpose of the 2008 Act; consider all provisions in the 2008 Act that advocate for protection of non-shareholder interests and finally consider supporting material such as the King Code Reports as they reflect the international standards of corporate governance.

A predisposition of the shareholder value approach in South Africa places the interests of creditors at stake as there is no formal recognition of interests of the non-shareholder constituencies. South Africa’s company law draws its basis from English law hence section 76(3)(b) of the 2008 Act should be formulated in a similar fashion as section 172(1) of UK’s Companies Act of 2006 as shall be discussed under the subsequent sub-heading. Thus, this will suit the prevailing trends in other jurisdictions that ensures that a corporate governance system that protects interests of all corporate participants is adopted in South Africa.¹²⁶

¹²³ Musakwa L, ‘Shareholder Value versus Stakeholders’ Interests—A Critical Analysis of corporate Governance from a South African Perspective’ (2015) *Vol 43 No. 3, Journal of Social Science* 217-225 , 220.

¹²⁴ See the following sections of the 2008 Act: Sections 22, 214 on reckless and fraudulent trading; sections 128-154 on business rescue; section 20(7) on the *Turquand Rule*; sections 4; 46(1), section 113 etc on the solvency and liquidity test.

¹²⁵ Section 72(4) of the 2008 Act; Regulation 43 of the Companies Regulations, 2011. R. 351 GG 34239 OF 26 April 2011.

¹²⁶ Section 7 of the 2008 Act seeks to promote compliance with the bill of rights hence considering the welfare of relevant stakeholders in appropriate circumstance, reaffirming the concept of the company as a means of achieving economic and social benefits.

2.3.2. Enlightened shareholder value approach

The “enlightened shareholder value approach” is an alternative version of the shareholder value approach which seeks to strike a balance between the shareholder primacy model and the pluralist approach. It is a go between approach in that the shareholder primacy model is an extreme approach to protecting the interest of shareholders by directors by disregarding other stakeholders whereas the pluralist approach is an extreme side of recognizing interests of all stakeholders and seeks to vest directors with a duty to consider the interests of all stakeholders in the performance of their duties. The enlightened shareholder value approach, however, permits directors to have regard, where appropriate, to the interests of other stakeholders in the company, but with shareholders’ interests retaining primacy.¹²⁷ The interests of other stakeholders are thus to be appreciated only insofar as it would promote the interests of the company and members as a whole. In terms of the enlightened shareholder value approach the interests of the company include the interests of shareholders with a possibility of an inclusion of interests of other stakeholders.¹²⁸

In *BEC Inc v 1979 Debentureholders*¹²⁹ the court stated that the fiduciary duty of the directors to the corporation is a broad, contextual concept. It is not confined to short term profits or share value, and as such the corporation as a going concern must look to its long term interests. The shareholder value approach is restricted to the short term interests, that is, profit maximization for shareholders’ pleasures at the expense of other stakeholders. With the enlightened shareholder value approach, the company is as a going concern implored to consider its long term goals by giving due regard to the interests of non-shareholder constituencies which secures the company’s long term interests for a continued benefit of shareholders. Unlike the shareholders primacy model, the enlightened shareholder value approach does not close the door of possible consideration of interests of other stakeholders. According to Prof Nwafor, a company cannot maximize the shareholder value through a systematic exploitation of its stakeholders.¹³⁰ He recognizes Martin’s observation that if a company takes good care of its customers or suppliers as well as the community and environment, its shareholders will be drawn for a nice ride, thus sustaining its operations in the long term due to benefits that accrues from goodwill.¹³¹

¹²⁷ DTI, *opcit* note 4, p 23.

¹²⁸ *Ibid*.

¹²⁹ 2008 SCC 69 (CanLII), [2008] 3 SCR 560.

¹³⁰ Nwafor, *opcit* note 109, p 676.

¹³¹ *Ibid*.

An interesting statutory exposition of the enlightened shareholder value approach is reflected in section 172(1) of the UK Companies Act¹³² which deals with the directors' duty to promote the success of the company. That section provides as follows:

A director of a company must act in a way that he considers, in good faith, would be most likely to promote the success of the company for the benefit of the members as a whole, and in doing so have regard (amongst other matters) to, the likely consequences of any decision in the long term, the interests of the company's employees, the need to foster the company's business relationships with suppliers, customers and others, the impact of the company's operations on the community and the environment, the desirability of the company maintaining a reputation for high standards of business conduct, and the need to act fairly between members of the company.

Section 172(1) sets a comprehensive example of what the enlightened shareholder value approach constitutes. It must be noted that the directors owe these duties to the company itself and not to any of the stakeholders.¹³³ Further, the provision retains the primacy of member, but in a different fashion, as it requires a subjective consideration of other stakeholders whose interests may be promoted as long as the end result benefits the company. This is what differentiates the enlightened shareholder value approach from the pluralist approach which seeks equal recognition of all stakeholders. Besides the UK Companies Act 2006, the King IV Report in South Africa states as follows;

Although a company is an economic institution, it remains a corporate citizen and therefore has to *balance* economic, social and environmental value. The triple bottom line approach enhances the potential of a company to create economic value. It ensures that the economic, social and environmental resources the company requires to remain in business are treated responsibly. By looking beyond immediate financial gain, the company ensures that its reputation, its most significant asset, is protected. There is growing understanding in business that social and environmental issues have financial consequences.¹³⁴

It is therefore in the shareholder's long term benefit to consider the interests of all participating stakeholders. In response to the King Reports, the 2008 Act provided for the need for a social and ethics committee in public limited companies which is one of the traits of the enlightened shareholder value approach. In terms of section 72(4), every listed company and every state owned company is required to appoint a social and ethics committee.¹³⁵ Further, private companies or any other type of company may as well appoint such a committee if it is desirable in the public interest to do so. This is however subject to certain conditions which are related to the company's annual turnover which must be at least R500 million; the company's size of workforce which must be at least 500; a company which

¹³²UK's Companies Act of 2006.

¹³³ Nwafor, opcit note 109, p 677.

¹³⁴ King IV report, opcit note 2.

¹³⁵Section 72(4) of the 2008 Act.

for any two of the previous 5 years had 500 public interest score points; as well the nature and extent of the company's activities.¹³⁶ The committee must comprise not less than three directors or prescribed officers and at least one of the directors must be responsible for the day-to-day running of the company's business and must not have been so involved in the previous three financial years.¹³⁷

In terms of the companies Regulation, Reg 43 the committee monitors the company's activities with regard to good corporate citizenship/social responsibility and that includes the following:

- ❖ Ensuring the company's promotion of equality and the prevention of unfair discrimination;
- ❖ Ensuring the company's contribution to the development of the communities in which the company's activities are predominantly conducted;
- ❖ Keeping the company's record of sponsorship, donations, and charitable giving;
- ❖ Ensuring the environmental health and public safety;
- ❖ Regulating issues relating to consumer relationships and employer and employee relations.

The responsibilities of the social and ethics committee, obviously relates to the corporate responsibilities towards the various stakeholders. There is however no direct duty owed to stakeholders by directors or prescribed officers or the committee but the standards of good practice require that due regard be given to the interests of non-shareholder constituencies. At the present moment there are no sanctions set for a qualifying company that fails to comply with the social and ethics committee requirement. A company may therefore choose to comply with this requirement or file documents with the CIPC to motivate its exemption from this requirement.¹³⁸ The responsibilities of the social and ethics committee are in line with the expository outline of the enlightened shareholder value approach by section 172 of UK Companies Act of 2006. Thus, the social and ethics committee extends the company's goals to consider the interests of other stakeholders although all these other interests are subject to the primacy of shareholder interests.

As has been said, the enlightened shareholder value approach is permissive to the recognition of other stakeholder interests although the directors do not owe them a direct

¹³⁶Regulation 43 of the Companies Regulations, 2011. R. 351 GG 34239 OF 26 April 2011.

¹³⁷Ibid.

¹³⁸ Cassim, opcit note 31, p 470.

duty as they do to members. It is therefore fairly settled that the laws of the jurisdictions in focus allow the directors limited freedom, in the performance of their duties, to consider interests of non-shareholder constituencies, and so long as the promotion of the interests of the company is the ultimate goal.¹³⁹ Thus, a predisposition of the enlightened shareholder value approach in South Africa would therefore entail a subjective protection and advancement of creditor interests among other stakeholders. The researcher considers this approach more suitable as it does not do away with the company's traditional goal but instead allows limited recognition of other stakeholders' interests in pursuing its traditional goal.

2.3.3. Pluralist approach

According to this approach, the directors may, in certain instances, ignore the interests of shareholders in favour of other interests in corporate decision-making. Thus interests of other stakeholders have independent value and are not subordinated to those of shareholders. This approach calls for a statutory imposition of enforceable obligation on the directors to consider the interests of all the stakeholders in their own rights in the performance of their duty.¹⁴⁰ A predisposition to this approach would almost invariably necessitate changing the traditional legal position to defining 'interests of the company' as being identified not only with shareholders, but also with other stakeholders.¹⁴¹ The pluralist approach asserts that 'co-operative and productive relationships will only be optimised where directors are permitted (or required) to balance shareholders' interests with those of others committed to the company.¹⁴² The difference between this theory and the enlightened shareholder value approach is that with this approach shareholders' interests would be equally considered and weighed against other interests when making decisions whereas with the enlightened view other interests are subordinated to those of shareholders.

This approach is strongly reflected in section 166 of the Indian Companies Act of 2013 as it expands directors' duties to include all stakeholders. Section 166(2) provides that a director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of the environment. Section 135(1)(5) of the Act goes on to require companies exceeding a certain threshold amount on their annual turnover to commit, at least two percent of their average profits made during the

¹³⁹ Nwafor, *opcit* note 109, 678.

¹⁴⁰ *Ibid.*

¹⁴¹ DTI, *opcit* note 4, p 23.

¹⁴² *Ibid.*

three immediately preceding financial years, to the company's corporate social responsibility policy with special focus on the company's local area and areas around where it operates. This provision, unlike the UK Companies Act provision in section 172 and South Africa's Regulation 43 on the social and ethics committee, expressly imposes a mandatory obligation to commit some portion of the companies' net profits to promote the interests of non-shareholder interests. The pluralist approach draws its basis from the communitarian school of thought which accommodates a state's political goals with a possible negative influence on the company's commercial goals. Requiring a company to commit a portion of its profits to the development of the local area, in addition to taxes imposed on these corporations, may entail some political benefits to the ruling government. It is the duty of the government to procure taxes from these large entities and then use such revenue to perform one of its duties which is to develop the living standards of its citizens. Committing such a goal to companies is a diffusion of commercial goals with politically-oriented goals. On the other hand, standards of good governance benefit the company in the long run, hence a company may earn itself goodwill benefits in a long term.

In the light of the pluralist approach, there is a considerable body of opinion, which strongly endorses the idea that corporate governance is concerned with holding a balance between economic and social goals with the result that corporate governance should be seen as the system by which organizations are or ought to be governed and controlled with the contribution of and for the benefit of all stakeholders, including shareholders, employees, creditors, suppliers, and the society at large.¹⁴³ The pluralist theory, if not properly developed, would result in discouraging investors from initiating new companies since there will be no differentiation between them and other stakeholders. Practically, if directors' duties are to be identified with serving all stakeholders, it may lead to a situation where the directors may not effectively account to anyone since there would be no clear yardstick for judging their performance.¹⁴⁴ A moderate application of this model, which in this case turns out to be the juxtaposing enlightened shareholder value approach, would be appropriately a proper fashion that considers interests of all stakeholders but with more primacy being placed on shareholders hence retaining traditional goals of the company but in a developed mode. The researcher thus prefers the enlightened shareholder value approach to the

¹⁴³Cheffins, *opcit* note 87, 151-153, 574-601; R Smerdon 'A Practical Guide to Corporate Governance' (1998), 6-10; BR Cheffins 'Trust, Loyalty and Cooperation in the Business Community: Is Regulation Required?' in B. A. K. Rider, ed, *The Realm of Company Law*, (1998) 73. A very illuminating discussion of possible interpretations of 'the best interest of a company' is provided by the 1999 UK's DTI Consultation Paper entitled "Modern Law for Competitive Economy: The Strategic Framework." This consultation paper set in motion the review of core company law undertaken in the UK by the DTI and which culminated in the publication of a white paper on modernizing company law in July 2002.

¹⁴⁴Nwafor, *opcit* note 109, p 679.

pluralist approach. Thus, the former does not lose the essence of the company's traditional goals yet extending its arms to a considerable recognition of other stakeholders' interests which thus includes creditors' interests who are the subject of this research enquiry.

2.4. CONCLUSION

This chapter dealt with a number of issues that are pertinent to creditor protection in an attempt to propound a theoretical basis for creditor protection by corporate laws beyond the protection afforded to creditors by contract laws. The researcher has thus joined a pool of scholars who continuously debate on theoretical issues underlying the protection of creditors by corporate laws. The researcher is of the view that creditors are entitled to protection afforded by corporate laws, beyond contract laws, and thus they are entitled to protection of directors' fiduciary duties in appropriate circumstances.¹⁴⁵

The researcher explored the consequences of incorporation of a company. One of the consequences is the separate legal existence concept of a company which separates the company's own interests from those of shareholders or directors. The separateness helps to secure interests of all stakeholders as there is no stakeholder constituency that finds its personal affairs colliding with the affairs of the company. The company's assets and gains are for the company and for its benefit and for good governance which considers interests of participating stakeholders in appropriate circumstances. This justifies the protection of creditors by corporate laws even as other stakeholders deserve such protection regardless of the fact that they have separate laws that protects them.

Further, the researcher explored various schools of thoughts to reflect the background view of the theories of corporate governance. The theories of corporate governance are based on the beliefs drawn from various schools of thoughts. This therefore extends to the way in which these theories govern relationships between the company and its stakeholders. It is the findings of this research that many jurisdictions favour an approach that retains the traditional goal of companies with a considerable moderation that strikes a fair balance between shareholder interests and that of other stakeholders on given circumstances.¹⁴⁶ It is advised that the meaning of "best interests of a company" in section 76(3)(a) of the 2008 Act be developed specifically to accommodate the interests of non-shareholder constituencies in line with the purpose of the 2008 Act in its section 7 as well as many other provisions of the

¹⁴⁵ See the purpose of the 2008 as stated in Section 7(a); (d); (k).

¹⁴⁶ See the enlightened shareholder value approach discussed at para 2.3.2 above

2008 Act that reflect an extension of the company`s goals to cater for the interests of other stakeholders such as the creditors.¹⁴⁷

Building on from the findings in this chapter, in particular the imminent need to extend corporate goals to cater for interests of other stakeholders, the following chapter shall thus deal with protection of creditors by mandatory corporate laws. Thus, it shall be limited to an examination of only those mandatory corporate laws (creditor protective mechanisms) which were entrenched in the 1973 Act but have now been re-enacted in the 2008 Act.

¹⁴⁷ They are various creditor protective mechanisms entrenched in the 2008 Act; other corporate constituencies are as well protected by the same Act; opcit note 124. That shows an inclusion of non-shareholder constituencies in the phrase “best interests of the company”. King code principles should as well be applied to ensure good governance standards which are internationally recognized.

CHAPTER 3

RE- ENACTED CREDITOR-PROTECTIVE MECHANISMS

3.0 INTRODUCTION

Creditors are an important part of the stakeholders in companies. Their importance is to enhance the ongoing concern through supplying companies with various goods and services which those companies may need to ensure their smooth operations. Creditor companies are needed for the survival of companies to which they supply goods and services. These creditor companies also receive goods and services from other companies which are creditor companies to them. In most cases you may find that both companies are selling their goods and services to each other due to the inter-dependence between these companies. Oftenly, suppliers of goods and financial institutions which lend money to business entities are at a disadvantage because they do not have control over the affairs of the companies that they lend to or supply goods on credit to. They are unable to readily ascertain whether their input, through credit supply of goods or through lending money, will be treated for a good cause which will in turn enable debtor companies to pay them their debts as they become due and payable.

One of the risks that creditors face is that of unjustified expropriation. Expropriation can take a variety of forms, sometimes company controllers may withhold what is due to outsiders in order for them to pursue their own interests. They may as well sell the output or the assets of the firm they control, but which outsiders have financed, to another entity they own, at below market prices. In worse situations, some companies may endow controlling powers on possibly unqualified family members and some may overpay their executives in a way that is not justified by their production output which in turn reduce the probability of creditors being repaid, their debts, as per contractual terms. Moreso, company controllers may sometimes use the profits of the firm to benefit themselves rather than return what is due to the outsiders/ or creditors. If extensive expropriation undermines the functioning of a credit system, how can it be controlled in order to reckon the import of the credit system in company affairs?

The previous chapter dealt with the question whether creditors can only rely on contract laws when it comes to protection of their interests in company affairs. It has been one of the findings that indeed contract laws are not sufficient to protect the interests of creditors. Mandatory corporate laws or principles, herein termed “creditor protective mechanisms”, are needed in order to afford better protection to the interests of creditors who happen to be one

of the outsiders in company affairs. It is for this reason that the 2008 Act, in pursuit of one of its goals, that is to provide appropriate legal redress to investors and third parties,¹⁴⁸ has re-enacted several creditor protective mechanisms that were entrenched in the now-repealed 1973 Act and has even enacted new mechanisms in an attempt to protect creditors' interests among other stakeholders. It is therefore the enquiry of this chapter or segment of the research to find out whether the 2008 Act has developed the mechanisms that existed in the 1973 Act in a way to enhance creditor protection. Thus, this chapter shall specifically deal with mechanisms that were previously enacted in the 1973 Act or in its **Amendment Act 1999**¹⁴⁹ but have now been re-enacted in the 2008 Act. These include;

- ❖ “Solvency and liquidity test”;
- ❖ “Sanctioning of directors/ directors' liability”;
- ❖ Liquidation” and;
- ❖ “Compromise”.

Each of these mechanisms shall therefore be dealt with in detail in order to examine whether they have been sufficiently developed by the 2008 Act in order to afford creditors the expected protection.

3.1. SOLVENCY AND LIQUIDITY TEST CONCEPT

3.1.1 Scope and meaning of this concept

One of the mechanisms that were re-employed by the 2008 Act to protect the interests of creditors is the solvency and liquidity test *in lieu* of the capital maintenance rules.¹⁵⁰ In brief, this concept entails that a company's assets must exceed its liabilities and it must appear that the company will be able to settle its debts as they become due and payable for a period of twelve months from the day of determination of its financial status. Thus, the test will be an accounting exercise carried out in terms of the guidelines set in the 2008 Act.¹⁵¹ The “solvency status” relates to the assets of the company, fairly valued, being equal to or exceeding the liabilities of the company.¹⁵² The “Liquidity status” relates to the company

¹⁴⁸ See preamble of the 2008 Act.

¹⁴⁹ Companies Amendment Act 37 of 1999 (herein referred to as the “Amendment Act of 1999”).

¹⁵⁰ Capital maintenance rules shall be discussed below in paragraph 3.1.2.

¹⁵¹ Tomlinson Mquni James Attorneys ‘Solvency and Liquidity’ Law talk: Newsletter’ (2011) at <http://www.tmj.co.za> (accessed 15 October 2015).

¹⁵² CIPC ‘The Solvency and Liquidity test’ at <http://www.cipc.co.za/index.php/manage-your-business/manage-your-company/solvency-and-liquidity-test> (accessed 26/08/2016).

being able to pay its debt as they become due in the ordinary course of business for a period of 12 months.¹⁵³

This concept was legislated in a broader way as compared to its previous existence in the 1973 Act and/or its amendment Act of 1999. Van de Merwe asserts that the 2008 Act dramatically expands the scope of the application of the liquidity and insolvency test requirement and that the requirement presents itself as a critical protective device in transactions influencing the rights of creditors.¹⁵⁴ Thus, a deeper look into this subject will thus have to be embarked on in order to assess the effectiveness of this protective mechanism in so far as protection of creditors is concerned.

3.1.2. Historical background to the Solvency and Liquidity test concept

The concept of solvency and liquidity test was introduced in an amendment to the 1973 Act by the Companies Amendment Act of 1999. Its introduction was premised at juxtaposing between its full application as in the 2008 Act and a reformation from the **capital maintenance rule**, which prior to the 1999 Amendment Act was a dominating concept/ or principle. The capital maintenance rule has its origin in English law dating back to more than a century ago in *Trevor v Whitworth*.¹⁵⁵ The underlying object of this rule was to grant creditors protection in that they looked to the company's equity for payment of their debts. Capital was viewed to be fixed and readily-ascertained and its purpose was to stand as the absolute hope for creditors of the company, it being a "permanent fund" and/ or a "form of security" and/ or a "guarantee" for repayment of their debts.¹⁵⁶ Thus, Lord Halsbury, L.C, in *The Ooregum Gold Mining Company of India Ltd v Roper*,¹⁵⁷ declared that:

"[t]he capital is fixed and certain, and every creditor of the company is entitled to look to that capital as his security."

This was maintained some decades later in *Cohen NO v Segal*,¹⁵⁸ where the court, in prohibiting the payment of a dividend out of share capital, stated that;

¹⁵³ Ibid.

¹⁵⁴ C. P. van de Merwe 'Reconsidering distributions: A critical analysis of the regulation of distributions to shareholders in the Companies Act 2008, with special reference to the solvency and liquidity Requirement' unpublished dissertation, Stellenbosch University (2015) 51.

¹⁵⁵ 1887 12 App CAS 409 (HL).

¹⁵⁶ F.H.I Cassim and R Cassim 'The Capital Maintenance Concept and Share Repurchases in South African Law' I.C.C.L.R. 2004, 15(6), 188-191.

¹⁵⁷ [1892] A.C. 125 at 133.

¹⁵⁸ 1970 (3) S.A. 702 (W) at 705H.

“[w]hatever has been paid by a member cannot be returned to him and no part of the corpus of the company can be returned to a member so as to take away from the fund to which the creditors have a right to look as that out of which they are to be paid. The capital may be spent or lost in carrying on the business of the company, but it cannot be reduced except in the manner and with the safeguards provided by the statute.”

In terms of the “limited liability” principle, creditors have no recourse to shareholders when a company cannot pay their debts and that forces them to rely on a company’s assets. Funds that are raised through the issuing of shares are thus assets of the company which shareholders cannot claim back at the expense of creditors. It is however anomalous to expect creditors to rely on an asset which ordinarily diminishes as business operations demands cash. The court in the *Cohen* case quoted above said it well that capital may be spent and lost in the carrying on of business. This then leaves the researcher with unanswered questions as to what was the rationale behind expecting creditors to have a guarantee based on something possibly unrealistic or just a mirage projecting to what may not be there in future. The fact that figures of the equity structure remain untainted or unchanged does not entail that the actual funds which shareholders contributed are still there. The main reason for issuing shares is to raise capital which will be used to run specific business operations. It is thus unlikely that any funds may remain when shares have been issued as such money has its purpose to achieve. In this case creditors are left to hope in the unknown. This has been depicted again in the *Whitworth* case above where creditors were expected to rely on an assumption that capital funds have not been paid out except in the ordinary legitimate course of business.¹⁵⁹ What remains is, whether legitimate or illegitimate course of business, the funds raised from capital are always meant to be used up especially where there are losses in the business. Only in instances where the business makes substantial profits will such capital funds be retained, backed up by financial reserves.

Regardless of the above flaws of the capital maintenance concept, it should be noted that the concept had its rules that were meant to protect the integrity of the company’s equity which were as follows;

- It was unlawful for dividends to be paid out of capital.¹⁶⁰

¹⁵⁹ *Trevor v Whitworth* (1887) 12 App Cas 409 at 423-4 (HL); Lord Watson said: “paid-up capital may be diminished or lost in the course of a company’s trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to, a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has subsequently been paid out, except in the legitimate course of its business”.

¹⁶⁰ R Jooste ‘Corporate Finance’ opcit note 31, pp 264.

- It was unlawful for a company to acquire its own shares or shares of its holding company.¹⁶¹
- It was unlawful for par value shares to be issued at a discount except under stringent conditions.¹⁶²
- It was unlawful for a company to provide financial assistance for the acquisition of its own shares or shares in its holding company.¹⁶³

It was thus difficult under the 1973 Act to endeavour into certain transactions which were deemed to have a hold on the capital base of the company. The company's capital was deemed as its permanent fund and hence a protected territory where much of the restraints were placed to deter any unlawful tempering with the capital fund. The capital maintenance rule was removed in South African company law, in particular from the 1973 Act, by the Amendment Act 1999. This amendment juxtaposed itself in the middleway of the two primary international models of maintenance of capital, namely the English model of the capital maintenance rule and the American solvency and liquidity test. The amendment hence did not completely remove this outdated archaic rule, capital maintenance rule. The rule could not survive the demands of the modern and fast developing business world of South Africa.

The amendment, in favour of the American solvency and liquidity rule, gave leverage for the company to make payments to its shareholders without profit however this was under certain conditions.¹⁶⁴ These distributions were done only if the articles of association provides for such. Further there has to be a reasonable belief that after such payment, the company will be able to pay its debts as they become due in the ordinary course of business and if its consolidated assets, fairly valued will exceed the consolidated liabilities of the company.¹⁶⁵ Also, companies could now be allowed to buy back their shares and those of their holding companies as long as their articles of association permitted it and also the solvency and liquidity test was met.¹⁶⁶ The statutory adoption of the solvency and liquidity test concept benefited company creditors as the concept promotes creditor protection while at the same time advancing interests of the company and other stakeholders. Most transactions that are

¹⁶¹ Ibid.

¹⁶² This was only permitted upon fulfilling the requirements of section 81 of the 1973 Act which required there to be a special resolution and sometimes a court order in other circumstances.

¹⁶³ In terms of s 38 of the 1973 Act no company shall give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares of the company, or where the company is a subsidiary company, of its holding company.

¹⁶⁴ MA Shabangu 'A critical analysis of capital rules in the Companies Act 71 of 2008' Unpublished LLM dissertation, University of Pretoria, 2009, 10.

¹⁶⁵ That's the solvency and liquidity test-section 90 of the 1973 Act as amended by the Amendment Act 1999.

¹⁶⁶ Section 85 of the 1973 Act as amended by the 1999 Amendment Act.

meant to affect the company's financial position undergo this test to ensure that the financial interests of creditors are safeguarded. The application of this concept was however limited in the 1999 Amendment Act as it also required that despite the solvency and liquidity test being met still a company's articles of association had to approve of such transaction. This is no longer the position when comparing it with its broader application in the 2008 Act; the test is now applied to any qualifying transaction as long as the conditions, restrictions or prohibitions in a memorandum of incorporation are fulfilled. This shall be dealt with in detail in subsequent paragraphs.

3.1.3. The 2008 Act and the solvency and liquidity test concept

The American's liquidity and solvency test effectively and fully stormed the South African corporate laws in 2011 when the 2008 Act was enforced. The test in the 2008 Act comes to dominance as it totally eliminates the scent of the capital maintenance rules and the limitations that were placed on this test in the 1999 Amendment Act. It should thus be noted that for most distributions or transactions to be effected, no shareholder approval of any kind may be needed, it is all now left to the board of directors which should make sure that the company meets the solvency and liquidity test.¹⁶⁷ The application of the solvency and liquidity test in terms of the 2008 Act does not require that the company objectively be solvent and liquid in all circumstances. An application of the solvency and liquidity test by the relevant directors differs in different sections of the 2008 Act.¹⁶⁸ For instance, if a company wants to provide financial assistance in connection with the acquisition of its shares, the 2008 Act does not require that the company in fact be solvent and liquid, but rather that the board of the company in applying the test be "satisfied" that the company would satisfy the solvency and liquidity test.¹⁶⁹ When pursuing a distribution, it must reasonably appear that the company will satisfy the solvency and liquidity test and that the board of the company must acknowledge, by resolution, that it has "applied" the solvency and liquidity test and "reasonably concluded" that the company will satisfy the test.¹⁷⁰

In terms of the 2008 Act, the liquidity and solvency test has to be applied in the following circumstances;

- ❖ Distributions (as defined in section 1 of the 2008 Act) to shareholders;¹⁷¹
- ❖ The provision of financial assistance to third parties for the acquisition of the company's own shares;¹⁷²

¹⁶⁷ R Jooste 'Corporate Finance' opcit note 31, 269.

¹⁶⁸ King Code IV, opcit note 2.

¹⁶⁹ Section 44(3)(b) of the 2008 Act.

¹⁷⁰ Section 46(1)(b) & (c) of the 2008 Act.

¹⁷¹ Section 46 & 48 of the 2008 Act.

- ❖ Loans or other financial assistance to related parties, including subsidiary companies, holding companies and directors;¹⁷³and
- ❖ An amalgamation or merger with another company.¹⁷⁴

Each of these transactions shall be discussed in detail in order to elucidate how the applications of the test on these aspects necessitate protection of creditors. The application of the test is exclusive to directors of the relevant company.¹⁷⁵ Thus, the directors are required to consider "all reasonably foreseeable financial circumstances of the company at that time". This envisages a predictive element requiring the directors to consider matters which may not be reflected in the accounting records and financial statements of the company, but are rather based on elements such as how the economy or political circumstances may impact on the financial state of the company in the future.¹⁷⁶

Directives are given to company directors such that any "financial information" concerning the relevant company and which is to be considered by the directors must be based on the accounting records and financial statements that satisfy the requirements of the 2008 Act. Also, the board or any person applying the test must consider a fair valuation of the company's assets and liabilities including any reasonably foreseeable contingent assets and liabilities, and may consider any other valuation of the company's assets and liabilities that is reasonable in the circumstances.¹⁷⁷ The requirements for fulfilling the test however differs from transaction to transaction as shall be discussed in the succeeding paragraph. It must however be noted that despite the 2008 Act's wide extension of the solvency and liquidity regime, it unfortunately does not provide concrete principles to assist directors who are required to apply the solvency and liquidity test. It remains to be seen whether any further changes will be brought about through courts' interpretations and prospective amendments to the 2008 Act.¹⁷⁸

¹⁷² Section 44 of the 2008 Act.

¹⁷³Section 45 of the 2008 Act.

¹⁷⁴section 113 of the 2008 Act.

¹⁷⁵K Pretorius; T de Wit and C Morrissey 'The solvency and liquidity test: where did we come from? where do we go from here?' at <https://www.ensafrica.com/news/the-solvency-and-liquidity-test-where-did-we-come-from-where-do-we-go-from-here?id=300&STitle=corporate%20commercial%20ENSight> (accessed on 10/10/2016)

¹⁷⁶ King Code III - Chapter 13: Solvency and liquidity tests available at <http://www.pwc.co.za/en/king3/solvency-and-liquidity-tests.html> (accessed on 10/10/2016).

¹⁷⁷C Grove 'How Will South Africa's New Liquidity And Solvency Test Affect Your Company?' (2012) *The Journal of the Global Accounting Alliance*, at <http://www.gaaaccounting.com/how-will-south-africas-new-liquidity-and-solvency-test-affect-your-company/> (accessed on 20/10/2016).

¹⁷⁸ Ibid.

3.1.3.1. Distributions

Basically, distributions are governed by section 46 and 48 of the 2008 Act.¹⁷⁹ Distributions are among those transactions where the solvency and liquidity test shall apply under the 2008 Act. Distributions are defined in section 1 of the 2008 Act as follows;

“‘Distribution’ means a direct or indirect-

(a) transfer by a company of money or other property of the company, other than its own shares, to or for the benefit of one more holders of any of the shares of that company or of another company within the same group of companies, whether-

(i) in the form of a dividend;

(ii) as a payment in lieu of a capitalisation share, as contemplated in section 47;

(iii) is consideration for the acquisition-

(aa) by the company of any of its shares, as contemplated in section 48; or

(bb) by any company within the same group of companies, of any shares of a company within that group of companies; or

(iv) otherwise in respect of any of the shares of that company or of another company within the same group of companies, subject to section 164 (19);

(b) incurrence of a debt or other obligation by a company for the benefit of one or more holders of any of the shares of that company or of another company within the same group of companies; or

(c) forgiveness or waiver by a company of a debt or other obligation owed to the company by one more holders of any of the shares of that company or of another company within the same group of companies,

but does not include any such action taken upon the final liquidation of the company;”

All of the transactions which qualify as distributions cannot therefore be performed unless a liquidity and solvency test is satisfied among other pre-requisite requirements. Pertaining to distributions, section 46 requires the board of directors to ensure that the test has been performed and that a resolution that acknowledges that a company will satisfy the test immediately after completion of the proposed distribution has been reasonably concluded.¹⁸⁰ These requirements are supposed to be met unless the distribution is pursuant to a board resolution, an existing obligation or court order.¹⁸¹ Only directors are required to authorize a distribution; shareholders should not participate in such exercise.¹⁸² This is so to protect creditors and minority shareholders from abuse of their interests by major shareholders. Of importance is that when it comes to distributions, the solvency and liquidity test is to be

¹⁷⁹ Section 46. (1) A company must not make any proposed distribution unless (a) the distribution— (i) is pursuant to an existing legal obligation of the company, or a court order; or (ii) the board of the company, by resolution, has authorised the distribution; (b) it reasonably appears that the company will satisfy the solvency and liquidity

test immediately after completing the proposed distribution; and (c) the board of the company, by resolution, has acknowledged that it has applied the solvency and liquidity test, as set out in section 4, and reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution. S 48 entails that a company may not acquire its shares or that of a holding company unless it meets the requirements of section 46 i.e. the solvency and liquidity test and its assurance among other conditions. Although section 48 specifically deals with share buy backs, it should be noted that share buy backs are part of distributions as defined by the Act and that they are to be treated as any other distributions when it comes to pre-requisite requirements of undertaking such transactions.

¹⁸⁰ Section 46 of the 2008 Act.

¹⁸¹R Jooste, opcit note 31, 269.

¹⁸² Ibid, 246.

applied in a more objective fashion. For instance, section 46 provides that in order for distributions to be authorized, the board of directors must be satisfied of the following *vis-à-vis* the solvency and liquidity test:

- ❖ That it reasonably appears that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution; and;
- ❖ That the board of the company, by resolution, has acknowledged that it has applied the solvency and liquidity test, as set out in section 4, and reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution.¹⁸³

In brief, the duties of the directors concerning this test on distributions comes in two parts; one which entails the actual test has been carried out and finally, the rubber-stamping of the test through a resolution of the board of directors reasonably asserting that the test qualifies the distribution. This is where a reasonable director's test would be applied should the transaction thereafter prejudice the interests of creditors and the company itself. Also, section 4 of the 2008 Act is not that helpful concerning how the solvency and liquidity test is supposed to be carried out. Either way, proper accounting records and financial statements must be relied upon in addition to the need for the board of directors to consider a fair valuation of the company's assets and liabilities.¹⁸⁴ Comparably, section 6.40(d) of the American statute of 1984 gives the same guidelines as in s4 of the 2008 Act on what directors must rely on when applying the solvency and liquidity test.¹⁸⁵ Leaving directors with a choice of which course of action to pursue places the interests of creditors at risk in instances where directors will apply their own accounting standards, which they deem to be reasonable (although unreasonable), to achieve their desired goal which may only favour their intended transaction and not creditors. There is thus a gap in both the American laws and the 2008 Act in this regard; at least more clear guidelines could have been laid out to determine a clear course of action when applying this test than merely placing directors in a position where they enjoy the leverage to determine what would in their views entail a reasonable apprehension of the application of the test.

¹⁸³ S 46 of the 2008 Act.

¹⁸⁴ K Van Der Linde 'The solvency and Liquidity approach in the Companies Act 2008' (2009) 2 *Journal of South African Law* (n 57) 231. She holds that it is difficult to conceive of the circumstances where a valuation of the company's assets that is not fair valuation would nevertheless be reasonable in the circumstances.

¹⁸⁵ Section 6.40(d) of The American Revised Model Business Corporation Act 1984 states that 'the board of directors may base a determination that the distribution is not prohibited under s 6.40(c) either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances, or on a fair valuation or other method that is reasonable in the circumstances.'

Furthermore, to ensure that the company still abides with the test required, if the company does not complete a distribution within 120 days after it had objectively carried out the test then the board is required to reconsider the solvency and liquidity test before proceeding with the proposed distribution.¹⁸⁶ The 120 day period is however criticized by scholars as literally it seems that as long as it is within the 120 day period, a proposed distribution should be performed regardless of the fact that the position might have changed from the day the test was made.¹⁸⁷ It is proposed that the pros and cons pertaining to the treatment of distributions within the 120 day required period be revisited in order to safeguard the interests of creditors and thus perfecting the application of the solvency and liquidity test in this modern world. Allowing a distribution to proceed simply because it is still within the required 120 day period may entail serious prejudice to the interests of creditors in instances where the financial position change before a distribution is effected. It is proposed that once a test for solvency and liquidity has been met, then the envisaged distribution should be carried out within a period of at least a month as it is mostly unlikely that the financial position may dramatically change within such a period. Requiring a distribution to be effected within the 120 day period seemingly compromises the standard set in section 46 of the 2008 Act which provides that a distribution should not be effected if the company will not satisfy the test immediately after distribution. Thus, it is recommended that a lesser period in which to effect a distribution be imposed once the solvency and liquidity test has been carried out in order to avert a situation where much delay will invite changes which affect the determined financial position.

Despite the above discrepancies concerning the application of the solvency and liquidity test, it goes without saying to hold that the test has brought about significant changes to the South African corporate law. It remains in the hands of legislators to take note of comments and recommendations so as to develop the South African corporate laws for the best interest of companies themselves and all stakeholders. The researcher cannot overemphasize the significance of the solvency and liquidity test however it is important to examine how it strengthens the position of stakeholders when applied on the specific types of distributions;

- a) Dividends:** As has been said earlier, prior to the solvency and liquidity test concept, directors could not be allowed to declare dividends out of the company's capital

¹⁸⁶ Section 46(3)(a) of the 2008 Act.

¹⁸⁷ K Van Der Linde, *opcit* note 167, 239. She says " 'I recommend that a company should be prohibited from proceeding with a distribution if the directors are no longer satisfied that the company's financial situation allows it. In such a case a shareholder should not be able to enforce her claim despite the existence of a current acknowledgement by the directors. My proposal does not obviate the need for a formal reconsideration by directors, but merely attaches less weight to the acknowledgement.' "

under the hold of capital maintenance rules. This was meant to abide with the limited liability principle which suggests that shareholders are not entitled to their capital investment as it becomes a company's asset but to proceeds from the profits of the company. In the case of *Verner v General and Commercial Investment Trust*¹⁸⁸ Lindley LJ stated that;

[T]he statutes do not even expressly and in plain language prohibit a payment of dividend out of capital. But the provisions as to capital, when carefully studied, are wholly inconsistent with the return of capital to the shareholders, whether in the shape of dividends *or otherwise*, except, of course, on a winding up ... The fact is that the main condition of limited liability is that capital of a limited liability company shall be applied for the purposes for which the company is formed, and that to return the capital to the shareholders either in the shape of dividend *or otherwise* is not such a purpose as the Legislature intended.

It should thus be noted that courts have always been so strict against any transactions that could be entered into as a disguise meant to extend illegitimate shareholder hands to the capital funding.¹⁸⁹ This was however meant to protect the interests of creditors as capital was what they could look up to for repayment of their debts. Basically, protecting the interests of creditors should be balanced with protecting interests of the company itself and other important stakeholders such as shareholders who actually are the engine behind economic growth and corporate development. When one starts a business they expect a benefit at some stage if it is so justifiable hence the solvency and liquidity test has solved this problem. Under the solvency and liquidity test, shareholders are now able to receive some dividends out of capital itself as long as the test is passed upon considering the liquidity state of the business, the assets, the liabilities, past profits, past losses, the contingencies and so forth. Directors of the company, being responsible for declaring dividends, could manipulate financial records through retaining/ or diverting the company's profits to enhance the capital base (which is a benefit to the company itself but prejudice to shareholders' interests). However, the problem is when such a diversion robs shareholders of their entitlements to dividends. Directors have a fiduciary duty to consider the interests and legitimate expectations of shareholders on determining the value of dividends to be declared and must bear in mind that one of the major benefits to members is the payment of dividends.¹⁹⁰ It is improper for them to retain profits for the greater growth and glory of the company at the expense of members'

¹⁸⁸ [1894] 2 Ch 239264 (CA).

¹⁸⁹ This was expressed in *Aveling Barford Ltd v Perion Ltd* [1989] BCLC 626 at 677 by Hoffmann J as follows '[w]hether or not a transaction is a distribution to shareholders does not depend upon what the parties choose to call it. The court looks at the substance rather than the outward appearance.'

¹⁹⁰ MS Blackman et al 'Commentary on the Companies Act' Vol 1(2002), 5-157.

dividend entitlements when with entire propriety and commercial ease profits could be paid out to members as dividends.¹⁹¹

b) Share repurchases: As has been said earlier, share repurchases as a form of distribution,¹⁹² whether directly by the company buying from its shareholders or indirectly by the sub-holding company buying from its holding company, was prohibited in the 1973 Act. The United States of America has been the leading part of the world rejecting the prohibition in favour of the solvency and liquidity test for justification and was latter on joined by Canada,¹⁹³ the United Kingdom,¹⁹⁴ Australia,¹⁹⁵ New Zealand,¹⁹⁶ and of late, South Africa.¹⁹⁷ The following reasons were advanced to motivate the need to amend company laws so to allow companies to acquire own shares:

The principles of capital maintenance have undergone significant changes in most countries. The modern notion of capital maintenance is that companies may reduce capital, including acquisition of their own shares, but subject to solvency and liquidity criteria. This has the advantage of affording protection to creditors whilst at the same time giving flexibility to companies to achieve sound commercial objectives. These aspects of flexibility and achievement of sound commercial goals have become extremely important since South Africa's re-entry into the global market...¹⁹⁸

From the foregoing, one can note the advantages that were considered in contemplation of abandoning the capital maintenance rules. Flexibility should always be preferred to rigidity where flexibility insinuates economic benefit for the company's stakeholders especially those with a financial stake such as shareholders and creditors. According to

R Jooste, the following are justifications for share re-purchases;¹⁹⁹

- They are useful where a company has an employee share incentive scheme because they enable the company to purchase employees shares when they leave their employment.
- They can be used to buy out dissenting shareholders;

¹⁹¹ *Ex Parte Glossop* (1988) 1 WLR 1068, 1075.

¹⁹² Section 1 of the 2008 Act; a(iii) of the distribution definition.

¹⁹³ Canadian statute: established in Section 39 of The Business Corporations Act of 1970

¹⁹⁴ The UK Statute: established in the Companies Act of 1981.

¹⁹⁵ Australian Legislation: sections 257A-257J of the Corporations Law 1989.

¹⁹⁶ See the New Zealand Companies Act 1993 sections 58-67C.

¹⁹⁷ Firstly in the 1999 Companies Amendment Act and fully fledged in the 2008 Act. It is quite an interesting reformation in South African law and something to admire about South African legislators in their bid to ensure that their laws are premised at meeting internationally approved standards.

¹⁹⁸ See Memorandum on the Objects of the Companies Amendment Bill, 1999.

¹⁹⁹ R Jooste 'Corporate Finance' opcit note 31, 296-298.

- They enable a company to return surplus funds to shareholders who can then make other more profitable investments;
- They are used to achieve a desirable debt equity ratio i.e. Risk, Gearing, Leverage Ratio: a financial ratio indicating the relative proportion of shareholders` equity and debt used to finance company assets.²⁰⁰
- They help where a company has many shareholders with small shareholdings, the administrative overheads that this causes can be reduced by the company buying out these ‘odds-lots’ without incurring any material cost;
- They help companies engaging in takeovers and mergers through removing shares from the market and re-issuing them as consideration in takeovers and mergers without dramatically increasing the company`s issued shares.²⁰¹
- They help management to gradually ensure control of their company through buying out others and minimizing the number of shares that have to be acquired in order to gain full control thereof.²⁰²

It is thus established that allowing share-buy backs on the strength of the solvency and liquidity test is like killing two birds with one stone in that while the creditors are protected by the test, shareholders achieve several economic goals as established above. Creditors cannot exist in a vacuum without companies where they have to invest either through loans or the supply of goods and services. To that end, companies are the machinery for the benefit of shareholders hence the happiness of shareholders is the happiness of creditors as well who find business in those companies. Thus, the solvency and liquidity test ensures flexibility, incentivizes investors and ultimately boosts economic growth while at the same time securing creditors` interests.

c) Other forms of distributions: Another form of distribution is capitalisation of shares which is generally meant to give more shareholding value to existing shareholders as a way to promote the company`s shareholders.²⁰³ This concept does not really benefit creditors but shareholders, however; it should not cross the lines to prejudice

²⁰⁰ Debt Equity Ratio, available at https://en.m.wikipedia.org/wiki/Debt-to-equity_ratio (accessed on 26 August 2018).

²⁰¹ MS Blackman et al , opict note 190, 5-55.

²⁰² Ibid, 5-61.

²⁰³ Capitalisation of shares is whereby new shares are issued to existing shareholders in proportion to their existing shareholding. See Capitalisation of shares, available at <https://en.m.wikipedia.org/wiki/Capitalisation-shares> (Accessed on the 24 of September 2018).

creditor interests. The solvency and liquidity test should be applied to protect creditor interests whenever such a distribution is contemplated. Also, to encourage investment through incentivizing shareholders, a company is allowed to perform the following transactions/ distributions as long as it satisfies the solvency and liquidity test which is ultimately meant to strike a balance between the company's interests, shareholder and also the interests of creditors;²⁰⁴

- A company may directly or indirectly incur debts or other obligations for the benefit of one or more holders of any of the shares of that company or of another company within the same group of companies; or
- A company may directly or indirectly forgive or waive a debt or other obligation owed to the company by one or more holders of any of the shares of that company or of another company within the same group of companies.
- These forms of distributions need no further explanation as they are clear and self-explanatory. As earlier stated, when shareholders are impressed, it is a motivation for further investment and the propping up of new investors which may entail more business opportunities for creditors hence a striking of scales of balances for all-stakeholder interests for a healthy and growing economy.

To sum it up, it is important to reckon the contribution by the solvency and liquidity test concerning several forms of distribution. Most distributions were under the archaic capital maintenance rules barred but now they are entertained subject to their compliance with the solvency and liquidity test among other requirements. Far and above all determinations, the solvency and liquidity test has become the main basis for determining the lawfulness of a distribution. A distribution that falls short of this test is unlawful and is liable to be reversed in addition to the sanctioning of directors who participate in such an unlawful distribution at the expense of creditors.²⁰⁵ The protection of creditors by the solvency and liquidity test cannot be overemphasized however several discrepancies discussed above should be addressed to ensure its adequacy. Shareholders are also left out on the decision making concerning distributions, leaving directors with the ultimate decision making. This somewhat does not settle well with shareholders as distributions affect much of their rights hence they should as

²⁰⁴ (b) & (c) of the definition of "distributions" under s 1 of the 2008 Act.

²⁰⁵ See R Jooste, *opcit* note 31, 282; 287; 306; 311. The plight of corporate laws to give courts powers to reverse unlawful distributions and to sanction unscrupulous directors who authorize unlawful distributions shows how serious legislators are concerning the need to protect creditors and the company interests. This shall be discussed separately under paragraph 3.2.

well participate in the decision making to the extent they do not trample on creditors' interests and the interests of the managers of the company.²⁰⁶

3.1.3.2. Financial assistance versus creditor protection

Dating back to a period prior²⁰⁷ and through the reign of the 1973 Act, corporate laws have always been prohibiting what is termed "financial assistance". This position has now been changed, firstly by the 1999 Amendment Act, and finally by the 2008 Act subject to certain conditions which shall be canvassed below. Financial assistance is however not defined in both the 1973 Act and the 2008 Act. Both Acts just give examples of what they mean by financial assistance and what they do not mean by same.²⁰⁸ A literal meaning would entail 'the action of helping someone either financially or in relation thereto', however, it is imperative to find the concept's legal meaning.²⁰⁹ Courts had to devise several guidelines to determine whether or not financial assistance had been granted.²¹⁰ It is not financial assistance when the direct object of the transaction is simply to give to another what he or she is in any event entitled to even where the transaction involves a net transfer of value from the company.²¹¹ For instance, it cannot be financial assistance when a company ordinarily pays a debt that is due and payable, even if such payment has a condition of a share sale.²¹² Be that as it may, both Acts govern financial assistance in two forms as follows;

1. The giving of financial assistance to anyone so that they buy shares of the company;²¹³
2. The giving of financial assistance to directors or any prescribed officers for any reasons whatsoever.²¹⁴

²⁰⁶ R Jooste 'Issues Relating to Regulation of Distribution by the 2008 Companies Act' (2009) 126(4) *South African Law Journal* 650.

²⁰⁷ Common law principles and the Companies Act of 1926.

²⁰⁸ S 38 of the 1973 Act and s 44 of the 2008 Act; section 226 of the 1973 Act and s 45 of the 2008 Act.

²⁰⁹ See financial assistance for share purchase, available at

[https://en.m.wikipedia.org/wiki/Financial_assistance_\(Share_purchase\)](https://en.m.wikipedia.org/wiki/Financial_assistance_(Share_purchase)) (accessed on 01/10/2018). Financial assistance is in law meant to refer to the assistance given by a company for the purchase of its shares or shares in its holding company and/ or for any reason which is justifiable.

²¹⁰ In *Charterhouse Investments Trust Ltd v Tempest Diesel Ltd* (1986) 1 BCLC 1, Hoffman J, referring to a UK Equivalent of section 38 of the 1973 Act, stated that 'There is no definition of giving financial assistance in the section, although some examples are given. The words have no technical meaning and their frame of reference is in my judgment the language of the ordinary commerce. One must examine the commercial realities of the transaction and decide whether it can properly be described as giving financial assistance by the company, bearing in mind that the section is a penal one and should not be strained to cover transactions which are not fairly within it.

²¹¹ *Ibid*, at 10. A proper distribution of a dividend is not financial assistance. See also *Brady v Brady* 1989 AC 755 at 783.

²¹² *MT Realisations v Digital Equipment* (2003) 2 BCLC 117 (CA).

²¹³ Section 38 of the 1973 Act and s 44 of the 2008 Act.

²¹⁴ Section 226 of the 1973 Act and s 45 of the 2008 Act.

It is thus important to deal with each form of financial assistance in order to establish the position of the law in relation to them and to examine the pros and cons of the previous prohibition of financial assistance and the subsequent leeway under the solvency and liquidity test regime in so far as it relates to creditor protection in company affairs.

a) Financial assistance to purchase shares versus creditor protection

Prior to the 1999 Amendment Act, financial assistance to purchase a company's shares or those of a holding company, to either existing or prospective shareholders of the company, was strictly prohibited by section 38 of the 1973 Act.²¹⁵ The rationale behind such prohibition was premised on averting the mischief which in some instances could be aimed at abusing the company in a way that persons without sufficient funds or credit facilities of their own, purchased shares of the company out of borrowed funds and after gaining control of the company, they could then use the funds of the company to pay for shares acquired by them.²¹⁶ Thus, the object of section 38 was simply to ensure that corporate funds were to be used for their legitimate purpose and nothing else.²¹⁷ One of the legitimate purposes of the funds of the company is to ensure that the company is in a liquid state allowing it to meet all its debts as they become due and payable. Such prohibition was thus meant to protect the interests of the company itself and creditors, amongst other stakeholders. This was explained in *Lewis v Oneanate (Pty) Ltd*²¹⁸ where Nicholas AJA stated the following:

The objective of a provision such as section 38(1) is the protection of creditors of a company, who have a right to look to its paid – up capital as the fund out of which their debts are to be discharged....The purpose of the legislature was to avoid that fund being employed or depleted or exposed to possible risk in consequence of transactions concluded for the purpose of or in connection with the purchase of its shares.

The reasoning in the *Lewis's case* concerning creditor protection is purely a progeny of capital maintenance rules where it was believed that a company's capital should not be tempered with for any purpose other than that which it is intended for in the ordinary course of running business operations.²¹⁹ This position was however provisionally changed in the 1999 Amendment Act where financial assistance is allowed subject to certain important

²¹⁵ Section 38(1) of the 1973 Act provided that 'no company shall give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares of the company, or where the company is a subsidiary company, of its holding company'.

²¹⁶ R Jooste 'Corporate Finance' opcit note 31, 313-332.

²¹⁷ See *Chastin v SWP Group plc* (2003) 1 BCLC 675 (CA) 686 where it is stated that the company's resources or that of its subsidiaries should not be used directly or indirectly to assist purchase of its own shares.

²¹⁸ 1992 (4) SA 811 (A) 818.

²¹⁹ See capital maintenance rules under paragraph 3.1.2. above.

conditions which are premised on securing interests of creditors and other stakeholders. Section 38 (2A) of the 1973 Act, being a result of the 1999 Amendment, clearly marks the original intention of legislature which is to ensure creditor interests are safe as follows;

‘(2A) Subsection (1) does not prohibit a company from giving financial assistance for the purchase of or subscription for shares of that company or its holding company, if-

- (a) the company's board is satisfied that-
 - (i) subsequent to the transaction, the consolidated assets of the company fairly valued will be more than its consolidated liabilities; and
 - (ii) subsequent to providing the assistance, and for the duration of the transaction, the company will be able to pay its debts as they become due in the ordinary course of business; and
- (b) the terms upon which the assistance is to be given is sanctioned by a special resolution of its members.’

The wording of s38(2A) clearly favours the solvency and liquidity test although it lacks the detail and particularity that is propounded in s 44 of the 2008 Act. Section 44 of the 2008 Act takes greater caution against this partial liberty to financial assistance in order to avert any abuses of the liberty. Section 44 firstly allows financial assistance only to the extent that the memorandum of incorporation allows.²²⁰ In other words, if the memorandum of incorporation prohibits financial assistance then it may not be given under any circumstances. Secondly, section 44 gives the ultimate power to directors concerning an authorization of a financial assistance and this is to curtail the powers which shareholders may have in a bid to abuse such powers for unlawful gains at the expense of other stakeholders like creditors.²²¹ A special resolution by shareholders to approve a financial assistance will still need to go through the final discretion of directors for such financial assistance to be ultimately given.²²² Thirdly, section 44 prohibits financial assistance unless it meets the following requirements despite the provisions of the memorandum of incorporation;

- The financial assistance should be pursuant to an employee share scheme that is compliant with section 97 of the 2008 Act.²²³ or
- The financial assistance must be pursuant to a special resolution of the shareholders, adopted within the previous two years, which approved such assistance either for the specific recipient or category of potential recipients, and the specific recipient falls within the category.²²⁴
- The solvency and liquidity test should precede the envisaged financial assistance;²²⁵

²²⁰ Section 44(2) & (4) of the 2008 Act.

²²¹ Ibid.

²²² Section 44(3)(a)(ii) of the 2008 Act.

²²³ Section 44(3)(a)(i) of the 2008 Act.

²²⁴ Section 44(3)(a)(ii) of the 2008 Act.

²²⁵ Section 44(3)(b)(i) of the 2008 Act.

- The best interests of the company should be considered when giving financial assistance.²²⁶

The core business of these provisions is to protect interests of outsiders, i.e., creditors since they do not have control in the company affairs yet they have an important financial stake in the company which has to be preserved. Although corporate laws aim to promote an investor incentive economy by allowing members of the company to trade freely, still there remains much need to protect outsiders of companies from an abuse of such liberty. The researcher would want to appreciate the current position of the law in allowing financial assistance as it also places existing shareholders at an advantage and also giving other prospective shareholders a chance to acquire company shares. This chance is also provided for employees, through the employee share scheme,²²⁷ who may not be able to purchase shares but have important contributions to the company such that their input deserves a bit of courtesy remuneration, including the access of a stake in the company's equity. The position of the 2008 Act concerning financial assistance caters for the interests of creditors, shareholders, employees, and also the best interests of the company.²²⁸ Further, directors are under a duty to act in good faith and to ensure that they do not incur personal liability due to the current reprimands of the law on those directors who participate in a resolution meeting concerning a possibly invalid financial assistance.²²⁹ The researcher thus concludes that the solvency and liquidity test and its application has allowed for the provision of financial assistance for purchasing a company's shares which is a good catch for shareholders and employees while at the same time ensuring that the interests of creditors are safeguarded which matters most in this research.

b) Financial assistance to directors and others

In terms of the 1973 Act, financial assistance to directors or managers was prohibited. Section 226 provides as follows;

- (1) No company shall directly or indirectly make a loan to-
 - (a) any director or manager of-
 - (i) the company; or
 - (ii) its holding company; or
 - (iii) any other company which is a subsidiary of its holding company; or

²²⁶ Section 44(3)(b)(ii) of the 2008 Act. Comparably, this position of ensuring the best interests of the company when giving financial assistance is also maintained in s 76(2)(b) of the New Zealand companies Act 1993 which provides that a company may give financial assistance if the board has previously resolved that giving assistance is in the best interests of the company and that terms and conditions of the assistance are fair and reasonable to the company.

²²⁷ Section 44(3)(a)(i) of the 2008 Act.

²²⁸ See enlightened shareholder value approach and the pluralist approach in chapter 2 above, paragraph 2.3.2 and 2.3.3 respectively.

²²⁹ Section 44(6) read together with s 77(3)(e)(iv) of the 2008 Act; to be discussed in detail below under paragraph 3.2.

(b) any other company or other body corporate controlled by one or more directors or managers of the company or of its holding company or of any company which is a subsidiary of its holding company;
or provide any security to any person in connection with an obligation of such director, manager, company or other body corporate.

The 1973 Act prohibited such financial assistance as a way to avert the potential abuse by those in positions of power which may affect the company's best interests and the interests of various stakeholders including creditors.²³⁰ Directors or managers could at any time procure loans from the company which they control and it could be that they would not normally qualify for same if the affordability test was to be considered. That would then risk the liquidity state of company to the detriment of creditors in the event that they fail to pay back the loans as arranged. Same is true when they use the company's assets as security for their personal financial obligations with third parties and they eventually fail to meet their obligations with third parties who will turn to the assets of the company itself, again affecting the company's best interest and the interests of important stakeholders such as creditors who look up to those assets as security for their debts.

The stance by the 1973 Act on financial assistance, although it was meant to protect creditors, disregarded the interests of directors and other important employees of the company. Their importance in the company deserves recognition and they should be granted access to some of these credit facilities to safeguard their personal interests, a happy employee realizes his best potential at work. The 2008 Act brings a solution which is aimed at protecting the financial interests of these directors and prescribed officers²³¹ while at the same time protecting the best interests of the company and creditors. Section 45 of the 2008 Act allows for provision of financial assistance to directors and prescribed officers subject to certain requirements being met. Majority of those requirements are exactly the same as those in section 44 discussed above in paragraph 3.1.3.2.1 hence the researcher shall not discuss them hereunder. Of importance again is the need to ensure that company passes the solvency and liquidity test before the board of directors approves of any financial assistance to directors and prescribed officers.²³² This once again stresses the need to protect creditors by the solvency and liquidity test while simultaneously allowing some transactions like financial assistance which may be beneficial to other stakeholders as well. What remains for the legislature is to ensure that there are strict rules or polices; guidelines

²³⁰ R Jooste 'Corporate Finance' opcit note 31, 335.

²³¹ Prescribed officers in the 2008 Act means the holder of an office, within a company, that has been designated by the Minister in terms of section 66 (11); This includes managers, accountants, company secretaries etc.

²³² Section 45(3)(b) of the 2008 Act.

and procedures set in motion to avert any abuses of this privilege by those on the steering wheel of the company.

3.1.3.3. Creditor protection during amalgamations or mergers & other fundamental transactions

The concept of amalgamation and mergers had been governed by common law until the 2008 Act came into force in South Africa. Section 1 of the 2008 Act defines amalgamation and mergers as follows;

Amalgamation or merger' means a transaction, or series of transactions, pursuant to an agreement between two or more companies, resulting in-

(a) the formation of one or more new companies, which together hold all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement, and the dissolution of each of the amalgamating or merging companies; or

(b) the survival of at least one of the amalgamating or merging companies, with or without the formation of one or more new companies, and the vesting in the surviving company or companies, together with such new companies, of all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement.

The aim of an amalgamation or merger is to bring two or more companies basically to ensure that the resulting combo- company is well equipped to adapt to changing business conditions in the interests of economic growth and wealth creation.²³³ It goes without saying that an amalgamation or merger will definitely affect the interests of all stakeholders from amalgamating or merging companies. This then creates reason to look into the position of creditors when these transactions are in process.

The merger procedure as governed by sections 113-116 of the 2008 Act involves five steps²³⁴ which are among others the need to ensure the resulting company passes the solvency and liquidity test immediately after its formation²³⁵ and the subsequent notice that should as well be given to creditors informing them of the proposed merger or amalgamation by each of the companies intending to do so.²³⁶ Of importance is that creditors are further given a right to approach the court within 15 business days of receiving the aforesaid notice only in instances where they hold that the proposed merger or amalgamation will materially prejudice their interests.²³⁷ Thus, the 2008 Act does indeed have interests of creditors at heart when it comes to this fundamental transaction as it provides a double-barrel approach

²³³ MF Cassim & J Yeats 'Fundamental transactions, Takeovers & Offers' opcit note 31, pp 677.

²³⁴ Ibid, at 684.

²³⁵ Section 113(4)(b) read with section 115 of the 2008 Act. I shall not reiterate the importance of the solvency and liquidity test concerning the protection of creditors as much has already been covered concerning this concept.

²³⁶ Section 116(1)(a) of the 2008 Act.

²³⁷ Section 116(1)(b) &(c) of the 2008 Act.

to creditor protection *via* the machinery of the solvency and liquidity test and the leeway of affected creditors to approach the court for a review of the merger or amalgamation. The researcher is however perplexed with the silence of the 2008 Act on creditor protection concerning the other fundamental transactions such as where a company has to dispose a greater, all or part of its assets,²³⁸ where a scheme of arrangement²³⁹ is to be effected and on takeovers²⁴⁰ as well. The researcher is of the view that something was supposed to be strictly provided for to ensure that the interests of creditors are well secured when these fundamental transactions are being effected.

3.1.4. A summary to the solvency and liquidity test concept

The researcher welcomes the importance of the solvency and liquidity test which cannot be overemphasized. Vahed J, in *First Rand Bank Ltd v Wayrail Investments (Pty) Ltd*,²⁴¹ commented on the import of the solvency and liquidity test *vis-à-vis* all the transactions that it stands as a grand pre-requisite for their authorization as follows;

[34] As best as I can make out, the sections of the 2008 Act that refer to and call for the application of the solvency and liquidity test set out in section 4, are those dealt with in paragraphs 24 to 33 above. To my mind, the solvency and liquidity test, as described in section 4, is a device or tool for the purposes of implementing the provisions or satisfying the restrictions imposed in or by those sections.

From the foregoing, it is undeniably acknowledged that the solvency and liquidity test is a restricting measure which has to be passed before most of the transactions that affect creditors can be approved. Thus, the test has helped in removing barriers to several transactions and thus promoting an investor friendly environment for economic growth with interests of shareholders taken care of while at the same time promoting interests of creditors who are outsiders to the company. Further, it is the researcher's finding that the test is applied with differences in form and strictness of its requirements and this varies from transaction to transaction.²⁴²

²³⁸ Section 112 of the 2008 Act leaves only major shareholders with the absolute right to decide on this aspect; leaving minority shareholder with appraisal rights only; and nothing mentioned of creditors. When a company's assets are sold, the solvency status of the company is affected and that subsequently affects the interests of creditors who rely on the company's assets as security for their investments.

²³⁹ Section 114 read together with section 115 of the 2008 Act.

²⁴⁰ Sections 117 -127 of the 2008 Act.

²⁴¹ A reportable case from KZN High Court; Durban (Case No. 684/2012) ; judgment delivered on 20/12/2012.

²⁴² This is reflected in sections 44; 45; 46; 47 & 48 of the 2008 Act.

3.2. SANCTIONING OF DIRECTORS/ DIRECTORS` LIABILITY

One of the creditor protective mechanisms that corporate laws have always been employing, whether in common law or statutory law, is the sanctioning of those who control companies, in particular, directors and managers together with some important officials in the company. Where these company officials find themselves on the wrong side of the law while acting on behalf of the company or where they put the interests of the company and any stakeholder at risk, corporate laws have been set to deter them from such conducts. The issue will be whether such deterrence is sufficient to ensure that directors will not abuse their control rights to the detriment of creditors and other stakeholders. In the 1973 Act, directors were to be held *criminally liable* for certain unlawful conducts/ contravening provisions of the 1973 Act and they would normally incur civil liability under the common law except for some instances where civil liability was statutory.²⁴³ The 2008 Act makes an attempt to decriminalise directors` liability in most instances in favour of civil liability. One would suggest that imposing both criminal and civil liability would completely deter directors from engaging in certain unlawful dealings at the expense of other stakeholders. Criminal sanctions are however problematic for the threat that they impose on the director`s ability to perform his/her duties freely without fear of finding oneself behind bars.

Of importance is also the codification of the directors` duties, responsibilities, obligations and standards expected of a director in sections 75 & 76 of the 2008 Act as a way to develop common law and to ensure certainty as to the protection of interests of the company itself and other stakeholders from abusive directors. Section 76(3) provides that a director is supposed to act in good faith and for a proper purpose; in the best interests of the company; and with the degree of care, skill and diligence expected from a reasonable director. If one is to act in the best interests of the company he is expected to ensure interests of several stakeholders are upheld because for best interests of the company to be achieved, the stakeholders must be satisfied and this includes creditors who are important to the ongoing concern of the business operations through their supplies and funding. A director who acts in the best interests of the company will save himself and the company from inevitable civil suits or possible criminal liability in some circumstances. Section 77(1) - (10) of the 2008 Act statutorily sets out the liability of directors and prescribed officers of a company in several different transactions. The provision also applies to members of the audit committee, a committee of the board, irrespective of whether the persons serving on the committee are

²⁴³ Section 424(4) of the 1973 Act imposing criminal liability for reckless and fraudulent trading; section 38 of the 1973 imposing no civil liability on directors responsible for contravening its provisions but imposing a criminal liability in its subsection 3.

directors of the company, as well as alternate directors. Section 77(2) of the 2008 Act provides as follows:

- “2) A director of a company may be held liable-
- (a) in accordance with the principles of the common law relating to breach of a fiduciary duty, for any loss, damages or costs sustained by the company as a consequence of any breach by the director of a duty contemplated in section 75, 76 (2) or 76 (3) (a) or (b) ; or
 - (b) in accordance with the principles of the common law relating to delict for any loss, damages or costs sustained by the company as a consequence of any breach by the director of-
 - (i) a duty contemplated in section 76 (3) (c) ;
 - (ii) any provision of this Act not otherwise mentioned in this section; or
 - (iii) any provision of the company's Memorandum of Incorporation....”

The above provision shows that what could be obtained through common law under contract and delict can now be obtained statutorily in a more certain way in as far as breach of directors' duties and any related delictual losses is concerned. The 2008 Act has taken cognisance of common law and has thus codified it to give much effect to the liability of directors for any loss, damage or costs incurred as a result of their conduct.

3.2.1. Actions/ or omissions where directors may be held liable

Section 77(3) lists specific actions of directors for which they can be held liable. Each of them shall be briefly discussed to take note of differences with the 1973 Act and also the importance in creditor protection thereof.

3.2.1.1. Acting on behalf of the company without authority to do so

A director who acts for the company without necessary authority will be held personally liable for the loss the company may suffer as a consequence thereof.²⁴⁴ This reconciles with the fact that the 2008 Act, unlike the 1973 Act, now has given credence to the *Turquand* rule *in lieu* of the 1973 Act's doctrine of constructive notice.²⁴⁵ Under the 2008 Act, third parties like creditors who deal with company directors who are unauthorised are not affected by the deficiencies thereof and a company may not deny its obligations but shall have recourse against its directors who so acted. This development is important as far as creditor protection is concerned.

²⁴⁴ Section 77(3)(a) provides that a director will be liable for loss damages and costs if he acted in the name of the company, signed anything on behalf of the company, or purported to bind the company or authorize the taking of any action by or on behalf of the company, despite knowing that the director lacked the authority to do so. “Knowing” is very widely defined in s 1 and includes knowledge which he or she reasonably ought to have had or reasonably ought to have investigated to the extent that would have provided him or her with actual knowledge or to have taken measures that would reasonably be expected to have provided him or her with actual knowledge.

²⁴⁵ The Turquand rule shall be discussed in detail in chapter 4.

3.2.1.2. Fraudulent, reckless and Insolvent trading

A director shall be held personally liable for losses, damages and costs if he acquiesced in carrying on of the company's business despite knowing that it is prohibited in terms of section 22.²⁴⁶ Section 22 of the 2008 Act provides that a company must not carry on its business recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose; or trade under insolvent circumstances. Insolvent trading affects mainly creditors who may keep on supplying goods or investing in a company without the knowledge of its insolvency. Directors are further called to apply their minds and act reasonably in all circumstances ensuring that they avert any reckless trading or fraudulent conduct. This is for the best interests of the company and several stakeholders and creditors who are of essence in this research.

Still on fraudulent trading, under section 77(3)(c) of the 2008 Act, a director will be held specifically liable where he/she has been a party to an act or omission by the company despite knowing that the act or omission was calculated to defraud a creditor, employee or shareholder of the company, or had another fraudulent purpose. Specifically deterring directors from defrauding any of the stakeholders such as creditors makes this sanctioning of essence to this research. Creditors' interests are safeguarded knowing that any fraudulent conduct against them is covered by the law. Some directors falsify financial statements of the company in order to convince creditors that they can afford the credit facility. Section 77(3)(d) of the 2008 Act strictly holds directors liable for authorizing financial statements or any company documents such as the prospectus when they knew that third parties will be misled into believing a false picture.

Comparably, section 424 of the 1973 Act governed fraudulent and reckless trading but it was limited only to judicial management and to winding up or liquidation of both insolvent and solvent companies.²⁴⁷ Section 22 of the 2008 Act is broader as it is not constricted to winding up or liquidation time i.e. there is no need to first have the company undergo liquidation processes in order to discover whether it was trading under insolvent conditions or not. However, the discovery dates back to a period even before liquidation and directors would account as to why they traded under such unlawful conditions. Section 22 of the 2008

²⁴⁶ Section 77(3)(b) of the 2008 Act.

²⁴⁷ Section 424 provides as follows; "(1) 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..."

Act has also added another type of wrongful trading which is “trading under insolvent conditions” which safeguards more of the interests of creditors. In *Ozinsky NO v Lloyd*²⁴⁸ the court laid down the general principle that that if a company continues to carry on business and to incur debts when, in the opinion of a reasonable businessman, standing in the shoes of the directors, there would be no reasonable prospect of the creditors receiving payment when due, it will in general be a proper inference that the business is being carried recklessly.

Trading under insolvent conditions consists of both reckless and fraudulent trading. Section 22 however is seemingly giving a task of finding out these unlawful tradings to the Commission alone; perhaps affected persons are the ones who will refer disputes to the Commission. The 1973`s section 424 confers *locus standi* to a specific list of stakeholders to access courts to hold a director personally liable for the unlawful conducts.²⁴⁹ Section 22 is however backed up by section 218(2) which gives *locus standi* to creditors to deal with unlawful conducts which affect their rights in company affairs. With section 218 creditors may actually approach court to claim for costs losses or damages perpetuated by an unlawful act of a director.

Section 214(1)(c) revives the concept of criminal liability against those who knowingly act fraudulently in company affairs. This is similar to subsections 3 & 4 of section 424 of the 1973 Act. Section 214 of the 2008 Act only invites criminal sanctions to deter specific and limited crimes; this is contrary to the 1973 Act which had a broader application of the criminal sanction on several conducts. When it comes to fraudulent trading, directors who recklessly and fraudulently trade at the expense of creditors should be ready to meet the law in both the civil and criminal aspects. The researcher views this stance as a noteworthy double barrel approach which is of essence in the protection of creditor interests among other stakeholders. In addition to the above, shareholders also have a claim for damages against any persons who intentionally, fraudulently, or due to gross negligence causes the company to do anything inconsistent with the 2008 Act or a limitation, restriction or qualification contemplated in section 20 of the 2008 Act unless there is ratification by shareholders.²⁵⁰ Thus when shareholders have recourse against any directors who mismanage the company affairs, it entails a deterrence of abuse of creditor interests among others although creditors may not have the same *locus standi* as shareholders.

²⁴⁸ 1992 (3) SA 396 (C) at 414G.

²⁴⁹ This includes, the master, creditors, judicial manager, liquidator etc.

²⁵⁰ Section 20(6) of the 2008 Act.

3.2.1.3. Participation in a meeting which authorises unlawful transactions

Section 77(3)(e) of the 2008 Act lists several transactions which if unlawfully authorised will inevitably attract liability to each and every director who participated in the meeting and failed to vote against the resolution. These transactions are eight in number but for the sake of this research, the researcher shall only deal with those transactions which are relevant to creditor protection as follows;

- ❖ **Financial assistance:** Directors would under the 2008 Act be held personally liable for damages, losses and costs which the company may suffer as a resulting of participating in a meeting and failing to vote against a resolution for providing financial assistance for acquisition of securities to any person despite knowing that the financial assistance is in contravention of section 44 or alternatively the company's Memorandum of Incorporation.²⁵¹ Moreso, a director will be held liable for participating in a meeting and failing to vote against the provision of financial assistance to a director or prescribed officer under section 45 despite knowing that it is in contravention of the Act or the company's Memorandum of Incorporation.²⁵²

Section 38(3) and s 37(2) of the 1973 Act imposed criminal liability on directors who engaged in financial assistance as it was then strictly prohibited. On the other hand, the sections 44, 45 and 77(3) of the 2008 Act have no criminal liability but impose civil liability only. It is submitted that although decriminalisation of companies' legislation in many respects is an appropriate and positive development, the threat of potential criminal liability for directors was an effective deterrent in certain contexts and the criminal liability provision should have been retained for the purposes of sections such as this one.²⁵³ A proper deterring sanction against directors who abuse the current leeway to give financial assistance will help avert the abuse creditor interests as propounded under paragraph 3.1.3.2 above.

- ❖ **Distributions including acquisition of own shares:** Directors will be held personally liable for damages, losses and costs arising from participating in a resolution meeting and failing to vote against the drawing up of a resolution approving a distribution despite knowing that the said distribution is not in accordance with section 46 and also for supporting an acquisition by a company of

²⁵¹ Section 77(3)(e)(iv) of the 2008 Act.

²⁵² Section 77(e)(v) of the 2008 Act.

²⁵³ R Jooste 'Corporate Finance' opcit note 31; 333. Only section 214 of the 2008 Act retains criminal liability on limited grounds.

any of its shares despite knowing that the said acquisition was contrary to sections 46 or 48.²⁵⁴ The liability of a director only arises if immediately after making all distributions the company does not satisfy the solvency and liquidity test and it was unreasonable at the time of the resolution to come to the conclusion that the company would satisfy the solvency and liquidity test after making a distribution.²⁵⁵ A Court may make a decision setting aside in whole or in part, absolutely or conditionally and make any further order that is just and equitable in the circumstances, including an order;

- To rectify the decision, reverse any transaction, or restore any consideration paid or benefit received by any person in terms of the decision of the board;²⁵⁶ and
- Requiring the company to indemnify any director who has been or may be held liable, including indemnification for costs of the proceedings.²⁵⁷ It should however be noted that where there is actual knowledge on the part of the director that distribution is unlawful, it is unlikely that the court will order indemnification of such director in any way.

A leeway to recover unlawful distributions helps restore the company to its *status quo* which may as well be beneficial to creditors who are protected by the solvency and liquidity test in these circumstances. Comparably, the 1973 Act gave creditors *locus standi*, concerning an acquisition of shares, to approach court against unlawful acquisition as provided by section 86(3) which reads as follows;

“Where the acquisition by the company of shares issued by it is in contravention of the provisions of section 85 (4), any creditor who was a creditor at the time of the acquisition, or who is a creditor by reason of a cause of debt which arose before such acquisition, or any shareholder, may apply to the Court for an order, and the Court may, if it finds it equitable to do so-

- (a) order a shareholder or former shareholder to pay to the company any money or return any consideration that was paid or given by the company to acquire the shares;
- (b) order the company to issue an equivalent number of shares to the shareholder or former shareholder;
- (c) make such other order as it thinks fit.”

²⁵⁴ Section 77(3)(e)(vi; vii) of the 2008 Act.

²⁵⁵ Section 77(4)(a) of the 2008 Act.

²⁵⁶ Section 77(5)(b)(ii)(bb) of the 2008 Act.

²⁵⁷ Section 77(5)(b)(ii)(bb) of the 2008 Act.

Similarly, the aim for deterring unlawful distributions clearly shows that the legislature wanted to protect the interests of creditors, among other stakeholders, especially given the provisions of s86(3) of the 1973 Act above which outrightly gave creditors access to courts. Presently, if directors are to authorize distributions without considering underlying principles such as the liquidity and solvency status of the company, then creditors will be left to suffer when their debts can no longer be paid as they become due and payable.

3.2.2. Summary on director liability

Conclusively, one would note that directors were much threatened by criminal sanctions under the 1973 Act. Much of the claims for civil liability were being claimed through principles of common law such as delict. For instance, where a director had abused the legal person for his own advantage, one would opt to apply for the lifting of the corporate veil under the common law as this was not statutorily provided for. The 2008 Act has far reaching developments concerning the sanctioning of directors. Of importance is the codification of the director's fiduciary duties for the ascertaining of the law concerning what a director is expected to do.²⁵⁸ Section 77 codifies the common law position in as far as breach of a fiduciary duty is concerned.²⁵⁹ It also confirms that a director will be held liable in delict should he or she fail to execute his or her duties with the necessary degree of care and skill.²⁶⁰

In addition, section 77(3) specifically lists examples of unlawful transactions which directors may be held liable as a result of participating in their authorisation. Most of those unlawful transactions inevitably affect the interests of creditors hence the need to deter directors from trampling on the feet of outsiders (creditors). The common law duties however still apply, and one would always be able to revert thereto, should a particular set of facts not fall squarely within the ambit of the examples provided for in section 77(3).²⁶¹ The decriminalisation of director liability, in most cases, in favour of the civil liability is a reflection of the adoption of the common law principle of piercing the corporate veil which shall be discussed in chapter 4 in as far as creditors' protection is concerned. The courts are to look beyond the veil of the company and attach liability upon a director who blindly commits

²⁵⁸ Section 75 & 76 of the 2008 Act.

²⁵⁹ S 77(2)(a) of the 2008 Act.

²⁶⁰ S 77(2)(b) of the 2008 Act.

²⁶¹ AP Grové 'Company Directors: Fiduciary Duties and the Duty of Care and Skill' *unpublished LLM Dissertation*, university of Pretoria, 2012, 47.

prohibited acts/ omissions at the expense of the legal person.²⁶² With this, creditors remain with a great deal of remedies available for them in terms of statutory corporate laws backed up with their usual common law remedies. Although the provisions are not completely perfect, one would want to acknowledge these legal developments on creditor protection as they make the law certain and easily accessible.

3.3. LIQUIDATION/ WINDING UP VERSUS CREDITOR PROTECTION

Liquidation of a company is another concept which corporate law employs to safeguard interests of creditors among other stakeholders.²⁶³ Basically, winding up of a company is the method of ending, or dissolving a business. The winding up activity includes selling all assets, paying off creditors, and distributing remaining assets to the members or shareholders.²⁶⁴ The process also involves the appointment of a liquidator who will be responsible for ensuring that a company winds up effectively so to benefit all interested parties.²⁶⁵ The winding up process ends when the company has been deregistered from the register of companies by the Companies Commission upon receipt of a liquidation and distribution account that would have been also submitted to and approved by the Master prior to deregistration.²⁶⁶ A company can be wound up when it is either insolvent or solvent.²⁶⁷ When a company is insolvent and its prospects of resuscitation are slim, then any interested party (this includes creditors) may enforce process of liquidation.²⁶⁸ When a company is solvent, it can either be liquidated voluntarily by a special resolution²⁶⁹ or by a court order on specific grounds.²⁷⁰ Among other stakeholders, creditors are given *locus standi* to approach the court for an application to liquidate a company regardless of the company being solvent or insolvent. That position of the law shows how creditor interests

²⁶² Section 20(9) of the 2008 Act. The section gives any interested party the *locus standi* to use this remedy of last resort. Much shall be discussed under chapter 4.

²⁶³ Where a company is solvent but cannot pay the debts of the creditors or perpetuates *nulla bona* returns or where a company is actually insolvent, creditors may actively participate in the liquidation process and ensure that they recoup something from their debts. Section 345 of the 1973 Act and section 80 & 81 of the 2008 Act read together with the Insolvency Act of 1936.

²⁶⁴ Winding Up, available at <https://www.investopedia.com/terms/w/windingup.asp> (accessed on 07/10/2018), also referred to as company dissolution or liquidation.

²⁶⁵ A liquidator is appointed by the creditors and shareholders depending on who initiated liquidation processes and once a court approves of a liquidation then the master makes a final confirmation/ appointment of the liquidator. The master thus has an active role in the liquidation of a company including the receipt and approval of liquidation and distribution account which must cater for interests of all creditors first and then the residue of the assets being distributed to shareholders as per their shareholding values. See J Yeats 'Winding Up' opcit note 31; 921-2.

²⁶⁶ Ibid, 924. Yeats says a company is effectively dissolved as of date when its name is removed from the companies registered (deregistration).

²⁶⁷ Ibid; pp 914 for solvent companies and pp 918 for insolvent companies.

²⁶⁸ Ibid.

²⁶⁹ Section 80(1) of the 2008 Act.

²⁷⁰ Section 81 of the 2008 Act.

are also valued especially on proceedings as these where their interests may be affected. Where another stakeholder other than a creditor moves a motion to liquidate a company, then creditors will be entitled to adequate notices of such proceedings for their participation therein.²⁷¹

In any event, creditors must however not abuse this process as courts will be reluctant to grant a liquidation approval where it is found that the company is still viable and can meet its obligations on account of other commercially reasonable arrangements.²⁷² It is recommended that the enforcement of the liquidation process be a last resort remedy which may be employed after exhausting other available remedies such as, *inter-alia*, the business rescue procedure and creditor compromises. Creditors should not abusively enforce payment of their debts on threats of liquidating a debtor company.²⁷³ Companies are a means to ensure economic growth hence having to dissolve them is counter-economic development which is the reason why creditors must take greater caution when utilizing this remedy to recoup their entitlements. A proper employment of liquidation process will however ensure that creditors recover something out of either a solvent company, a financially distressed, or an insolvent company as the case may be. Thus, legislation provides for liquidation of a company when it is insolvent and even when it is solvent and this shall be discussed below.²⁷⁴

3.3.1. Winding up of solvent Companies

Winding up of solvent companies is regulated by the Companies Act of 2008²⁷⁵ whereas winding up of insolvent companies is still governed by Companies Act of 1973. The 2008

²⁷¹ Ibid.

²⁷² This is so because liquidation basically affects interests of many stakeholders including employees who may lose their employment and shareholders who may not be economically active thereafter. See A Vos 'Abuse of the Liquidation Process' (2007); available at <http://www.mondaq.com/southafrica/x/53216/Insolvency+Bankruptcy/Misuse+Of+The+Liquidation+Process/> (accessed on the 31/08/2018).

²⁷³ Ibid.

²⁷⁴ Sections 79-81 of Part G, Chapter 2 of the 2008 Act deal with winding up of solvent companies and chapter XIV of the 1973 Act still regulates the winding up of insolvent companies. This position will remain so as transitional arrangements until insolvent laws are reformed as well. The responsible minister has a task to reform insolvent laws, in particular the Insolvent Act 1936 which regulates insolvency laws. Thus, there is no change in so far as liquidation of insolvent companies is concerned whereas change is noticed in liquidation of solvent companies. Schedule 5 of the 2008 Act has made a "transitional arrangement" that Chapter 14 of the old Companies Act will continue to apply with respect to the winding-up and liquidation of companies as if that Act had not been repealed.

²⁷⁵ Although a solvent company is wound up by the 2008 Act, still there are some remnants of the 1973 Act that still apply to solvent companies to the extent they are applicable to consolidate the 2008 Act. Item 9 of Schedule 5 of the 2008 Act provides as follows "... (2) Despite sub-item (1), sections 343, 344, 346 and 348 to 353 [of the Companies Act 61 of 1973] do not apply to the winding-up of a solvent company, except to the extent necessary to give full effect to the provisions of Part G of Chapter 2."

Act does not define the meaning of a solvent company or an insolvent company. In the *Boschpoort Ondernemings (Pty) Ltd v ABSA Bank Ltd*,²⁷⁶ it was held that the inclusion of section 345 of the 1973 Act when it comes to the winding-up of solvent companies under sub-item 9(1) of schedule 5 of the 2008 Act and the subsequent exclusion of section 344 of the 1973 Act under sub-item 9(2) is significant when it comes to determining what is meant by a “solvent” company. Section 345 of the 1973 Act was retained in sub-item 9(1) to enable a determination to be made in terms of section 79(3) of the 2008 Act that a company ‘is or may be insolvent’ – even though the application was made in terms of either section 80 or 81 of the Companies Act 2008 for its winding-up as a so-called “solvent” company. The deeming provisions concerning the inability to pay its debts contained in section 345 of the 1973 Act may be used to establish the insolvency of a company. It was further held that the retention by the legislation in the context of a winding-up of a solvent company in the 2008 Act, of the deeming provisions as to when a company is unable to pay its debts as contained in section 345 of the 1973 Act, is a clear indication of what is meant by an insolvent company in the 2008 Act. It can only mean a company that is commercially insolvent. It therefore follows that a solvent company must be the opposite: that is a commercially solvent company.²⁷⁷ Factual solvency of a company is not in itself a determinant of whether a company should be placed in liquidation or not, accordingly, it is not a defence against an application to wind up a commercially insolvent company in terms of the 1973 Act. It will, however, always be a factor in deciding whether a company is unable to pay its debts or not. Thus a commercially solvent company (whether factually solvent or insolvent) may be wound up in terms of the 2008 Act only; a solvent company cannot be wound up in terms of the 1973 Act.

3.3.1.1 Voluntary Winding up of solvent Companies

Having defined the meaning of a solvent company, it should now be noted that a solvent company may be wound up in two ways namely, voluntary winding up by a special resolution and winding up by court order.²⁷⁸ Where a company is voluntarily wound up by a special resolution, such resolution shall provide whether the company is to be wound up by its creditors or by the company itself. The resolution must be filed together with prescribed fee to the Companies Commission and the Commission will subsequently submit a copy to the Master. The company may therefore arrange for security satisfactory to the Master for payment of its debts within 12 months after commencement of winding up or to obtain consent from the Master to dispense with security where a sworn statement by a director

²⁷⁶ (936/12) [2013] ZASCA 173.

²⁷⁷ Ibid.

²⁷⁸ Section 79(1) of the 2008 Act.

authorized by the board has been submitted to the Master stating that the company has no debts or a certificate by a company auditor suggesting same.²⁷⁹ A liquidator appointed by a resolution procedure has same powers given by the 2008 Act as one appointed by court where winding up is initiated by way of court order.²⁸⁰ During the winding up period, the company still remains a legal person and regards its powers as such except that its business has to cease or continue only to the extent required for the beneficial winding up of the company.²⁸¹ Basically there is not much difference with the provisions of the 1973 Act concerning voluntary dissolution either by shareholder or creditor resolution. Of importance to this research is the power both pieces of legislation give to creditors to enforce a dissolution of a company by way of a resolution in a bid to ensure that their interests are protected when a company has to cease operations under any given circumstances.

3.3.1.2 Winding up of solvent Companies by court order

Where a solvent company is sought to be wound up by a court order, in terms of section 81 of the 2008 Act, the following are circumstances under which a court may wind it up;

- Where a company has passed a special resolution that it be wound up by court or where a company has applied to court to have its voluntary winding up continued by the court.²⁸² A voluntary wind up as has been discussed above also serves interests of creditors as creditors may be given powers through a special resolution to oversee the flow of liquidation process in order to protect their interests.
- Where the company was under business rescue and the practitioner has applied to court in terms of section 141(2)(a) for winding up on the grounds that there is no reasonable prospect of the company being rescued.²⁸³ Business rescue process is a new concept in South African legislation, also meant to protect creditors by trying to revive a financially distressed company for the economic benefit of all stakeholders who have a financial stake in the company. This shall be discussed in detail in chapter 4 of this research work.
- One or more of the creditors have applied to court on the grounds that the business rescue proceedings have ended in a manner contemplated in section 132(2) and it appears to the court that it is just and equitable for the company to be wound up. Creditors may as well apply on any grounds other than those related to business rescue as long as they can show that it is just and equitable for the company to be

²⁷⁹ Section 80 of the 2008 Act.

²⁸⁰ J Yeats 'Winding Up' in *opcit* note 31; 915.

²⁸¹ *Ibid*.

²⁸² Section 81(1)(a) of the 2008 Act.

²⁸³ Section 81(1)(b) of the 2008 Act. Section 141(2)(a) gives a business rescue practitioner powers to approach court to discontinue rescue proceedings where there is no reasonable prospect of resuscitating the business.

wound up.²⁸⁴ Creditors are allowed to participate and monitor the progress of business rescue process and when they fail to resuscitate the company, creditors may apply to court to enforce liquidation in order to protect their interests.

- Where the company, one or more directors or one or more shareholders have applied to court on the grounds that the directors are deadlocked in the management and shareholders are unable to break the deadlock and irreparable injury to the company is resulting or may result from the deadlock or the company's business can no longer be conducted to the advantage of shareholders generally. The other ground is where shareholders themselves are deadlocked in voting power and have failed for a period that includes at least two consecutive annual general meeting dates, to elect successors to directors whose terms have expired. In all these circumstances it must be shown that it is just and equitable to wind up the company.²⁸⁵ Shareholders and directors also have a right to approach the court where there is a deadlock in company affairs and this to protect their interests and that of other stakeholders. Creditors are affected when there is a deadlock in company affairs in some instances hence it is recommended that they also be given a leeway/ *locus standi* to approach court when they learn of a deadlock that affects their financial interests.
- Where a shareholder has applied, with leave of the court, for an order to wind up the company on the grounds that the company controllers are acting or have acted in a manner that is fraudulent or otherwise illegal or that the company's assets are being misapplied or wasted.²⁸⁶ It is recommended that this circumstance be revised to also give creditors *locus standi* on this aspect; creditors also deserve same rights to approach court especially where fraudulent, illegal activities are being committed. This is worsened when company's assets are being misused yet creditors look up to those assets as security for their debts. In terms of section 22 of the 2008 Act, creditors as interested parties may however report to the Companies Tribunal for an investigation on issues as these.
- Where the Commission has applied to court on the grounds that the company or its controllers are acting or have acted in a manner that is fraudulent or otherwise illegal and the commission or panel has issued a compliance notice but still the company has failed to comply. Further where within the previous five years, enforcement procedures in terms of the Companies Act or the Close Corporation Act of 1984,

²⁸⁴ Section 81(1)(c)(i)&(ii) of the 2008 Act. Section 132(2) propounds the circumstances under which a business rescue may be terminated.

²⁸⁵ Section 81(1)(d) of the 2008 Act.

²⁸⁶ Section 81(1)(e) of the 2008 Act.

were taken against the company or its controllers for substantially the same conduct, resulting in an administrative fine or conviction of an offence.²⁸⁷ The establishment of the Companies Tribunal by the 2008 Act as an outside eye to affairs of the company helps outsiders as creditors who may not have *locus standi* to approach court in certain circumstances. This is a notable development because what creditors may not deal with outrightly via court process may be taken up through this Tribunal. What remains a question is the extent of the effectiveness of this Tribunal in handling matters reported to it. This can only be tested with time through a study of case law that relates to same. Chapter 4 shall as well deal with the import of the Companies' Tribunal as a new concept forum to resolve trade disputes in company affairs.²⁸⁸

The above circumstances when compared with section 344 of the 1973 Act clearly shows that there is a substantial change on circumstances in which a company may be dissolved. The researcher's analysis shows that although the 2008 circumstances still have some discrepancies such as not giving creditors *locus standi* in some circumstances, section 81 circumstances are inclined to protecting creditor interests as appears in their inclusion of business rescue failure as a ground for liquidation among other circumstances. This is a bit different from section 344 of the 1973 Act which had a lot of other circumstances which were archaic and unsuited for the 21st century corporate laws, save for those in s344(f)&(h) which are repeated in the 2008 Act in one way or the other.²⁸⁹ To reconcile both Acts in this regard, s344(h) of the 1973 Act seemingly stands as a determining factor for the court to grant liquidation under most circumstances in section 81 of the 2008 Act.²⁹⁰ There is a repetition of section 344(h) in section 81 of the 2008 Act of the need to ensure that there are just and equitable grounds to justify a liquidation order. What determines just and equitable grounds is not a closed list but case law has to this stage developed the following guidelines;²⁹¹

- Where the company's substratum has disappeared hence impossible for the company's objects to be pursued.
- Where the company has been pursuing illegal objects and fraudulent purposes.

²⁸⁷ Section 81(1)(e) of the 2008 Act.

²⁸⁸ Sections 193-5 of the 2008 Act.

²⁸⁹ Section 344(f) of the 1973 Act provides that a company may be wound up by court order where a company is unable to pay its debts as described in s345 of the 1973 Act. Section 345 is still applicable to complement the new provisions of the 2008 Act. Section 344(h) of the 1973 Act provides that liquidation may be granted where it is just and equitable to grant same; this is constantly repeated in s81 of the 2008 Act.

²⁹⁰ Section 81(c)(ii); s81(d)(iii) of the 2008 Act.

²⁹¹ *Apco Africa (Pty) Ltd v Apco Worldwide Inc* 2008 (5) SA 615 (SCA); Also see Blackman et al 'Commentary on the Companies Act' (2002) (1), 14-102; 14-116.

- Where there is a deadlock in the company's administration which renders the company incapable of carrying on its business.
- Where there is irretrievable destruction of the relationship in a domestic company (or *qausi* partnership).

The above meanings of just and equitable grounds have now been clearly legislated in section 81 of the 2008 Act hence clearing the air on what legislation previously meant by those grounds as interpreted by courts over years. The ambiguous provisions of the 1973 Act have now been clearly propounded hence bringing certainty in circumstances which may invite a dissolution of a solvent company by court order. Thus, there is no doubt that creditor interests are to a large extent safeguarded by the new provisions although a bit of touch ups needs to be done as recommended by the researcher above.²⁹²

3.3.2. Winding up of insolvent companies

As pointed out above, the winding up of insolvent Companies is still governed by the relevant provisions of the 1973 Companies Act. Where a company is insolvent, an application may be made to the court for winding up by either the company itself or its creditors or its members or by executor or administrator or trustee or curator or guardian in respect of the deceased estate of a member or whose estate is under sequestration or who is otherwise under disability or the liquidator of a body corporate in the course of being wound up which is a member of the company.²⁹³ Such an application may be initiated by a combination of any of the stakeholders mentioned above. The term "insolvency" describes a situation where a company is unable to pay its debts.²⁹⁴ A company is deemed to be unable to pay its debts if,²⁹⁵

- A creditor that is owed R100 by the company has served a demand for payment and the amount has not been paid for three weeks, or
- The sheriff has issued a *nulla bona* return to a warrant of execution, or
- It is proved to the satisfaction of the court that the company is unable to pay its debts.

Creditors have *locus standi*, inter-alia, to approach court by way of application to liquidate an insolvent company as a way to protect their interests. The application takes the form of a

²⁹² The researcher is of the view that creditors be granted *locus standi* to approach court on most of the circumstances listed in section 81 as an alternative to the Companies Tribunal. This allows parties to explore all available avenues for their convenience.

²⁹³ Section 346 of the 1973 Act.

²⁹⁴ Section 345 of the Companies Act of 1973.

²⁹⁵ Ibid.

notice of motion together with an affidavit supporting the facts on which the applicant relies for relief.²⁹⁶ In *Breetveldt v Van Zyl*²⁹⁷ the judge explained that the purpose of the application is to place before court, the company, the creditors and shareholders, a statement of the material facts upon which the winding up order is claimed and to provide information to the Master, the Sheriff, the Liquidator and other interested parties. Sufficient security has to be furnished to the Master for payment of all fees, charges and costs necessary for the success of winding up proceedings.²⁹⁸ A liquidator will be appointed to initiate the process and is endowed with powers to bring or defend legal proceedings, agree to settlements with debtors of the company, compromise or admit claims against the company, make arrangements with creditors, submit disputes to arbitration, carry on or discontinue the business of the company, sell the property of the company, and approach court for leave to perform any act or exercise any power for which he is not expressly authorized.²⁹⁹

As pointed out previously, creditors must however not abuse this process; it has been stated that where an application for winding up amounts to an abuse of process in that the motive is not merely to establish a *concursum creditorium* but is *mala fide*, the court will not grant a winding up order.³⁰⁰ Moreso, when winding up is used in a bid to enforce debt repayment for a debt which is disputed by a company in good faith on reasonable and substantial grounds, the court will not grant liquidation.³⁰¹ The court has thus a discretion on whether or not to allow liquidation especially where the company is factually insolvent.³⁰² Conclusively, winding up of an insolvent company is a process meant to protect interests of creditors such that shareholders should not abuse available assets at the expense of creditors and also that directors should not favour some creditors at the expense of other creditors. At least, all creditors should get equal attention/ proportions of their monies although the amounts to be recouped will depend on each creditor's value. Thus, the researcher is of the view that creditors are well protected by 1973 Act when it comes to liquidation of an insolvent company as they have *locus standi* to approach court and also are active in the liquidation process to protect their interests. What remains will be to take notice of the amendments made by the legislature to the 2008 Act after the Minister of Trade and Industry has reformed laws of insolvency, perhaps cumbersome requirements such as the need to furnish the

²⁹⁶ Section 347 of the 1973 Act.

²⁹⁷ 1972 (1) SA 304 (T) 314.

²⁹⁸ Section 346 of the 1973 Act.

²⁹⁹ Section 386 (4) of the 1973 Act.

³⁰⁰ J Yeats 'Winding Up' opcit note 31, 919.

³⁰¹ Ibid.

³⁰² Supra note 276, *Boschpoort Ondernemings* case, the company has to be actually commercially insolvent.

Master with security of liquidation costs may be done away with.³⁰³ Not all creditors may have enough funds to furnish such security yet they will be having a just cause in moving a motion for liquidation.

3.3.3. Summary on the liquidation mechanism.

It has already been provided above that the researcher is of the view that the 2008 Act has made helpful changes to promote creditor interests in as far as liquidation of solvent companies is concerned. The 2008 Act has done away with ambiguous circumstances under which a solvent company could be wound up and has made the law clear and certain. Minor amendments have already been proposed by the researcher in this regard. It is common cause that there are no changes yet concerning the liquidation of insolvent companies as creditors are protected in this regard save that some cumbersome elements of the process must be done away with in order to ensure effective creditor protection.

3.4. COMPROMISES WITH CREDITORS VERSUS CREDITOR PROTECTION

A “compromise with creditors” of the company is one of the mechanisms used to advance the interests of creditors while simultaneously aimed at catering for the well being of the company itself. Compromises are dealt with in section 155 of the 2008 Act. Previously they were dealt with under section 311 of the 1973 Act. Both these sections permit a company (or a liquidator of a company) to propose an arrangement or compromise of the financial obligations of the company to all creditors or to the members of any class of creditors. The literal meaning of the word “compromise” gives a glimpse of what a compromise with creditors may entail or mean.³⁰⁴ From a legal perspective, a compromise is an agreement between a company and its creditors or a class of creditors that terminates a dispute over rights of the parties through an arrangement agreed to by both parties amicably.³⁰⁵ A compromise, inter-alia other mechanisms, is a direct - step away from the contractarian theory³⁰⁶ in that it causes creditors to do away with the strict application of the contractual terms of repayment in favour of newly defined “corporate rescue oriented” terms which are presumably meant to be in the best interests of both the company and its creditors.

³⁰³ Section 346 of the 1973 Act.

³⁰⁴ According to the Cambridge dictionary, a compromise is literally an agreement in an argument in which the people involved reduce their demands or change their opinion in order to agree. Basically a compromise would do away with certain standards or principles or rules or facts in a way to strike an understanding between parties. Same is where creditors have to forgo contractual payment of their claims for a compromise to payment according to newly defined terms.

³⁰⁵ FHI Cassim ‘Business Rescue and Compromises’ opcit note 31; 910.

³⁰⁶ See paragraph 2.2.1 of chapter 2 above.

According to Cassim, a compromise is a way appropriate in reaching an agreement between a company and its creditors where normal mechanisms are not available.³⁰⁷

A compromise may be entered into regardless of whether or not a company is financially distressed as defined by section 128(1)(f) of the 2008 Act.³⁰⁸ A compromise may be undertaken even when the company is undergoing liquidation; however it cannot be engaged while the company is undergoing business rescue processes.³⁰⁹ In the 1973 Act there was need to obtain both leave to propose a compromise to creditors and also an order sanctioning the commencement of a compromise from court.³¹⁰ Under the 2008 Act, there is no requirement that the leave of the court must be obtained before the compromise is proposed to the creditors yet still the compromise must be sanctioned by the court in order to protect interests of creditors and the company.³¹¹ The board of the company or the liquidator (where the company is under liquidation) must deliver notice to the creditors concerned, requesting them to attend a meeting. The notice of meeting must be accompanied by a copy of the compromise proposal which must be detailed sufficiently to help creditors prepare.³¹² The proposal will be considered to have been adopted if at least 75% (in value) of the creditors present and voting vote in favour of the proposal.³¹³ Once the proposal has been approved through voting then directors or the liquidator may approach the court for the sanctioning of the compromise proposal. The court has the final say on whether or not to sanction a compromise despite it having been voted for by the majority of creditors, however once the compromise has been sanctioned by the court, it will be binding on all creditors or class of creditors and also on the company or, if applicable, the liquidator.³¹⁴ A compromise order for a company that is being liquidated goes simultaneously with an order discharging a liquidation order.³¹⁵ The final step in validating a compromise will be to file a court order sanctioning compromise with the companies' commission within 5 business days of the order.³¹⁶

³⁰⁷ FHI Cassim 'Business Rescue and Compromises' opcit note 31; 910

³⁰⁸ Section 155(1) of the 2008 Act.

³⁰⁹ FHI Cassim 'Business Rescue and Compromises' opcit note 31; 910; Putting a company under business rescue processes will automatically stop compromise negotiations.

³¹⁰ Section 311 of the 1973 Act; see also A Loubser 'Some Comparative Aspects of Corporate Rescue in South African Company Law' 2010, PHD Thesis, University of South Africa, 147.

³¹¹ Section 155(7) of the 2008 Act.

³¹² Section 155(3) outlines what should constitute a proper compromise proposal.

³¹³ Section 155(6) of the 2008 Act.

³¹⁴ A Loubser, opcit note 310, 148.

³¹⁵ Ibid.

³¹⁶ Section 155(8) of the 2008 Act.

3.4.1. Enforcement of creditor rights during compromise procedures

Firstly, it is imperative to consider the aspect of *locus standi* when it comes to proposal of a compromise. As pointed out above, under the 2008 Act, only directors and liquidators (as the case may be) have locus standi to propose a compromise.³¹⁷ In the 1973 Act, creditors and shareholders had *locus standi* to propose a compromise.³¹⁸ The rationale behind streamlining stakeholders with *locus standi* is really unknown to the researcher but the researcher is of the view that this position limits creditors' rights in respect of this mechanism. Creditors will have to convince directors or the liquidator to propose a compromise to them which makes it a difficult process when compared to the 1973 Act where they could actually propose a compromise themselves to the directors. It is however the researcher's view that perhaps the reason for the streamlining was to ensure that a compromise is be proposed by people in control of the company who have a more objective assessment of the company's records to actually conclude that a compromise will be in the interests of both the company and all the creditors. This is backed by the position under the 2008 Act which actually outlines what a compromise proposal should be comprised of.³¹⁹ Most of the information forming the basis of a compromise proposal will need someone with direct access to company records and/ or information in order to compile the proposal.³²⁰ It is recommended that legislation also gives creditors *locus standi* to propose a compromise provided that they have sufficient information to lay the basis of their proposal.

Secondly, unlike the 1973 Act, the 2008 Act has clearly outlined what a compromise should consist of in section 155(3). The researcher shall not delve into details on this aspect, but it should be noted that the 2008 Act has outlined the layout of a compromise into three segments as follows;

- Part A: background
- Part B: proposals
- Part C: assumptions and conditions.

All these segments constitute detailed information which will basically help a creditor to make an informed decision on whether or not to accept a compromise proposal. This development is thus of importance to protect creditor interests such that they do not have to jump into what they do not have much clarity on which may possibly prejudice their interests in future. To enhance creditor protection, the proposal must conclude with a certificate by an authorized director or liquidator stating that any factual information provided appears to be

³¹⁷ Section 155 (2) of the 2008 Act.

³¹⁸ See section 311(1) of the 1973 Act.

³¹⁹ The 1973 Act did not clearly outline what should be comprised in a compromise proposal yet the 2008 Act in section 155(3) clearly outlines the detailed information to be disclosed in a compromise proposal.

³²⁰ See s 155(3) of the 2008 Act.

accurate, complete and up to date, and declaring that the projections provided are estimates made in good faith on the basis of factual information and assumptions as set out in the statements.³²¹ It is the view of the researcher that liability for costs, losses and damages may actually apply to a director or liquidator who provides a false statement to justify a proposal with an intention to defraud creditors into accepting a grossly fallible compromise proposal.³²²

Thirdly, it must be noted that the sanctioning of a compromise places all creditor claims on a moratorium such that creditors may not enforce their rights against the company or its directors save in so far as the compromise agreement is concerned. This was actually the position in the 1973 Act; perhaps some analysis may deduce some change under the 2008 Act. The practical understanding is that creditors cede their rights in terms of their contractual debts repayments rights to the company or the proposer and hope in the success of the compromise agreement.³²³ In *Ex Parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (In Liquidation)*,³²⁴ Stegmann J had to decide whether creditors, in an application in terms of s 311 of the 1973 Act for an order that meetings be held of classes of creditors of a company in liquidation to consider a proposed compromise or arrangement, could both surrender their claims against the company and retain any rights that they might have against its representatives/ directors under s 424(1) of the 1973 Act.³²⁵ He outlined the purpose of a section 424(1) application as follows:

What is aimed at by an application in terms of s 424(1) is that a person contemplated by the subsection (often a director or officer of an insolvent company, and whom I shall call a 'wrongdoing company representative') should be declared personally responsible for 'the debts or other liabilities of the company', or at least for such of them as the Court may conclude that he should be held personally responsible for.³²⁶

It is important to explore the application of section 424 on this aspect in that this section is important as it was premised on holding directors liable for damages and costs as a result of reckless and fraudulent trading which could latter on be identified by creditors at proceedings

³²¹ Section 155 (5).

³²² Sections 20; 22; 2018 of the 2008 Act may apply under the circumstances.

³²³ See *Steel v Shanta Construction (Pty) Ltd and Others* 1973 (2) SA 537 (T) at 542.

³²⁴ 1992(2) SA 95 (WLD).

³²⁵ Section 424 of the 1973 Act provided as that "(1) 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..".

³²⁶ Supra note 306; at 107F-107G.

such as liquidation or judicial management or otherwise.³²⁷ Thus, In *Ex Parte De Villiers* case, Stegmann J further made the following *dictum* contending that the existence of ‘debts and liabilities’ were a prerequisite for the operation and functioning of s 424(1) of the 1973 Act:

For s 424(1) to be operable at all, the company must have ‘debts or other liabilities’. If the company has no’ debts and liabilities ‘an essential requirement is missing and s424(1) cannot provide a remedy. In a case in which the creditors have all agreed in terms of s 311 to a compromise which specifically provides for the extinction of all the company’s debts and liabilities, it seems to me to be obvious that s 424(1) cannot possibly function after the extinction of such debts and liabilities by the agreement of the creditors and sanction of the Court.....To my mind the words of s 424(1) make it quite clear that 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 as an ancillary liability, and that when that foundation ceases to exist (e.g. by the discharge or extinction of the company’s debts) the wrongdoing company representatives which otherwise might have been declared personally responsible in terms of s 424(1) cease to be amenable to any such declaration. The liability of the wrongdoing company representatives to be declared personally liable for a company’s debts or other liabilities in terms of s 424(1) is a liability ancillary to the company’s own debts or other liabilities and it cannot exist without them.³²⁸

Simply put, the moment creditors agree to a compromise, the company technically remains without liabilities and debts and begins to enjoy the benefits of a compromise. A creditor will thus be barred from claiming against any unlawful activities by reason of that creditor having ceded the *locus standi* of being a creditor. Moreso, section 424 applies when a company has debts and liabilities, yet once a compromise is entered such debts and liabilities will be deemed extinguished meaning invoking section 424 will be a futile exercise. This was further confirmed by Kathree-Setiloane, J who upheld a special plea precluding creditors from using the section 424 remedy on a contention that upon the sanctioning and implementation of an offer of compromise, in terms of which creditors were deemed to have ceded their claims against the company to the proposer, any rights which they might have against representatives of the company, in terms of s 424(1) of the 1973 Act, were extinguished.³²⁹ It was further held that whether creditors’ claims against the company were “deemed” to be ceded, or “actually” ceded was accordingly of little moment.³³⁰ Thus, this position has not been favourable for creditors especially where they find that a compromise was just

³²⁷ Section 424 of 1973 Act could not give the meaning of the word “otherwise” which presumably could also include compromise proceedings; interpretation by courts could give what legislation meant by the word “otherwise” which seemingly also included creditor compromises proceedings. Creditors who make a compromise in good faith and later on notice a series of fraudulent activities which had been ongoing even prior to compromise proposals then they may make use of section 424.

³²⁸ Supra note 306, at 107G-108B.

³²⁹ *Freidlein Company (Pty) Ltd v Andrew William Simaan & Others*; South Gauteng High Court, Reportable, Case No: 2009/45807, at paragraph 21.

³³⁰ Ibid.

proposed as a way to defray them from their right to approach court where in fact the company was being recklessly and fraudulently managed against their interests.

The almost equivalent of section 424 of the 1973 Act is section 22 of the 2008 Act. It should be noted that section 424, being in chapter 14 of the 1973 Act still applies to the extent that it is consistent with the 2008 Act.³³¹ Section 424 then shall apply to companies that are in winding up/ liquidation since judicial management provisions have been repealed. Section 22 of the 2008 Act applies in all circumstances, that is, in the ordinary course of business and during liquidation.³³² Section 22 is wider than section 424 and unlike section 424; it will not apply only to companies under liquidation.³³³ It will apply to any company that is still a going concern, irrespective of whether it is being wound up or not.³³⁴ Thus, since the protection of section 22 of the 2008 Act is not limited to companies in liquidation, it will thus accordingly apply to the compromise process although this still remains to courts for interpretation of these provisions.

The just rationale is, where a compromise is preceded by reckless and fraudulent activities which affect creditor interests and same activities were unknown by creditors at the time of reaching a creditors` compromise, it is in the interests of justice to correct the wrong. Can creditors be bound by terms of a compromise that was proposed in bad faith or misrepresentation or without sufficient information placed before them for their own informed decision? Same line of questioning should be asked where during a compromise, directors begin to pursue activities that negatively affect the interests of creditors; can creditors still be bound under the circumstances? Thus, it is common sense that creditors could not reach a compromise if they had known that there were preceding reckless and fraudulent activities or that there were going to be such activities during compromise processes.

3.4.2. Summary to creditor compromises

To a large extent, the researcher appreciates the advantage which creditors may have in circumstances where compromise proceedings are brought into picture without any hidden agenda or in utmost good faith. There is a clear lay out in section 155 of the 2008 Act of what should be included in a proposal for a compromise in order to help a creditor(s) make an informed decision on whether or not to accept a compromise. The criticism laid by the researcher is that of not giving creditors *locus standi* to also propose a compromise where

³³¹ See paragraph 4.3 above.

³³² FHI Cassim 'The Duties & Liability of Directors' opcit note 31; 588.

³³³ Ibid.

³³⁴ Ibid.

necessary. Reference is made also to the protection of creditors while on the “compromise period”, despite having forfeited their rights in terms thereof. The researcher is of the view that creditors who notice previous or ongoing traits of reckless, fraudulent and insolvent trading may utilize remedies in section 22 and section 214 and 218 of the 2008 Act against any responsible director despite the fact that a company is undergoing compromise proceedings.

3.5. CONCLUSION

It has been the main enquiry of chapter 3 of the research to find out whether the 2008 Act has developed the mechanisms that existed in the 1973 Act in a way to enhance creditor protection. From the onset, researcher has applauded the legislature for moving away from capital maintenance rules in favour of the American Solvency and liquidity test. The 2008 Act has dramatically expanded the scope of the solvency and liquidity test, unlike in the 1999 Amendment Act to the 1973 Act, such that many transactions which are good for healthy corporate governance are now allowed as long as they pass the solvency and liquidity test.³³⁵ The solvency and liquidity test, although it has been found that its application should be revisited in some circumstances, has helped ensuring a balance in recognition of the rights of shareholders, creditors, employees and the company itself which is in line with the enlightened shareholder value approach as South Africa`s adopted model of corporate governance.³³⁶

Also, the scope of director liability has been developed to be more of a civil nature in *lieu* of criminal liability. The researcher agrees with other scholars who applaud the legislature for enhancing civil liability, but still the legislature could utilize both avenues to deter directors from acting against the interests of creditors and other stakeholders through abusing their position of authority. Creditor`s interests are as well safeguarded during liquidation processes and during compromises under the 2008 Act. Notwithstanding a notable change in liquidation of solvent companies, there has not been change in liquidation of insolvent companies as the minister is yet to reform insolvency laws in order to open a way for company laws to be revisited in that aspect. In conclusion, the researcher finds that the refinement of some of these creditor protection mechanisms has to a larger extent helped to enhance creditor protection.

³³⁵ These transactions include distributions, financial assistance, mergers and amalgamations as already discussed above in this chapter.

³³⁶ The enlightened shareholder value approach has been discussed in chapter 2 under paragraph 2.3.2.

CHAPTER 4

THE INNOVATIVE STATUTORILY ADOPTED CREDITOR-PROTECTIVE MECHANISMS

4.0 INTRODUCTION

This chapter deals with the statutorily adopted creditor-protective mechanisms as provided for in the 2008 Act. The researcher seeks to examine the effectiveness of these mechanisms in affording creditors` protection in company affairs. Most of these mechanisms have their roots entrenched in common law which thus entails development of common law. When common law is developed and legislated, it helps to clear legal uncertainties. Legislative provisions are strongly preferred over uncodified common law principles. Also, some of these mechanisms are borrowed from other jurisdictions like the United States of America, Australia, the United Kingdom, *inter-alia*, which are believed to be advancing corporate laws from an international standard standpoint. Moreso, it will be noted that some of these mechanisms are a replacement of some old and archaic principles which were believed to be ineffective and outdated such that they can no longer find a place in the modern corporate world. South Africa is thus amongst the developing countries which seek to adopt international standards in the area of corporate law for the benefit of its citizens in dealing locally and internationally. This enhances economic development goals in that corporate laws which protect stakeholder interests in companies attract investments.

The researcher in this chapter thus touches several mechanisms which appear for the first time in South African legislation. These mechanisms shall be briefly discussed to assess their import in advancing creditors protection in company affairs. Thus, the researcher has identified the following mechanisms that are codified in the 2008 Act;

- ❖ The business rescue Concept;
- ❖ The Turquand rule;
- ❖ The piercing of the corporate veil;
- ❖ Enforcement mechanisms

Each of these shall thus be briefly discussed below in order to assess their single and overall import in advancing creditor interests in company affairs.

4.1. BUSINESS RESCUE CONCEPT AND CREDITOR PROTECTION

4.1.1. Introduction and background

One of the purposes of the 2008 Act is to provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders.³³⁷ This has been achieved by the introduction of a completely new business rescue concept which is geared at facilitating the rehabilitation and/or reorganization of a company that is in financial distress.³³⁸ The merits of a well executed business rescue process have proven in most jurisdictions that it offers a very useful alternative to the liquidation process.³³⁹ Where in the ordinary course of doing business a company is failing to meet its financial obligations as they become due and payable and creditors are considering it suitable for liquidation in order for them to recover their debts, new corporate laws prefer business rescue process to the liquidation process.

As has been said in chapter 3, the liquidation process is to be used as a last resort avenue; that is, where a company has actually undergone the business rescue process and the attempt has proven unsuccessful to warrant closure of the business. The term 'rescue' has been defined to mean a major intervention necessary to avert eventual company failure, alternatively, a reorganization of a company to restore it to a profitable entity and avoid liquidation.³⁴⁰ In a United States Case, *NLRB v Bildisco*,³⁴¹ it was held that the fundamental purpose of business rescue proceedings is to prevent a debtor company from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources. This ensues from the fact that the liquidation process ends the company's existence and that entails the ultimate loss of jobs which is counter-economic growth; a reduction in the gross domestic product³⁴² and a loss of benefits for all stakeholders to the company including the society wherein the company was established. Once more, in an American case *Re Gibson Group Inc*,³⁴³ it was held that the purpose of Chapter 11 of its Bankruptcy Code³⁴⁴ was to

³³⁷ Section 7(k) of the 2008 Act.

³³⁸ FHI Casim 'Business Rescue & Creditor Compromises' opcit note 31, 861.

³³⁹ Ibid. See United Kingdom Cork's Report (Cork K 'Insolvency Law and Practice: Report of the Review Committee' 1982 Cmnd 8558) where emphasis is made concerning the perseverance of a viable business enterprise as an alternative to insolvency or winding up processes. See also chapter 11 of America's Bankruptcy Code: Bankruptcy Reform Act of 1978 which places its strength on reorganising companies that are financially impended.

³⁴⁰ Ibid.

³⁴¹ 465 US 513 (1983) 528.

³⁴² See 'Gross Domestic Product' available at https://en.m.wikipedia.org/wiki/Gross_domestic_product (accessed on 22/10/2018); 'Gross domestic product' is a monetary measure of the market value of all the final goods and services produced in a period of time, often annually or quarterly, in a particular country.

³⁴³ 66 F.3d 1436 (Ohio, 1995).

³⁴⁴ Bankruptcy Code: Bankruptcy Reform Act of 1978.

provide a debtor with legal protection in order to give it the opportunity to reorganize and thereby to provide creditors with a going concern value rather than a more meagre satisfaction. This once again shows that business rescue proceedings are definitely premised on ultimately protecting the interests of creditors and the company itself among other stakeholders. A successful business rescue process will ensure that the company has been completely recovered or restored such that it regains its solvency and liquidity status thereby meeting creditors` obligations. However, this may not be the case always.³⁴⁵ In *Merchant West Working Capital Solutions (Pty) Limited's case*,³⁴⁶ Kgomo, J made the following comments in passing concerning the ultimate purpose of a business rescue;

Unlike during judicial management, business rescue does not require that a company be restored to solvency, though this is of course one of the objectives of business rescue. As the definition (of business rescue) further demonstrates, business rescue is also a system that is aimed or geared at temporarily protecting a company against the claims of creditors so that its business can thereafter be disposed of (if concern could not be saved) for maximum value as a going concern in order to give creditors and shareholders a better return than they would have received had the company been liquidated.

Thus, where a business rescue fails, the end result will be that during business rescue proceedings the company would be managed in a way to ensure that despite the ultimate company failure, creditors would still recoup something better than they could recover at liquidation if business rescue proceedings were not employed.

The business rescue concept is thus new in South African legislation and is a complete replacement of the judicial management concept that was enshrined in the 1973 Act. Basically a judicial management process entailed the following;

- An application be launched in the High Court for judicial management as a requirement;³⁴⁷
- A court order of judicial management was not easily granted. It was an extraordinary remedy and was also treated by the courts as such;³⁴⁸
- The applicant had to demonstrate to the court that a reasonable probability existed that, if given the protection of judicial management, the company would be able to pay its debts and be restored to a successful concern; and³⁴⁹

³⁴⁵ FHI Casim 'Business Rescue & Creditor Compromises' opcit note 31, 863. Sometimes a business rescue may end in a company undergoing management buy-out or a takeover of the distressed company or it may be restructured such that some of its business activities may be closed or sold off to others.

³⁴⁶ *Merchant West Working Capital Solutions (Pty) Limited v Advanced Technologies and Engineering Company (Pty) Limited & NO*, A reportable case, Case NO: 13/12406 (ZAGPJHC), at paragraph 4.

³⁴⁷ Ibid paragraph 11.

³⁴⁸ Ibid.

³⁴⁹ Ibid.

- A court-appointed judicial manager had to investigate the company's affairs and the likelihood of a successful rehabilitation. His report and creditors' views were then taken into account by the court when considering whether or not to grant the final order for judicial management.³⁵⁰

Comparably, in or during business rescue proceedings, it is no longer necessary for a company to get or obtain the court's approval first in order to obtain the protections offered by business rescue, including the freezing of creditors' claims. All that is now required, to get the machinery in motion, is a directors' resolution³⁵¹ that effectively declares that the company is, or could soon be, in a financial difficulty and that also appoints an independent person, selected by the board of directors, called "*a business rescue practitioner*". The business rescue practitioner replaced the judicial manager under the old process of judicial management.³⁵² A business rescue practitioner has a duty to investigate the company's affairs and then decide whether or not there are any reasonable prospects of rehabilitating the company.³⁵³ If the rescue practitioner decides or is of the view that there is such a prospect, he must then prepare a business rescue plan which must be placed before shareholders, creditors and all affected or interested parties or persons for approval.³⁵⁴ Once approved, the business rescue practitioner must oversee its implementation and there is again no need to place the plan before the court for any approval unless on just cause one of the affected person objects to the implementation of the plan and wishes to challenge it in court.³⁵⁵ Basically, this sum up a background to the new business rescue concept and below the researcher shall endeavour to deal with it specifically in terms of the 2008 Act.

4.1.2. Business rescue under the 2008 Act

Section 128(1)(b) of the 2008 Act defines business rescue proceedings as follows;

These are proceedings to facilitate the rehabilitation of a company that is financially distressed by providing for—

- (i) the temporary supervision of the company, and of the management of its affairs, business and property;

³⁵⁰ Ibid.

³⁵¹ This is however not always the case, in some instances affected persons such as creditors may as well approach the court for a sanctioning although when it's the board of directors resolving to a rescue plan there is no need for the court's sanctioning of the rescue plan. Perhaps this is to encourage directors to act in the best interests and utilize this avenue before the company goes to the dungeon leaving them and the company susceptible to claims. See discussion in para 4.1.2.2 below.

³⁵² Supra note 328, para 12.

³⁵³ Section 141(1) of the 2008 Act.

³⁵⁴ Section 140(1)(d) of the 2008 Act.

³⁵⁵ FHI Casim 'Business Rescue & Creditor Compromises' opcit note 31, 906.

(ii) a temporary moratorium on the rights of claimants against the company or in respect of property in its possession; and
(iii) the development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximises the likelihood of the company continuing in existence on a solvent basis or, if it is not possible for the company to so continue in existence, results in a better return for the company's creditors or shareholders than would result from the immediate liquidation of the company.

A company is deemed to be financially distressed under two circumstances as follows;

- Where it appears to be reasonably unlikely that the company will be able to pay all of its debts as they fall due and payable within the immediate ensuing six months;³⁵⁶ or
- Where it appears to be reasonably likely that the company will become insolvent within the immediate ensuing six months.³⁵⁷

It must be noted that the company does not necessarily need to be insolvent, either factually or commercially, at this stage; it must just be at the verge of insolvency or it must be facing liquidity problems.³⁵⁸ A business rescue process will thus be employed in order to help the company meet its liabilities. It is thus illegal to trade even where one reasonably foresees that the company is close to insolvency or where the company is actually insolvent as this will affect interests of several financial stakeholders including creditors.³⁵⁹ Further a company must meet its debts as they become due and payable. A company under the above circumstances must be placed under business rescue as an attempt to its financial rescue. This is opined by Professor Nwafor, in his analysis on the goal of the business rescue provisions, in particular section 128 of the 2008 Act, as follows;

The Act does not permit the company to proceed with its normal business when insolvent, as the interests of creditors would intrude. The future conduct of the company's business should at that point be geared at settling the company's obligations and not at profit making. Directors who disregard such injunction could be found to have flouted the statutory provisions against reckless trading with the attendant spiraling effect including the declaration of such directors as being delinquent and consequential disqualification from holding office as directors...³⁶⁰

From the foregoing, a director should apply his mind and act with standards expected of a reasonable director to ensure that where necessary a financially ailing company is placed under the rescue process to safeguard interests of creditors among other stakeholders. The essence of a business rescue is to restore the company to its footing so that it can meet its

³⁵⁶ Section 128(1)(f)(i) of the 2008 Act.

³⁵⁷ Section 128(1)(f)(ii) of the 2008 Act.

³⁵⁸ FHI Casim 'Business Rescue & Creditor Compromises' opcit note 31, 864.

³⁵⁹ Section 22 of the 2008 Act.

³⁶⁰ AO Nwafor 'Exploring the goal of business rescue through the lens of South African Companies Act 71 of 2008' (2017) 28 (3) *Stellenbosch Law Review* 600.

financial obligations as they become due and payable or should that fail, at least to give the best possible returns to affected stakeholders. In terms of section 128(1)(b)(iii) the object of a business rescue plan is to restructure the company's affairs, its debts and its liabilities in a manner that maximizes the likelihood of the company continuing to exist on a solvent basis or, if this is not possible, then to achieve a better return for creditors or shareholders than would result from immediate liquidation of the company.³⁶¹ From the definition of business rescue, it is deduced that the rescue process is a three stage process which firstly places the company on temporary supervision of its affairs by a person known as the business rescue practitioner and secondly, which calls out for a temporary moratorium on claims and proceedings against the company, and lastly, the development and implementation of a business rescue plan.³⁶² There are two ways in which rescue proceedings may be initiated and they shall be discussed below.

4.1.2.1. Voluntary resolution of the board

A company may be placed under business rescue by resolution of the board of directors of the company to voluntarily begin rescue proceedings if the board has reasonable grounds to believe that the company is financially distressed and there appears to be a reasonable prospect of rescuing the company.³⁶³ Cassim holds the view that the 2008 Act, as influenced by chapter 11 of the US Bankruptcy Code,³⁶⁴ introduces a debtor friendly environment as it allows the debtor to act within time, allowing the board of directors to cleanse their hands through placing a company under rescue assistance before it is too late to do so.³⁶⁵ A company, as a debtor, is thus given a leverage to put its house in order before outsiders intervene.

Of great importance to this research is that, once the envisaged process has been filed with the Companies Commission, a company has to publicize a notice of its resolution, in a prescribed manner, which is reasonably expected to bring the information to the attention of affected persons.³⁶⁶ Creditors are, *inter alia*, affected persons hence they are entitled to be notified of the company having to be placed under temporary supervision together with the effective date so that they may begin to actively participate in the process to ensure their

³⁶¹ Section 128(1)(b)(iii) of the Companies Act 2008.

³⁶² Section 128(1)(b) of the 2008 Act.

³⁶³ Section 129(1)(a) & (b) of the 2008 Act.

³⁶⁴ Supra note 339.

³⁶⁵ FHI Cassim 'Business rescue and compromises' opcit note 31, 866.

³⁶⁶ An affected person means a shareholder or creditor or, a registered trade union representing employees of the company, and each of those employees not represented by a trade union or the representative of such employees. See section 128 (1)(a) of the 2008 Act.

rights are safeguarded.³⁶⁷ Moreso, if the board of directors does not adopt the resolution to place the company under business rescue despite it believing on reasonable grounds that the company is financially distressed, then the board of directors will have to notify each affected person setting such grounds as in section 128(1)(f) of the 2008 Act and also of the reasons why such board would not adopt the resolution to so place the company under rescue processes.³⁶⁸ The underlying reason for this provision is to enable affected person, creditors in this case, to lodge an application for business rescue processes to court which again would protect their interests. Although section 129 (7) does not explicitly provide for any sanction for the failure by the board to give such a notice, the researcher holds the view that creditors will under relevant provisions be able to approach the court to hold directors liable for loss, damages and costs incurred as a result of such non compliance.³⁶⁹ Creditors as affected persons are thus protected by voluntary rescue processes despite them not having *locus standi* to commence these voluntary rescue processes.

4.1.2.2. Application by an affected person

An affected person may apply to a court at any time for an order placing the company under supervision and commencing business rescue proceedings. Thus, where the board has not passed a resolution to commence business rescue proceedings, any affected person has *locus standi* to approach the court for an order placing the company under supervision and to commence business rescue proceedings.³⁷⁰ An applicant must serve a copy of the application on the company and the Companies Commission and must notify each affected person of the application in the prescribed manner.³⁷¹ Importantly, each affected person has the right to participate in the hearing of an application without the need to apply to court for leave to intervene.³⁷² Since rescue proceedings are favoured to liquidation proceedings, once a company is under the business rescue process it may not be placed under the liquidation process unless the rescue process is ended, in which case a company may be placed under rescue proceedings even though it was undergoing the liquidation process.³⁷³ In terms of section 131 (4)(a) of the 2008 Act, the court would not grant business rescue application unless it is satisfied that;

- the company is financially distressed;

³⁶⁷ FHI Cassim 'Business rescue and compromises' opcit note 31, 867.

³⁶⁸ Section 129(7) of the 2008 Act.

³⁶⁹ Section 218(2) of the 2008 Act holds liable anyone who contravenes the provisions of the Act.

³⁷⁰ Section 131(1) of the 2008 Act.

³⁷¹ Section 131(2) of the 2008 Act.

³⁷² Section 131(3) of the 2008 Act.

³⁷³ This is because rescue proceedings are believed to be able to give the company a chance to revive itself alternatively, to realise considerable output for the benefit of creditors should liquidation results. FHI Cassim 'Business rescue and compromises' opcit note 31, 873.

- the company has failed to pay over any amount in terms of an obligation under or in terms of a public regulation, or contract, with respect to employment-related matters; or
- It is otherwise just and equitable to do so for financial reasons, and there is a reasonable prospect for rescuing the company.

Creditors would thus need to be careful that their application satisfies the above requirements as the court may dismiss with costs a frivolous and vexatious process aimed at abusing court process or the business rescue avenue itself in a bid to enforce payment of debts. Once again, a company that has been placed under the rescue process must notify each affected person within five business days from date of order.³⁷⁴ It is thus of importance to this research to applaud the 2008 Act's stance in giving creditors, among other affected persons, *locus standi* to approach court on grounds stated above to ensure that their interests are safeguarded through the business rescue process. This follows that creditors are outsiders in company affairs in the ordinary course of business, however, once business the business rescue process is approved it is the researcher's finding that they cease to be outsiders as they begin to actively participate, although informally, in the rescue process to protect their interests through rescue proposals.³⁷⁵

4.1.3. Enforcement of creditor rights during rescue processes

As has been said above, the business rescue process is targeted at protecting the interests of creditors. Its purpose is to ensure that the company is re-instated to its solvent status where it can actually be able to meet creditor claims as they become due and payable. However, even if the company fails to retain its solvent status or although creditors may suffer some loss during these proceedings, the result should by all means be an achievement of the best output value to benefit them unlike what the situation would have been if the liquidation process was to be preferred over the business rescue process.³⁷⁶ This is confirmed in the *Anglo Irish Bank Corporation Ltd's case*,³⁷⁷ where Traverso DJP held that 'a viable rescue plan must contain facts which show that if the intended resuscitation of the company fails, the creditors will not be worse off'. It is thus clear that creditors are the main reason behind business rescue process as the process diverts a business from a profit goal orientation to that of focusing on dealing with its financial obligations.³⁷⁸

³⁷⁴ Section 131 of the 2008 Act.

³⁷⁵ FHI Cassim 'Business rescue and compromises' opcit note 31, 902.

³⁷⁶ Section 128(1)(b)(iii) of the Companies Act 2008.

³⁷⁷ *Anglo Irish Bank Corporation (Pty) Ltd v West City Precinct Properties (Pty) Ltd* (2012) ZAWCHC 33.

³⁷⁸ AO Nwafor, opcit note 355.

Importantly, during rescue proceedings, creditor rights/ or claims are frozen by a moratorium which is aimed at giving a business rescue practitioner an opportunity to resuscitate the financially ailing company if so possible. Regardless of the later, creditors still have a right to approach court and deal with any issues outstanding as long as they acquire consent from the business rescue practitioner; or should they acquire leave from court on any grounds which the court deems suitable.³⁷⁹ This perhaps may give creditors a ground to approach court where during the business rescue process, a business rescue practitioner or any influential employee begin to abuse business rescue process or trade in circumstances prohibited in section 22 of 2008 Act. However, obtaining leave of the court may not be an easy exercise as one would have to justify the need for such leave. This is supported by Kgomo J in the following *obita dictum* concerning justifying the need for leave of court to deal with rights of affected persons during a moratorium on such rights;

A court being asked for leave to proceed against a company under business rescue, thus during a moratorium, must receive a well motivated application for that so that it could apply its mind to the facts and the law if necessary and then be in a position to make a ruling in accordance with any terms it may consider suitable in the peculiar circumstances.³⁸⁰

Thus one has to place the court in the light as to his grounds to seek such leave, yet it is the court's discretion to consider such grounds as suitable or not. This then entails that there are no specific grounds laid down which justify suitability for leave to be granted hence one needs to act with greater caution as the courts would ordinarily not be lenient should they perceive any envisaged abuse of process. It is the researcher's view that courts may however be inclined to grant leave for institution of legal proceedings during the business rescue process if interests of justice so permit or where it would ordinarily be just and equitable to deviate from moratorium provisions. In addition to the foregoing, another exception to the moratorium provisions is where criminal proceedings against the company or any of its directors or officers are a cause for concern.³⁸¹ This again gives creditors a leeway in terms of section 214 of the 2008 Act to instigate the laying of criminal charges against any criminal acts which prejudices their interests during rescue proceedings.

It should be noted that in order to give effect to creditor rights, although such rights are frozen by a moratorium that ensues from business rescue, the temporary setback is equivocally compensated by the fact that creditors are given a right to actively participate or

³⁷⁹ Section 133(1)(a)&(b) of the 2008 Act.

³⁸⁰ *Merchant West Working Capital Solutions (Pty) Limited v Advanced Technologies and Engineering Company (Pty) Limited & NO* A reportable case, Case NO: 13/12406 [2013] (ZAGPJHC), at paragraph 67.

³⁸¹ Section 133(1)(d) of the 2008 Act.

influence the business rescue process.³⁸² Thus, creditors to a certain extent, automatically acquire rights to act as insiders to company affairs so that they are able to monitor the flow of the business rescue plan in as far as protection of their interests is concerned.³⁸³ In the premises, creditors of the company have a right to vote to amend, approve or reject a proposed business rescue plan and if that plan is rejected they may as well propose an alternative plan.³⁸⁴

In addition to the preceding, they are entitled to be notified of each court proceeding, decision, meeting or other relevant event; participate in any court proceedings; formally participate in rescue proceedings to the extent provided for; and informally participate by making proposals to the practitioner for a business rescue plan.³⁸⁵ Creditors also have a right to form a joint committee constituting independent creditors which would directly deal with business rescue practitioner to ensure that creditor interests are safeguarded.³⁸⁶

Moreso, it should be noted that business rescue proceedings should be completed within a short space of time, that is, a period of three months, subject to any extension that the court may grant to the business rescue practitioner upon making justified representations to that effect.³⁸⁷ The reason of such time bars is to ensure that the enforcement of the rights of creditors, including their right to institute legal proceedings against the company, is not unnecessarily or unreasonably prolonged or kept in abeyance.³⁸⁸ It is for the very same reason that the business rescue practitioner will have to compile a report for assessment to justify the need to extend the 3 months period or any period which the court may have initially granted.³⁸⁹ On that same token, the business rescue practitioner is charged to immediately communicate to affected parties and to the court where the business rescue

³⁸² FHI Cassim 'Business rescue and compromises' opcit note 31, 902.

³⁸³ Ibid; where it opined that creditors acquire same rights as those of employees during business rescue processes.

³⁸⁴ Section 145(2) of the 2008 Act.

³⁸⁵ Section 145(1)(a)-(d) of the 2008 Act.

³⁸⁶ See FHI Cassim, opcit note 375, where it is provided that creditor committees may be given due feedback by the rescue practitioner concerning the progress of the rescue process although they may not give instructions to the rescue practitioner.

³⁸⁷ Section 132 of the 2008 Act.

³⁸⁸ See AO Nwafor 'Moratorium in Business Rescue Scheme and the Protection of Company's Creditors' (2017) 13 (1) *Corporate Board: Role, Duties & Composition*, Virtus Interpress, 60, where he states that '[T]hough the court has power, upon the application of the business rescue practitioner, to extend that period, such extension should always have in contemplation the statutory stated 'temporary' nature of the moratorium to ensure that this legislative scheme is not turned into a 'dubious' mechanism to deprive creditors of their legitimate right of recourse against the company to enforce mutual contractual obligations'.

³⁸⁹ Section 132 of the 2008 Act.

plan has failed or where it is reasonably foreseen that the business plan will fail.³⁹⁰ In *Gormerly v West City Precinct Properties (Pty) Ltd*,³⁹¹ Traverso DJP cautioned that the moratorium provisions could be subjected to abuse by the company insiders seeking to use those provisions to frustrate creditors' rights and to stave off liquidation for ulterior motives. It is thus clear that courts are well aware of the true intention of legislature in incorporating the business rescue concept into South African company legislation which is to ultimately safeguard interests of creditors while at the same time allowing for economic development through giving financially struggling companies an opportunity to revive.

Finally, in comparison with proposals for creditor compromises where contents of a compromise plan are clearly outlined, there is no specific/or detailed outline of how a business rescue plan should be, which then leaves uncertainties in that regard.³⁹² It thus follows that what is constituted in a business rescue plan should be something informative well enough to allow creditors to decide whether or not to adopt such a plan and that such content depends on merits of each and every situation that attracts the need for the rescue process.

4.1.4. Summary to the business rescue concept

Business rescue concept has brought an interesting mechanism/or avenue which creditors may use to safeguard their interests where a company unreasonably fails to meet their obligations or where it is actually insolvent. A properly designed business rescue plan would help company rescue for the benefit of the company and its creditors. It is however most likely that the business rescue process may fail as lending institutions may be skeptical dealing with a company that is under business rescue. Be that as it may, it is also a goal of the business rescue process that even when it fails but the least that could be recouped should be better than what creditors would get through an outright engagement of the liquidation process. The participation of creditors in the rescue process also helps safeguard their interests despite a moratorium on their rights. Thus, creditors are treated as insiders once the rescue process has commenced with same rights as employees. It is thus the researcher's view that creditor interests are to a large extent protected effectively by the business rescue concept and that credit should be given to the legislature for borrowing this mechanism or avenue for creditor protection from the leading countries.³⁹³

³⁹⁰ Sections 81, 132 and 142 of the 2008 Act. A business rescue process is preferred alternative to the liquidation process hence its failure mostly welcomes the liquidation process.

³⁹¹ [2012] zawchc 33, para 15.

³⁹² Section 155 (3) of the 2008 Act.

³⁹³ The UK, the USA etc.

4.2. THE TURQUAND RULE AND CREDITOR PROTECTION

4.2.1. Introduction

The Turquand Rule or ‘the indoor management rule’ emanated from an English case namely, *Royal British Bank v Turquand*.³⁹⁴ This common law principle was initially intended to mitigate the unbearable effects of the doctrine of constructive notice³⁹⁵ by entitling *bona fide* third parties who contract with a company, to assume that all of the company’s internal governance necessary for the conclusion of a valid contract has been complied with.³⁹⁶ In the genesis case, *Royal British case*, the articles of association of the company authorized its board of directors to borrow money provided they obtain prior approval from shareholders of the company. The board borrowed money from the Plaintiff without shareholders’ approval. The Bank or Plaintiff had no knowledge of this fact hence the court held that even though the articles of association’s requirements were not complied with, the company nevertheless bound itself to the loan taken from the Bank. The approval was thus an internal formality and the bank (creditor), acting in good faith, was entitled to assume that the internal formalities had been complied with hence the company could not use non-compliance with the internal formality as a defence.³⁹⁷ The Turquand rule was introduced and applied in South Africa in the case of *Mine Workers’ Union v Prinsloo*,³⁹⁸ where it was held to form part of South Africa’s common law for purposes of future development of common law. In *Tuckers Land and Development Corporation (Pty) Ltd v Perpellief*³⁹⁹ the court stated the following concerning this common law principle;

[4] . . . In contracting with a company the following categories of person or persons acting or purporting to act on its behalf may be encountered:

- (a) The board of directors;
- (b) The managing director or chairman of the board of directors;
- (c) Any other person or persons such as an ordinary director or branch manager or secretary.

5. Where someone contracts with a company through the medium of the persons referred to in paragraphs 4(a) and (b) above, the company will usually be bound because these persons or bodies will, unless the articles of association decree otherwise, be taken to have authority in one form or another to bind the company in all matters affecting it. Moreover all acts of internal management or organisation on which the exercise of such authority is dependent may, in terms of the Turquand rule, be assumed,

³⁹⁴ (1856) 6 E & B327, 119 ER 886.

³⁹⁵ Ibid. “The Turquand rule mitigates the unrealistic doctrine of constructive notice which deems anyone dealing with a company to know the contents of the company’s memorandum, articles of association, resolutions and other documents recorded on the company’s file with the Registrar of Companies. In its simplest form the Turquand rule, or ‘indoor management rule’, entails that if nothing has occurred which is obviously contrary to the provisions of the registered documents of the company, an outsider may assume that all the internal matters of the company are regular.”

³⁹⁶ FHI Cassim ‘Corporate Capacity, Agency and the Turquand Rule’ opcit note 31, 181.

³⁹⁷ Supra note 391.

³⁹⁸ 1948 (3) SA 831 (A).

³⁹⁹ 1978 2 SA 11 (T) 15.

by a bona fide third party, to have been properly and duly performed. Indeed unless some such principle was accepted no one would be safe in contracting with companies.

6. The same does not apply where the company is represented by the category of person referred to in paragraph 4(c) above. Here a third party is not automatically entitled to assume that such person has authority and the company is not precluded from repudiating liability on the ground that he had no authority to bind it. To hold the contrary would deprive a company of the rights which any natural principal would have of denying the allegation that a particular person is his agent. The application of the Turquand rule in this sphere is limited. It only comes into operation once the third party has surmounted the initial hurdle not present in cases falling under paragraphs 4(a) or (b) above and proves that the director or other person purporting to represent the company had authority. Once this is proved then, if the actual exercise of such authority is dependent upon some act of internal organisation, such can, by a bona fide third party, be assumed to have been completed. But in dealing with the type of person in question the other contracting party cannot use the Turquand rule to help him surmount the hurdle mentioned.

The above line of thinking helps clear out certain misunderstandings as to circumstances in which a third party may be estopped from relying on the Turquand rule. It follows that creditors or third parties, being outsiders in company affairs, do not always have the automatic right derived from the Turquand rule where they deal with any other person or persons such as an ordinary director or branch manager or secretary who purports to be acting on behalf of a company. In such circumstances they must ensure that the persons mentioned in the latter have proven authority to so act. In addition, a third party who lacks knowledge of internal affairs but is nevertheless suspicious that an internal irregularity might have taken place cannot rely on the Turquand rule.⁴⁰⁰ Thus in such cases a third party is expected to make an inquiry into such suspected irregularities.⁴⁰¹ Moreso, the Turquand rule does not protect a third party who acts on the strength of forged documents.⁴⁰² This possibly flows from a common law understanding that out of an unlawful cause no legal remedy is allowed.⁴⁰³ In order to invoke the Turquand Rule, one will have to rely on the doctrine of estoppel⁴⁰⁴ which debars the company from denying a creditor's claim on the basis of non-compliance with internal rules when the agreement was concluded, e.g., lack of authority by company's agent or transactions prohibited by the company or which it does not have authority to embark on (*Ultra Vires* acts). The Turquand rule has now been introduced into South African legislation and this shall be dealt with in the succeeding paragraph.

⁴⁰⁰ *Northside Developments (Pty) Ltd v Registrar General* (1990) 8 ACLC 611.

⁴⁰¹ *Ibid.*

⁴⁰² See *Rueben v Great Fingall Consolidated* 1906 AC 439 (HL).

⁴⁰³ Common law maxim: "*Ex Turpi Causa Non Oritur Actio*".

⁴⁰⁴ It is a judicial device in common law legal systems whereby a court may prevent or "estop" a person from making assertions or from going back on his or her word, the person being sanctioned is estopped. Estoppel, available at <https://en.m.wikipedia.org/wiki/Estoppel> (accessed on 29/10/2018).

4.2.2. The 2008 Act's Turquand rule *vis-à-vis* protection of creditors

The opposite doctrine to the Turquand rule, the doctrine of constructive notice, is abolished by section 19(4) of the 2008 Act which provides that a person may not be regarded as having received notice or knowledge of the contents of any document relating to a company merely because the document has been filed or is accessible for inspection at an office of the company.⁴⁰⁵ The preceding provision is however subject to subsection (5) which introduces a muted version of the doctrine of constructive notice. The constructive notice doctrine thus only applies to Ring fenced companies (expressed "RF" at the end of the company name). In other words, third parties or creditors must be very careful when dealing with ring fenced companies for they will be presumed/ deemed to have knowledge of the company's memorandum of incorporation and its restrictive conditions which may affect any third party who blindly deal with such companies.⁴⁰⁶ Another instance where the doctrine of constructive notice still applies is in the case of personal liability companies. A person dealing with such companies is deemed to be aware of the effect of the directors' and former directors' joint and several liability for debts and liabilities of the company contracted during their periods of office.⁴⁰⁷ Thus, it is the researcher's view that a creditor would ordinarily have right of recourse against the company and person or person(s) who were directors at the time of contracting and cannot claim against someone who was not a director at that particular time neither can they force the company into liquidation as it will personally affect the rights of a new director who was never part of the deal with a creditor. Like a sole trader business, a director would need to deal with debts and liabilities contracted during his term before leaving office as failure to do so will attract a follow up from creditors. It is the researcher's view that creditors would need to be careful when dealing with these companies as their claims may be difficult to pursue in cases where the previous director is no longer available for any reasons whatsoever including his death.

The Turquand rule is for the first time introduced into South African legislation by section 20(7) read together with section 20 (8) of the 2008 Act. The sections provides as follows;

(7) A person dealing with a company in good faith, other than a director, prescribed officer or shareholder of the company, is entitled to presume that the company, in making any decision in the exercise of its powers, has complied with all of the formal and procedural requirements in terms of this Act, its Memorandum of Incorporation and any rules of the company unless, in the circumstances, the person knew or reasonably ought to have known of any failure by the company to comply with any such requirement.

⁴⁰⁵ The opposite of this new provision was an upholding of the common law doctrine of constructive notice.

⁴⁰⁶ A ring fenced company is characterised by having some restrictive conditions applicable to that company only in terms of section 15(2)(b) & (c) of the 2008 Act.

⁴⁰⁷ FHI Cassim 'Corporate Capacity, Agency and the *Turquand* Rule' opcit note 31, 180-1.

(8) Subsection (7) must be construed concurrently with, and not in substitution for, any relevant common law principle relating to the presumed validity of the actions of a company in the exercise of its powers.

The above provisions maintain the common law position that does not allow persons who have inside information of the company such as directors, prescribed officers and shareholders to rely on the Turquand rule as they do not qualify as third parties regardless of them dealing with a company from an outsider's position. It is common cause that such persons will reasonably be expected to know or ought to have known of any failure by the company to comply with internal formalities and procedures. Therefore, the possibility that an insider can also be protected is expressly excluded and an institutional rather than a functional category is established.⁴⁰⁸ It is not clear why only these categories are excluded and why the functional category is secluded.⁴⁰⁹ There are thus similarities between the statutory and common law indoor management rule. The overlap between the two shows that section 20(7) goes much further than the common law Turquand rule in dealing with third parties who may not be covered by the Turquand rule. While common law will not protect third parties who knew or suspected that an internal formality or procedure had not been complied with, section 20(7) goes further and excludes a third party who 'reasonably ought to have known'.⁴¹⁰ This widens the scope of third parties who may not be protected by the Turquand rule hence putting creditors at risk where they may fail to pass this objective test: the 'reasonably ought to have known' ordeal. Moreso, section 20(8) reconciles common law to the statutory provisions of the rule. This is confirmed in a 2015 case, *One Stop Financial Services (Pty) Ltd v Neffensaam Ontwikkelings (Pty) Ltd & Another*,⁴¹¹ where the following is stated:

If s 20(7) is a codification of Turquand, s 20(8) might be thought to be a puzzling provision. However, I do not think that its existence justifies a strained interpretation of s 20(7). It is more likely, in my view, that the lawmaker was concerned that its attempts to formulate the Turquand rule in s 20(7) might not cover the whole ground. Section 20(8) was thus added to foreclose an argument that s 20(7) had inadvertently repealed any part of the Turquand rule.

It is thus clear that common law still equally applies but this time with much freedom of its application as its main reason for existence, the ramifications of the doctrine of constructive notice, have now been repealed. Some commentators thus wonder as to why the need for the Turquand rule when the constructive notice doctrine has been repealed, while others are of the view that it is there to deal with the remnants of this doctrine in ring fenced companies

⁴⁰⁸ P Delport 'Companies Act 71 of 2008 and the 'Turquand' Rule' (2011) 74 *Journal of Contemporary Roman-Dutch Law*, 136.

⁴⁰⁹ Ibid.

⁴¹⁰ Ibid, 187.

⁴¹¹ 2015 (4) SA 623 (WCC).

and personal liability companies.⁴¹² Of great importance to creditor protection is that, having the Turquand rule legislated brings an overriding stance against non-compliance with provisions of a memorandum of incorporation since the 2008 Act overrides any memorandum of incorporation.⁴¹³ Thus a creditor would not be expected to have known any provisions of a memorandum of incorporation (MOI) when dealing with a company's agency whether with real authority or ostensible authority unless such company is a ring fenced company.

4.2.3. Summary on the Turquand rule

The repealing of the doctrine of constructive notice in favour of the Turquand rule is good news for creditors when dealing with companies. The Turquand rule is by all means a tool or mechanism geared at safeguarding creditor interests. It is not reasonable to expect an outsider to know information that constitutes inside information or to go beyond the limit in trying to dig out whether the company representative has authority to act on behalf of the company or not. The concurrent application of the common law Turquand rule and the statutory one cannot be understated. That having been said, it should be noted that the doctrine of constructive notice still applies to ring fenced companies and personal liability companies hence creditors must be careful when dealing with these types of companies as they may be punished for their ignorance. In conclusion, it should be noted that creditors may not be protected in all circumstances by the Turquand rule; there are exceptions as laid out above.

4.3. THE PIERCING OF THE CORPORATE VEIL AND CREDITOR PROTECTION

4.3.1 Introduction

As depicted in chapter 2, a company has a separate legal (juristic) personality from its members (the shareholders) and its officers. It should be noted that a distinction is made between ownership and management in a company. The company is managed by its directors and prescribed officers who are mandated to act in the best interests of the company whilst it is assumed to be owned by its shareholders.⁴¹⁴ The United Kingdom case of *Salomon v Salomon & Co Ltd*⁴¹⁵ is the seminal case for the existence of a company as a

⁴¹² D Davis et al 'Companies and Other Business Structures in South Africa' (2006) 42. See also Delport, Opcit note 390, 135-8.

⁴¹³ This may certainly apply to non-restrictive provisions in an MOI of a ring fenced company.

⁴¹⁴ Section 76 of the 2008 Act.

⁴¹⁵ [1897] AC 22 (HL).

separate legal personality. Although fiduciary and related duties of directors are owed to the company, the directors' duties are also owed to the company's shareholders, who ultimately share in the company's profits.⁴¹⁶

According to HH Rajak, a specific challenge arises when directors' decisions are influenced by the threat of civil personal liability, that is, 'how to balance the interests of creditors and directors in terms of legislative provisions?'⁴¹⁷ Where the directors' decisions favour the interests of creditors more than the interests of the company and shareholders this may amount to a breach of directors' fiduciary and other duties. Directors are thus called to apply their minds as reflected in chapter 3 above and to ensure that they balance the interests of the company, the shareholders and the creditors otherwise they may attract liability from either of these groups which may entail the piercing of the corporate veil to hold them personally liable.

The concept of piercing the corporate veil is sometimes referred to as the 'lifting of the corporate veil' although these terms have different meanings.⁴¹⁸ This is beyond the scope of this discussion, however, it should be noted that courts would normally refer to 'piercing the veil' when it intends treating liabilities of the company as those of shareholders or directors and disregard the separate legal personality of the company.⁴¹⁹ In contrast, the courts would refer to 'lifting the veil' as that point when they are merely taking into account as to who the company's shareholders and directors are.⁴²⁰ The phrase preferred in this research is thus 'the piercing of the corporate veil' which goes beyond merely determining the identity of the company's owners and managers. When the veil of incorporation is pierced or lifted, the court acts to strip the protective covering of the limited liability presented by the company structure such that shareholders/or directors can be held personally liable for the actions influenced by them in the company's affairs.⁴²¹ The concept is applied reservedly in situations of fraud, dishonest and improper conduct as shown in the *Knoop NO*⁴²² case where the court held the following:

⁴¹⁶ See chapter 2 on the enlightened shareholder value approach.

⁴¹⁷ HH Rajak 'Director and officer liability in the zone of insolvency: A comparative analysis' 2008, *Potchefstroom Electronic Law Journal*(11) 1, 48/211.

⁴¹⁸ Sometimes termed as looking beyond the veil.

⁴¹⁹ R Cassim 'Legal Concept of a Company' *opcit* note 31, 46.

⁴²⁰ *Ibid*.

⁴²¹ As illustrated by the case of *Knoop NO and Others v Birkenstock Properties (Pty) Ltd and Others* (FB) (unreported case no 7095/2008, 4-6-2009) (Nxusani AJ), the shareholders can be held personally liable. This happens mostly when shareholders are involved in fraudulent activity, as found in *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd and Others* 1995 (4) SA 790 (A); or if shareholders are improperly using the separate legal personality, as found in *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168.

⁴²² *Ibid*, *Knoop* case.

The corporate veil may be pierced where there is proof of fraud or dishonesty or other improper conduct in the establishment or the use of the company or the conduct of its affairs and in this regard it may be convenient to consider whether the transactions complained of were part of a “device”, “stratagem”, “cloak” or a “sham”..

Thus, this mechanism may help creditors in instances where the company is stripped of all its assets and creditors have nowhere else to look to for recovering their debts. They may approach the court to look beyond the veil and hold those who are responsible for their misfortunes. Courts have however been reluctant to tamper with the most sacrosanct principle of a company’s separate legal existence hence it has not been easy to have the courts pierce the veil under the common law.⁴²³ Although it is accepted that the separate legal personality principle has to be sometimes disregarded, there has been inconsistencies in the application of the piercing of the veil concept and so far there were no clear guidelines as to when the courts would pierce the corporate veil.⁴²⁴ The Appellate Division in the *Cape Pacific Case*⁴²⁵ has endeavored to lay certain guidelines or principles relating to common law instances of piercing the veil and these are as follows;

- Courts are called to ensure that they do not lightly disregard the separate legal existence principle but should strive to uphold it as doing otherwise would undermine the policy and principles of the concept and the legal consequences thereof.⁴²⁶
- Courts should know that they do not have the general discretion to simply disregard the company as a separate legal personality whenever they consider it just to do so.⁴²⁷
- It is stressed that there is yet no formulation of general principles with regard to when and when not may the corporate veil be pierced. Thus each case must be treated on its own merits.⁴²⁸
- It was stated that where there is fraud or dishonesty or other improper conduct, the need to preserve the separate legal personality would in such circumstances have to be balanced against policy considerations which arise in favour of piercing the corporate veil.⁴²⁹
- It is not necessary that a company should have been conceived and founded in deceit and never have been intended to function genuinely as a company, before its corporate personality is disregarded.⁴³⁰

⁴²³ Cape Pacific case, supra note 421.

⁴²⁴ Ibid.

⁴²⁵ Ibid.

⁴²⁶ Ibid, 803.

⁴²⁷ Ibid.

⁴²⁸ Ibid, 802.

⁴²⁹ Ibid, 803.

⁴³⁰ Ibid, 804.

- It should also be noted that the fact that the plaintiff has an alternative remedy to piercing the veil does not bar the court from piercing the veil.⁴³¹

The above guiding principles are however not exhaustive as we have several cases where additional principles are deduced depending on the particular merits of each case. For instance, in *Nel v Metequity Ltd*,⁴³² it was held that the mere fact that a company has only one shareholder who is in full control of the company does not in itself constitute a basis for disregarding its separate personality. In *Botha v Van Niekerk*,⁴³³ it was held that the court will pierce the veil when the Plaintiff has suffered unconscionable injustice as a result of improper conduct on the part of the defendant. Although this approach was refused in the *Cape Pacific* case,⁴³⁴ it seems the 2008 Act, as shall be discussed below, portrays an almost similar wording notwithstanding that it is directed at the offended person and not necessarily the company itself. It is thus of essence that the provisions of the 2008 Act be examined below.

4.3.2. Piercing the veil under the 2008 Act *vis-à-vis* creditor protection

Piercing the corporate veil is one of the corporate principles which are used as means/or mechanisms to protect creditor interests among other stakeholders. Thus, for the first time in South African company law, a statutory provision has been enacted that permits a court to disregard the separate legal personality of a company. In terms of s 20(9) of the 2008 Act it is provided that:

If, on application by an interested person or in any proceedings in which a company is involved, a court finds that the incorporation of the company, any use of the company, or any act by or on behalf of the company, constitutes an unconscionable abuse of the juristic personality of the company as a separate entity, the court may –

- (a) declare that the company is to be deemed not to be a juristic person in respect of any right, obligation or liability of the company or of a shareholder of the company or, in the case of a non-profit company, a member of the company, or of another person specified in the declaration; and
- (b) make any further order the court considers appropriate to give effect to a declaration contemplated in paragraph (a).

The above provision clearly deters directors or shareholders from unconscionably abusing the legal personality of a company. Courts have discretion to deal with any such action

⁴³¹ Ibid, 805.

⁴³² 2007 (3) SA 34 (SCA) para 11.

⁴³³ 1983 (3) SA 513 (W), 525.

⁴³⁴ Supra note 421, at 805 where it was held that the approach in *Botha* was too rigid against the need for a flexible approach which allows the facts of each case to ultimately determine whether or not it is suitable to pierce the veil.

which qualifies as an ‘unconscionable abuse’ should any affected or interested person approach court on notice of motion supported by a substantial affidavit laying out the acts of ‘unconscionable abuse’. According to the *Gore* case,⁴³⁵ in terms of section 20(9), the words ‘may’ in the provision gives courts discretion to pierce the corporate veil where it finds that there has been an ‘unconscionable abuse’ of the juristic personality of a company. The use of the word ‘may’ is the one which shows that courts have discretion whether to pierce the corporate veil or not. It follows that even where the requirements of section 20(9) are met, a court is not obliged to pierce the corporate veil, but has discretion whether to do so or not.

The general test used to decide when the corporate veil may be pierced is that of ‘unconscionable abuse’ of the juristic personality of a company as a separate legal entity. The court would look at the conduct of the wrongdoer to determine whether such conduct constitutes ‘unconscionable abuse’.⁴³⁶ If the conduct constitutes ‘unconscionable abuse’ of the juristic personality of a company as a separate legal entity, the court may exercise its discretion and pierce the corporate veil hence holding the wrong doer liable. What constitutes ‘unconscionable abuse’ may be derived from common law such as issues of fraud, dishonesty, any conduct so considered hence the list cannot be a closed one in terms of section 20(9).⁴³⁷ Comparably, in terms of the Close Corporations Act of 1984, the test for piercing the corporate veil is ‘gross abuse of the separate legal personality of a company’.⁴³⁸ The term ‘unconscionable abuse’, according to the court in *Ex Parte Gore*,⁴³⁹ is less extreme as compared to the term ‘gross abuse’ used in section 65 of the Close Corporations Act of 1984. The term ‘unconscionable abuse of the juristic personality of a company’ postulates conduct in relation to the formation and use of companies diverse enough to cover all the descriptive terms like ‘sham’, ‘device’, ‘stratagem’.⁴⁴⁰ Section 20(9) is a solution or a remedy available to situations where the illegitimate use of the concept of juristic personality adversely affects a third party in a way that reasonably should not be countenanced.⁴⁴¹ In a 2017 case, *City Capital SA Property Holdings Ltd’s Case*,⁴⁴² Schippers AJA gave the following meaning to ‘unconscionable abuse’:

⁴³⁵ *Ex parte Stephen Malcolm Gore N.O and 37 Others N.N.O*, Reportable case, ZAWCHC, Case No. 18127/2012.

⁴³⁶ PT Mashiri ‘A critical analysis of the piercing of the corporate veil in South African corporate law, with special reference to the position in groups of companies’ (2016) UKZN, LLM Dissertation, 33.

⁴³⁷ *Supra* note 435.

⁴³⁸ Section 65 of the Close Corporation Act 1965.

⁴³⁹ *Supra* note 435, 34.

⁴⁴⁰ *Ibid.*

⁴⁴¹ *Ibid.*

⁴⁴² *City Capital SA Property Holdings Ltd v Chavonnes Badenhorst St Clair Cooper NO* (85/2017) [2017] ZASCA 177.

The meaning of unconscionable“ in the Oxford English Dictionary includes, showing no regard for conscience..... Unreasonably excessive.... egregious, blatant...unscrupulous.” It is in my view undesirable to attempt to lay down any definition of ‘unconscionable abuse’. It suffices to say that the unconscionable abuse of the juristic personality of a company within the meaning of s 20(9) of the 2008 Act, includes the use of, or an act by, a company to commit fraud; or for a dishonest or improper purpose; or where the company is used as a device or facade to conceal the true facts...

The above meaning shows the extent or the scope of what may attract the need for the piercing of the veil under the 2008 Act compared to the common law ambits. It is however recommended that the common law meaning be used concurrently with the new provisions in order to enhance interpretation of the meaning of ‘unconscionable abuse’.⁴⁴³ Prior to the 2008 Act, Scott JA in *Hulse-Reutter and others v Godde*⁴⁴⁴ said: “[W]hat, I think, is clear is that as a matter of principle in a case such as the present there must at least be some misuse or abuse of the distinction between the corporate entity and those who control it which results in an unfair advantage being afforded to the latter”. If the same approach is used, then ‘abuse’ of the corporate personality will not be sufficient alone to justify the application of section 20(9) of the 2008 Act, instead, it has to result in company controllers having an unfair advantage at the company’s expense and that will then result in the abuse being unconscionable. This approach also reconciles with *City Capital SA Property Holdings Ltd’s case* where unconscionable abuse is associated with acts of fraud and improper use among others.⁴⁴⁵ It is trite that fraud is purposed at unduly enriching or benefiting the fraudster at the expense of the victim. This approach is also supported by Professor Nwafor, who upon conducting an extensive exploration of the meaning of ‘unconscionable abuse’, from various angles, came to the following conclusive analysis;

This analysis suggests that an abuse of corporate structure only becomes unconscionable where there is benefit derivable by the abuser and which adversely affects the existing interest of a third party. The mere misuse of the corporate structure is simply not sufficient to constitute unconscionable abuse within the context of section 20(9) of the Companies Act.⁴⁴⁶

Despite the above approach, it should be noted that such an approach is just a guideline in relevant circumstances and should not be used as the only determining element of the meaning of unconscionable abuse. It has been observed that the circumstances which justify the piercing of the corporate veil are still far from being settled.⁴⁴⁷ Courts will however look beyond the corporate veil where justice requires it, and not only when there is no alternative

⁴⁴³ Supra note 435, 34.

⁴⁴⁴ [2002] 2 All SA 211 Para 20.

⁴⁴⁵ Supra note 442.

⁴⁴⁶ AO Nwafor ‘Piercing the Corporate Veil: An Incursion into the Judicial Conundrum’ (2015) 11 (3) *Corporate Board: Role, Duties & Composition*, Virtus Interpress, 148.

⁴⁴⁷ Ibid, 146.

remedy.⁴⁴⁸ To sum it up, what entails an unconscionable abuse of the juristic personality should not be an exhaustive list but should be determined according to the merits of each case.

Having attempted to define the meaning of unconscionable abuse above, it is thus important to consider applicability of the 2008 Act's provisions. It has always been the *modus operandi* from the *Cape Pacific* case guidelines that courts should use the balancing approach when deciding whether to pierce or not to pierce the corporate veil. It will require the court to weigh the separate legal personality against the principles that favours the piercing of the corporate veil as stated in the *Gore* case where the judge stated the following;

In my view the determination to disregard the distinctness provided in terms of a company's separate legal personality appears in each case to reflect a policy based decision resultant upon a weighing by the court of the importance of giving effect to the legal concept of juristic personality, acknowledging the material practical and legal considerations that underpin the legal fiction, on the one hand, as against the adverse moral and economic effects of countenancing an unconscionable abuse of the concept by the founders, shareholders, or controllers of a company, on the other. The courts have shown an acute appreciation that juristic personality is a statutory creation and that their separate existence remains a figment of law, liable to be curtailed or withdrawn when the objects of their creation are abused or thwarted.⁴⁴⁹

Thus the court has a duty to weigh the scales of balance between the need to promote interest of justice where unconscionable abuse is evidenced and also the need to preserve the corporate principle of juristic personality existing separately from company owners and controllers. If the scales of balance are in favour of the juristic personality's separate existence principle then affected or interested persons may not get relief under the piercing of the veil machinery yet the reverse is true. Of importance to this research, is the *locus standi* which is given to creditors, among other stakeholders, where there is unconscionable abuse of the juristic person to the detriment of their rights. Section 20(9) provides that any 'interested person' may approach court to seek orders in terms of subsection (a) & (b). The meaning of interested person is not given in the Act however it is trite that an interested person must be someone with an interest. The established principle is that for one to be considered as an interested person they need to have a direct and sufficient/ or substantial interest or perhaps have their rights enshrined in the Bill of Rights infringed.⁴⁵⁰ In the premises, a creditor whose rights or interests have been affected as a result of an unconscionable abuse of the juristic personality of a company will by all means qualify as an interested person hence having a right to stand before the court. It follows that the

⁴⁴⁸ Gore's Case, supra note 435 para 28.

⁴⁴⁹ Supra note 435, para 29.

⁴⁵⁰ Ibid, para 35; also *Jacobs en 'n Ander v Waks en Andere* 1992 (1) SA 521 (A), at 533J-534E.

researcher is of the view that the preceding understanding will unequivocally apply where a creditor's interests are affected by the 'unconscionable abuse conduct' of those running the affairs of the company.

4.3.3. Summary on Piercing of the corporate veil

Directors are under an obligation to act in the best interest of the company which may entail ensuring that all company's stakeholder interests are reasonably balanced. A director who breaches his fiduciary duties may be held personally liable in terms of section 20(9) of the 2008 Act as long as an interested person is able to prove that the breach amounts to an unconscionable abuse of the legal personality of the company. Same applies with shareholders who may want to manipulate directors in order to achieve a certain goal by taking advantage of the juristic person. Reckless and fraudulent trading in section 22 of the 2008 Act accordingly forms part of unconscionable abuse of the juristic person hence one may concurrently claim against the company together and/ or alternatively with its owners or controllers in terms of section 20(9) and section 218 of the 2008 Act. Shareholders and directors are thus called to be careful in their actions as far as infringing interests of creditors who happen to qualify as interested parties in terms of section 20(9). It should be noted that creditors should be careful when employing the 'piercing of the veil' mechanism as courts do not take it light when it comes to the need to disregard the company's separate legal personality. Thus, one has to be sure that the conduct indeed amounts to 'unconscionable abuse' or else it will be advised that creditors use other remedies which still holds directors liable without the need to invoke section 20(9).⁴⁵¹ Conclusively, the legislation on the 'piercing of the corporate veil' concept thus makes available different avenues in which creditors may deal with their abused rights in dealing with debtor companies hence ensuring the effectiveness of creditor protection through mandatory legislated company laws.

4.4. ENFORCEMENT MECHANISMS OPEN TO CREDITORS

The researcher shall not discuss anything hereunder in detail notwithstanding the import of these "enforcement mechanisms" in creditors' protection which however may be left open for further research. It is thus important to briefly set out the significance of certain developments in the 2008 Act which impact on the effectiveness of enforcement of rights of affected or interested persons such as creditors for purposes of this work. Firstly in terms of section 156 of the 2008 Act there are now four avenues which creditors or any affected or

⁴⁵¹ Section 22; 214, 218 are important alternatives.

interested person may use for addressing complaints on alleged contraventions of the 2008 Act or for securing or enforcing their rights. These are;

- Applying to High court for any orders necessary to enforce one`s rights;
- Filing a complaint with the companies commission or the takeover regulation panel;
- Applying to the Companies Tribunal either for adjudication; or
- Alternative Dispute Resolution.

It should however be noted that the High Court remains the primary forum for dispute resolution, the interpretation and enforcement of the 2008 Act.⁴⁵² The inclusion of the other three channels or alternatives for addressing complaints and enforcing rights under the 2008 Act helps reduce the burden on the Courts, save costs and time or other relevant resources.⁴⁵³ Instead of outrightly approaching the court which may be more costly, a creditor may lodge a complaint with the companies' commission for an investigation on the manner in which the company is being run that affects the creditor`s rights and those of others.⁴⁵⁴ The companies commissioner may upon investigation issue compliance notices which may result in positive results favouring the interests of the creditors among other stakeholders. Section 22 of the 2008 Act allows the commission the right to deal with any suspicions on reckless, fraudulent and insolvent trading in a company which it may obtain upon notice by any affected or interested person or by itself. It can accordingly issue a compliance notice which when not taken seriously may result in serious penalties which may even end at forced liquidation. Section 157(2) gives the commission powers to intervene or assist any person in legal proceedings. This may assist creditors who may be financially handicapped to enforce their rights. It provides as follows;

- (2) The Commission or the Panel, acting in either case on its own motion and in its absolute discretion, may—
- (a) commence any proceedings in a court in the name of a person who, when filing a complaint with the Commission or Panel, as the case may be, in respect of the matter giving rise to those proceedings, also made a written request that the Commission or Panel do so; or
- (b) apply for leave to intervene in any court proceedings arising in terms of this Act, in order to represent any interest that would not otherwise be adequately represented in those proceedings.

The Takeover Regulation Panel on the other hand may deal with any transactions which are considered affected transactions.⁴⁵⁵ Most of these affected transactions may result in the

⁴⁵² Memorandum on the Objects of the Companies Bill, 2008, Companies Bill [B61D-2008] para 3.

⁴⁵³ MF Cassim 'Enforcement and Regulatory Agencies' opcit note 31, 826.

⁴⁵⁴ Ibid, 835.

⁴⁵⁵ Section 117(1)(c) shows that all fundamental transactions are affected transactions unless specifically exempted.

jeopardy of creditor interests if not regulated hence the need for a panel like this which even go to the extent of applying to court for an order to wind up a solvent company in circumstances where there has been fraudulent and illegal activities and the subsequent failure to comply with its compliance notice.⁴⁵⁶ Moreso, a Companies Tribunal, being new in South African company law, serves to either adjudicate on matters referred to it just like a court of law and makes an order as guided by the Act or it may facilitate alternative dispute resolution processes between parties.⁴⁵⁷ Creditors with a dispute may prefer this forum as it may be cost effective while at the same time promoting a less formal means of resolving disputes. The Tribunal may approach the court to file its order or any resolution between parties amicably settling, so to certify same as an order of the court in terms of its rules.⁴⁵⁸ This will help enforce compliance of its orders or parties resolutions in terms of the court's rules.

Widening the scope of avenues through which rights may be enforced under the 2008 Act helps creditors affected by any conduct to have many options to explore in enforcing their rights. Even in instances where they are not really affected but feel the conduct is not favourable for the company, they still have a ground to report to the relevant bodies just as whistle blowers. The important part is that the Act ensures that whistle blowers⁴⁵⁹ are protected in harmony with the Protected Disclosures Act 26 of 2000.⁴⁶⁰ Thus, creditors have effective protection under the 2008 Act with an increased opportunity to approach any appropriate forum to enforce their rights under the 2008 Act.

Secondly, the 2008 Act has extended *locus standi* of various stakeholders to apply for remedies to appropriate forums or court or tribunal. Section 157(1) of the 2008 Act provides as follows;

- (1) When, in terms of this Act, an application can be made to, or a matter can be brought before, a court, the Companies Tribunal, the Panel or the Commission, the right to make the application or bring the matter may be exercised by a person—
- (a) directly contemplated in the particular provision of this Act;
 - (b) acting on behalf of a person contemplated in paragraph (a), who cannot act in their own name;
 - (c) acting as a member of, or in the interest of, a group or class of affected persons, or an association acting in the interest of its members; or
 - (d) acting in the public interest, with leave of the court.

⁴⁵⁶ Section 201 of the 2008 Act. See also MF Cassim & J Yeats 'Fundamental transactions, Takeovers & offers' opcit note 31, 747.

⁴⁵⁷ Section 195 of the 2008 Act.

⁴⁵⁸ Section 195(8) of the 2008 Act.

⁴⁵⁹ Those who disclose irregularities or contraventions of the 2008 Act.

⁴⁶⁰ Section 159 of the 2008 Act.

These broad provisions are new in company law as they were not part of the 1973 Act. In the premises, subsection 1(c) above gives creditors of a company a right to collectively or jointly institute proceedings in order to help divide costs amongst themselves which makes litigation accessible by all affected persons. Section 157(2) of the 2008 Act gives the companies commission *locus standi* to commence proceedings or apply for leave to intervene in proceedings on behalf of any person(s) whose rights may not be well represented without its intervention. This then entails that a creditor without a good financial standing may use the commission's avenue to enforce payment of its debts. Lastly, as we have seen under several mechanisms discussed in chapter 3 & 4, creditors have *locus standi* to influence the commencement of such proceedings or mechanisms either within the company or through the court process in most which when employed would safeguard creditor interests.⁴⁶¹ It is thus conclusive to reckon that the 2008 Act has devised a number of mechanisms, some of which are direct and some indirect, which at the end of it uphold one of its purposes which is to provide appropriate legal redress for investor and third parties within the companies.⁴⁶² This then promotes the development of companies within all sectors of the economy, and encourages active participation in economic organisation, management and productivity.⁴⁶³

4.5. CONCLUSION

Without doubt, the 2008 Act has achieved its goals and purposes in ensuring that investors or third parties or creditors are safe when dealing with debtor companies. New mechanisms which were not part of the previous South African legislation, although some were applied in a limited fashion under the common law, have been brought forth to enhance creditor protection. The business rescue process, with rights of creditors at heart, provides an opportunity for a company to revive its financial stamina as a going concern, whilst creditor rights are temporarily frozen. It has been found that the company does not necessarily have to be completely revived, but that the result should be best output compared to what creditors and shareholders would get in the outright employment of liquidation processes. In

⁴⁶¹ Such instances include the creditor's right to approach the court where directors have failed to ensure compliance with solvency and liquidity test on certain transactions which so require them to do so. Creditor's right to participate in creditor compromises although they may not propose a compromise themselves. Creditor's right to influence liquidation processes regardless of whether a company is insolvent or solvent. Creditor's right to influence business rescue processes, their *locus standi* in moving a motion for piercing the corporate veil and their protection by the Turquand rule etc.

⁴⁶² See preamble to the 2008 Act.

⁴⁶³ Section 7(f) of the 2008; Creditors or investors who know that their rights are protected would not hesitate contracting with companies knowing that they have a right of standing to approach any appropriate court, forum or tribunal to enforce their rights.

addition, the Turquand rule also places creditors on the safe side, as against its opposite (constructive notice doctrine) which still has its remnants in ring fenced companies and personal liability companies, by ensuring that creditors are not expected to know of non-compliances with internal procedures in debtor companies. Thus a debtor company will be bound by a creditor`s claim regardless of whether its internal procedures were complied with or not unless the debtor company falls under the exceptions to the Turquand rule.

Also, directors and shareholders are to be careful as they can no longer hide behind the veil of the limited liability principle should it be found that they unconscionably abused a company`s separate legal existence principle to the detriment of the interests of creditors. Although these new mechanisms may not be perfectly placed in some instances, but their weight cannot be understated as far as they contribute to the overall goal of achieving effective creditor protection through mandatory company laws. Also, access to justice has been made easier as the 2008 Act has added other cost effective forums to resolve corporate related disputes such as the Companies commission and the Companies Tribunal. Moreso, the extension of *locus standi* to various stakeholders including allowing the Companies Commission to act on behalf of or intervene in legal proceedings where it is of the view that one may not obtain appropriate redress without its intervention. In conclusion, the researcher applauds the legislature for adopting these new mechanisms as their import in ensuring effective creditor protection cannot be underestimated.

CHAPTER 5

CONCLUSIONS AND RECOMMENDATIONS

5.0 INTRODUCTION

The purpose of this research work was to examine whether the 2008 Act had provided for effective creditor protection in company affairs. In achieving this, the researcher, in chapter 2 sought to justify creditor protection by mandatory corporate laws contrary to the views that creditors need no protection from mandatory corporate laws as they are protected by contract laws. The researcher in chapters 3 and 4 explored the various re-enacted creditor protective mechanisms and newly-statutorily adopted creditor protective mechanisms respectively, which have been employed by the 2008 Act, in order to assess their effectiveness in advancing creditors' interests in company affairs. Upon intensive application of the doctrinal approach to this research, a number of conclusions and recommendations were respectively drawn and advanced.

5.1. CONCLUSIONS

Firstly, the researcher discussed a number of issues that are pertinent to creditor protection in an attempt to propound a theoretical basis for creditor protection. It was found that creditors cannot be sufficiently protected by contract laws alone hence their protection should be enhanced by mandatory corporate laws. To reach this conclusion, the researcher initially explored the consequences of incorporation of a company in as far as creditor protection is concerned. One of the consequences of a company's incorporation is the separate legal existence status of a company, which separates the company's own interests from those of shareholders or directors.⁴⁶⁴ This principle is set to separate the company's affairs from those of its directors and shareholders. This helps to clear any confusion so that third parties understand that when they are dealing with the company they are actually dealing with the company itself and not its controllers who are just its agents. It is however sad that the company controllers take advantage of this principle and commit several acts which prejudices creditor interests knowing that creditors will have recourse against the company and not themselves. This brings another consequence to the incorporation of a company, which is the 'limited liability principle', which asserts that shareholders are as a general principle not liable for the debts of the company.⁴⁶⁵ It is the finding of this research that mandatory corporate laws are required to restrict the conduct of company controllers so that they do not abuse these important principles of company law.⁴⁶⁶ Creditors are also

⁴⁶⁴See *Salomon v Salomon & Co Ltd* [1897] AC 22 (HL) at 51.

⁴⁶⁵ See *Airport Cold Storage (Pty) Ltd's case*, supra note 59.

⁴⁶⁶ See section 20(9) of the 2008 Act dealing with the principle of piercing the corporate veil (detailed in chapter 4); section 22 preventing reckless trading; section 214 imposing criminal sanctions on participants to

placed at an advantage by some other consequences of incorporation of a company such as the company's continued existence despite the death of its controllers or shareholders; the separation of its assets from those of its controllers or shareholders which secures creditors' interests as they rely on company assets as their security for debt repayment; the responsibility of the company to pay its debts regardless of who are its controllers; the profit of the company being for the company and not of its controllers who are only entitled to dividends; and lastly, the fact that creditors may sue the company directly in its own name to avoid the cumbersomeness of reaching out to company controllers.⁴⁶⁷

Further, the researcher explored various schools of thoughts to reflect on the background view of the theories (approaches or models) of corporate governance. The Contractarianism school of thought opposes the protection of creditors by corporate laws as it asserts that protective measures for creditors' interests are limited to terms in the actual contract between them and the company.⁴⁶⁸ It was found that proponents of this school of thought also favour the shareholder value approach as a model or approach to corporate governance.⁴⁶⁹ Also, a jurisdiction that follows the pluralist approach would have drawn its impetus from possibly the communitarian and associative school of thoughts.⁴⁷⁰ A jurisdiction that is predisposed to the enlightened shareholder value approach could be aligned to the dual-concessionarism school of thought.⁴⁷¹ South African company law is seemingly inclined to the enlightened shareholder value approach, a model of corporate governance that permits directors to have regard, where appropriate, to the interests of other stakeholders in the company, but with shareholders' interests retaining primacy.⁴⁷² It is the findings of this research that many jurisdictions favour the same approach as it retains the traditional goal of companies with a considerable moderation that strikes a fair balance between shareholder interests and that of other stakeholders.⁴⁷³ This then justifies the fact that creditors, just like any other stakeholder, require their interests to be protected by mandatory corporate laws binding directors to act in a certain way, despite the protection that is provided to them by contract laws as it is considered insufficient.

fraudulent activities against third parties and section 218 imputing civil liability thereof (detailed in chapter 3 under the topic 'sanctioning of directors'.

⁴⁶⁷ See paragraph 2.1.3 in chapter 2 above.

⁴⁶⁸ Keay, *opcit* note 16, p 673.

⁴⁶⁹ See para 2.3.1 in chapter 2 which describes this model as a model that values the interests of shareholders above interests of any other corporate constituencies.

⁴⁷⁰ See 2.2.2 and 2.2.4 and 2.3.3 in chapter 2 above.

⁴⁷¹ See para 2.2.3 and 2.3.2 in chapter 2 above.

⁴⁷² DTI, *opcit* note 4, p 23. Also see King IV report, *opcit* note 2.

⁴⁷³ See the enlightened shareholder value approach discussed at para 2.3.2 above.

Secondly, the researcher explored the creditor protective mechanisms that were previously entrenched in the 1973 Act and the Companies Amendment Act of 1999 and that are now re-enacted in the 2008 Act. These are: the solvency and liquidity test concept; the sanctioning of directors/ directors` liability”; liquidation” and “Creditor Compromises”. The solvency and liquidity test has proven to be an important tool aimed at protecting creditors while at the same time allowing transactions that were prohibited under the 1973 Act. The prohibition of those transactions was not healthy for the companies` success and economic growth as it affected interests of other stakeholders.⁴⁷⁴ The solvency and liquidity test was first introduced by the 1999 Amendment Act with limited application whereas its application in the 2008 Act is wide and comparably detailed. There is thus an improvement in the application of this concept in the 2008 Act as compared to its previous application and this is important for effective creditors protection. The test helps in removing barriers to several transactions thus promoting an investor friendly environment for economic growth with interests of shareholders taken care of while at the same time promoting interests of creditors who are outsiders to company affairs.⁴⁷⁵ There are, however, discrepancies concerning the application and requirements of this test on several transactions hence recommendations have been made below to ensure effective creditors protection.

As earlier stated, one of the mechanisms discussed in chapter 3 is the sanctioning of directors; this mechanism is aimed at deterring company controllers from committing certain acts which may affect creditor rights among other stakeholders. It is found that under the 1973 Act directors were mostly deterred by criminal sanctions where in most cases they would pay a fine far less than the loss of the company or third parties. Civil recourse against them could only be obtained at common law through principles like the piercing of the corporate veil which option could not be lightly adopted by the courts.⁴⁷⁶ The 2008 Act is pretty much different as it, in most cases, shifts from the criminal liability sanction to a civil liability sanction.⁴⁷⁷ The criminal liability sanction now only applies in limited circumstances such as where directors trade with intention to defraud creditors.⁴⁷⁸ Also, the 2008 Act has made the position of the law more certain by codifying the duties of directors and also

⁴⁷⁴ *First Rand Bank Ltd v Wayrail Investments (Pty) Ltd*, A reportable case from KZN High Court; Durban (Case No. 684/2012); judgment delivered on 20/12/2012.

⁴⁷⁵ Now companies may conduct share repurchases; issue dividends with or without profit; grant financial assistance for share purchases, financial assistance to directors and prescribed officers, engage in amalgamations and mergers as long as it passes the solvency and liquidity test. This was difficult under the 1973 Act yet it was a prohibition of transactions which are beneficial to participating stakeholders other than creditors. See chapter 3 above.

⁴⁷⁶ See its discussion in chapter 4 above.

⁴⁷⁷ Section 218(2) provides that any person who contravenes any provision of this Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention.

⁴⁷⁸ Section 214(1)(c)(ii) of the 2008 Act.

imputing liability on directors for failing to fulfil their fiduciary duties.⁴⁷⁹ This ensures that companies are run for their best interest, which may include the interests of non-shareholder stakeholders such as creditors. Section 77(3) of the 2008 Act specifically lists examples of unlawful transactions; directors may be held personally liable as a result of participating in authorising such transactions. Most of those unlawful transactions inevitably affect the interests of creditors hence the need to deter directors from trampling on the feet of outsiders (creditors).

Chapter 3 also discussed the process of winding up or placing a company under liquidation, in appropriate circumstances, as a creditor protective mechanism. Company liquidation protects the interests of creditors by ensuring that the company assets are liquidated or sold in order to pay creditors before shareholders divide the residue. Section 81 of the 2008 Act has brought in fresh grounds, which are much clearer compared to those in the 1973 Act, for approving an application to wind up a solvent company. Although creditor interests are catered for in the section 81 grounds, creditors are however not given *locus standi* in most of those grounds to represent their rights. On the contrary, there has not been any change in liquidation of insolvent companies as 1973 provisions still apply in this case. Creditors are however granted the right to approach the court where the company is insolvent or has committed acts prohibited in Section 345 of the 1973 Act. Creditors must however not abuse the liquidation process; it has been stated that where an application for winding up amounts to an abuse of process in that the motive is not merely to establish a *concursum creditorium* but is *mala fide*, the court will not grant a winding up order.⁴⁸⁰

Finally, chapter 3 also discussed 'creditor compromises' as a mechanism which protects creditor rights by ensuring that they compromise their rights temporarily in order to allow the company to gain its momentum financially. The researcher appreciates the advantage which creditors may have in circumstances where compromise proceedings are brought into picture without any hidden agendas or in utmost good faith. There is a clear lay out in section 155 of the 2008 Act of what should be included in a proposal for a compromise in order to help creditors make an informed decision on whether or not to accept a compromise. Although creditors do not have *locus standi* to propose a compromise as was the case under the 1973 Act,⁴⁸¹ it cannot be denied that creditors' compromise provisions in the 2008 Act are more clear and certain than those that were in the 1973 Act.

⁴⁷⁹ See section 75, 76 & 77 of the 2008 Act.

⁴⁸⁰ J Yeats 'Winding Up' opcit note 31, 919.

⁴⁸¹ See section 311(1) of the 1973 Act.

Lastly, chapter 4 discussed the effect of the innovative statutorily adopted mechanisms on creditor protection. These are mechanisms which are for the first time adopted into South African legislation. Chapter 4 discussed the business rescue concept, among other creditor protective mechanisms. Business rescue processes are a double barrel approach which seeks to resuscitate a financially ailing company while at the same time securing interests of creditors. This is achieved by ensuring that the company is financially rescued to meet creditor claims or, should the rescue fail, creditors would get better returns than they would get if liquidation processes were preferred over business rescue processes. Of importance is the participation of creditors in rescue processes which also helps them safeguard their interests despite a moratorium on their rights.⁴⁸² Thus, creditors are treated as insiders once rescue processes have commenced with same rights as employees. Moreso, creditors still have a right to approach court and deal with any issues outstanding as long as they obtain consent from the business rescue practitioner; or should they obtain leave from court on any grounds which the court deems suitable.⁴⁸³ It is thus the researcher's view that creditor interests are to a large extent protected effectively by the business rescue processes and that credit should be given to the legislature for borrowing this mechanism or avenue for creditor protection from the leading countries.⁴⁸⁴

Chapter 4 also discussed the Turquand rule as another mechanism for creditor protection. The Turquand rule is by all means a tool or mechanism geared at safeguarding creditor interests. It is not reasonable to expect an outsider to know information that constitutes inside information or to go beyond the limit in trying to dig out whether the company representative has authority to act on behalf of the company or not. The Turquand rule replaced the doctrine of constructive notice but it should be noted that the doctrine of constructive notice still applies to ring fenced companies and personal liability companies hence creditors must be careful when dealing with these types of companies as they may be punished for their ignorance.⁴⁸⁵ Creditors should also be aware of the exceptions to the protection by the Turquand rule as discussed in chapter 4 so that they are not caught on the wrong side of the law. Finally, it should be noted that common law provisions are to be used concurrently with the statutory provisions of the Turquand rule.⁴⁸⁶ Creditor interests are thus effectively protected by the application of the Turquand rule in terms of the 2008 Act.

⁴⁸² FHI Cassim 'Business rescue and compromises' opcit note 31, 902.

⁴⁸³ Section 133(1)(a)&(b) of the 2008 Act.

⁴⁸⁴ The UK, the USA etc.

⁴⁸⁵ Section 19(5) of the 2008 Act. See also FHI Cassim 'Corporate Capacity, Agency and the *Turquand* Rule' opcit note 31, 180-1.

⁴⁸⁶ Section 20(8) of the 2008 Act.

Chapter 4 also discussed the concept of piercing the corporate veil as a creditor protective mechanism. A director or shareholder who commits acts which are considered an unconscionable abuse of the legal person may be held personally liable in terms of section 20(9) of the 2008 Act. In terms of the common law, courts were reluctant to apply this concept as it was used as a last resort remedy yet under section 20(9) of the 2008 Act courts can apply this concept, regardless of whether or not there is an alternative remedy, as long as unconscionable abuse of the legal personality is proved.⁴⁸⁷ Uncertainties are however left as to the circumstances which results in unconscionable abuse of the legal personality. Common law guidelines are thus used to assist courts interpret the meaning of unconscionable abuse.⁴⁸⁸ It is also found that an abuse of a legal personality should be aimed at defrauding either the legal person or any person in order for it to be considered 'unconscionable'.⁴⁸⁹ Creditors thus have *locus standi* to approach court where they notice any abuses of the company's legal person in a way that affects their interests. It is thus undeniable that creditor interests are to a large extent protected by this concept as it gives creditors an opportunity to convince courts to look beyond the veil of the company and hold accountable the actual culprits.

Lastly, chapter 4 discussed several enforcement mechanisms that were set in motion by the 2008 Act to ensure that creditors have different avenues to enforce their rights.⁴⁹⁰ This was aimed at ensuring improved access to justice while simultaneously saving costs, time and other relevant resources. Section 157 of the 2008 Act also extends *locus standi* to affected persons to act individually or as a group and also gives the Companies Commission *locus standi* to institute or intervene in legal proceedings in court on behalf of any affected person(s). This is good news to the need for effective protection of creditors who are outsiders in company affairs.

⁴⁸⁷ S Phiri 'Piercing the Corporate Veil: A Critical analysis of section 20(9) of the Companies Act 71 of 2008' unpublished *LLM Dissertation*, University of Venda, 2016, 98.

⁴⁸⁸ *Supra* note 435.

⁴⁸⁹ See AO Nwafor, *opcit* note 442.

⁴⁹⁰ See section 156 of the 2008 Act which sites the Companies Commission which assists affected persons for free; the Companies Tribunal which is cost effective as it promotes alternative dispute resolution processes against the expensive adversarial court system.

5.2. RECOMMENDATIONS

In chapter 2, the researcher sought to find out whether directors owed a duty to company creditors and other stakeholders in addition to their traditional duty which they owe to company shareholders. It was the researcher's findings that creditors should also be protected under directors' fiduciary duties given that they have a financial stake in the company and that other stakeholders such as the community and employees have separate pieces of legislation protecting them in company affairs. The shortfall is that South African company legislation has no clear guideline on the need to protect non-shareholder stakeholders in company affairs. The 2008 Act in section 76(3)(a) provides that directors should act in the best interests of the company. It has been shown that common law referred to interests of shareholders when it referred to best interests of the company.⁴⁹¹ This is however not in line with the provisions of the 2008 Act which projects a shift from the traditional shareholder primacy model to a model which reasonably caters for other stakeholders as well.⁴⁹² The traditional view is also refuted by King's codes report IV which provides for the need to balance a company's economic goals with social and environmental goals.⁴⁹³ ***It is recommended that the meaning of 'best interests of a company' in section 76(3)(a) be specifically amended to cover interests of all stakeholders and to clearly show South Africa's shift to the enlightened shareholder value approach.*** The legislature is advised to consider adopting and rephrasing section 76(3)(a) in line with section 172(1) of the UK Companies Act⁴⁹⁴ which provides as follows:

A director of a company must act in a way that he considers, in good faith, would be most likely to promote the success of the company for the benefit of the members as a whole, and in doing so have regard (amongst other matters) to, the likely consequences of any decision in the long term, the interests of the company's employees, the need to foster the company's business relationships with suppliers, customers and others, the impact of the company's operations on the community and the environment, the desirability of the company maintaining a reputation for high standards of business conduct, and the need to act fairly between members of the company.

If the above recommendation is implemented then South African company legislation would have met standards of its inspiring jurisdictions and would have adhered to the provisions of the King's codes and the 2008 Act which reflect the upholding of the enlightened shareholder value approach. This will then ensure certainty of the protection of creditors and other stakeholders by mandatory corporate laws to promote a mutual benefit of all participating stakeholders and thus encouraging economic growth. Alternatively, courts

⁴⁹¹ See paragraph 2.3.1 of chapter 2 above and also *Greenhalgh v Ardenne Cinemas Ltd* [1951] Ch 286, 291.

⁴⁹² See the preamble of the 2008 Act which seeks to provide appropriate remedies to third parties who are creditors. See also several sections providing for mechanisms to protect creditor interests as outlined in chapter 3 and 4.

⁴⁹³ King iv report, opcit note 2.

⁴⁹⁴ UK'S Companies Act of 2006.

should interpret section 76(3)(a) to give effect to the true intention of legislature which is to cater for the interests of other stakeholders and not only shareholders in company affairs.⁴⁹⁵

In chapter 3, the researcher discussed several creditor protective mechanisms which were re-enacted by the 2008 Act. The solvency and liquidity test is one of those as it stands to be an important development in South Africa`s company law as far as protection of creditors is concerned while at the same time promoting interests of other stakeholder, in particular, shareholders. It is the researcher`s finding that the test is applied with differences in form and strictness of its requirements varying from transaction to transaction. There is a considerable degree of strict pre-requisite requirements on distributions as compared to financial assistance and amalgamations. ***It is recommended that the application and requirements of the solvency and liquidity test be uniform and strict in all transactions to ensure that the interests of creditors are protected in all transactions that inevitably affect their interests.***⁴⁹⁶ Section 4 of the 2008 Act lays no concrete principles or procedures set to assist directors who are required to apply the solvency and liquidity test hence it is recommended that the legislature should provide for same in some sort of regulations. This will ensure certainty as to the procedure and application of the solvency and liquidity test. Shareholders are also left out in the decision making concerning the approval of distributions and other transactions, leaving directors with the ultimate decision making.⁴⁹⁷ ***It is recommended that these transactions be approved also by a resolution of shareholders, in addition to other requirements already set in the 2008 Act. Shareholders will thus stand as an ultimate watch-eye to oversee the recommendations of directors who may fraudulently approve certain transactions to pursue their own interests since they will be having the sole control for approvals.***⁴⁹⁸

Another mechanism that was discussed in chapter 3 was the sanctioning of directors. As earlier stated, the 2008 Act has shifted from imputing criminal liability on directors to imputing civil liability upon any derogation from the law. ***It is however recommended that the legislature consider using both civil liability and criminal liability to deter directors from the abuse of their position of control and power in order to ensure absolute protection of creditor interests among other stakeholders` interests.*** This may however

⁴⁹⁵ See section 7(k) of the 2008 Act which provides that one of the purposes of the Act is to provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders; and also the preamble to the 2008 Act which seeks to provide appropriate remedies to third parties.

⁴⁹⁶ Compare its application on several transactions in sections 44, 45, 46, 48 and 113 of the 2008 Act.

⁴⁹⁷ Ibid. This is triggered by the fact that shareholders are ultimately affected by any form of distribution hence they should be involved in decisions that authorise such transactions.

⁴⁹⁸ That would act as a preventive measure which aids to correctional measures like section 77 of the 2008 Act which impute liability on directors who participate in meetings that authorise unlawful transactions.

be too strict and thus threatening on holders of an office of a director in company affairs as they may not freely perform and apply their mind in some justified circumstances with fear of being caught on the wrong side of the law. Legislature will have to strike a balance between protecting interests of all stakeholders through deterring directors by both civil and criminal sanctions while at the same time ensuring that directors are not unreasonably regulated to restrict performance of their duties without fear of the bands of the law.

Another mechanism discussed in chapter 3 is the liquidation process which is allowed in both solvent and insolvent companies. On liquidating solvent companies, creditors are not given *locus standi* to approach court for a liquidation order in most of the grounds laid in section 81 of the 2008 Act. ***It is recommended that legislature amends section 81 in order to provide for the right of creditors to approach court on any grounds laid in section 81 given that their interests are affected directly or indirectly by the grounds laid in section 81. It is also recommended that legislature amends insolvent laws so as to give effect to the repealing of the 1973 Act concerning provisions dealing with liquidation of an insolvent company.*** Thus, this is to ensure that laws relating to liquidation of insolvent companies tally with the gradual economic changes and aligns with international standards and that they exclude some cumbersome costly and archaic requirements in the 1973 Act.⁴⁹⁹

Chapter 3 also discussed ‘creditor compromises’ in addition to the above mechanisms. Criticism laid by the researcher is that the compromise provisions do not give creditors *locus standi* to also propose a compromise where they realise the debtor company is struggling in paying their debts. ***It is thus recommended that the compromise provisions be amended to allow creditors to propose compromises and to also allow them to access any information which helps them prepare a compromise proposal when need arises. It is also recommended that section 155 of the 2008 Act be amended to provide for circumstances where compromise agreements may be terminated in order to automatically revive creditor rights especially where the compromise process has been abused by company controllers.***⁵⁰⁰

⁴⁹⁹ An example will be section 346 of the 1973 Act which requires creditors to furnish the master with security of liquidation costs despite the fact that not all creditors have such security hence the law should find other means to secure such costs instead of burdening creditors who will be seeking relief through the liquidation avenue.

⁵⁰⁰ Such circumstances should include circumstances where creditors realize that the compromise avenue has been abused by directors to avert creditor claims against reckless, fraudulent and insolvent trading. It is the researcher’s view that creditor rights should be protected even during compromises and that they must be able to approach court in terms of sections 22, 214 and 218 of the 2008 Act where they notice any inappropriate conduct which prejudices their rights despite the compromise arrangements.

Chapter 4 dealt with the business rescue concept, among other creditor protective mechanisms which are for the first time adopted into South African legislation. When comparing this concept with proposals for creditor compromises where contents of a compromise plan are clearly outlined, one would find that there is no specific/or detailed outline of how a business rescue plan should be, which then leaves uncertainties in that regard.⁵⁰¹ ***It is recommended that the legislature amend the business rescue provisions to provide a template or clear outline of what must be constituted in a business rescue proposal. Moreso, it is also recommended that section 133 of the 2008 Act be amended to clearly lay out grounds which creditors may use to approach court during business rescue proceedings despite the temporary moratorium of their rights including the right to institute legal action.*** This would help creditors where there is abuse of the business rescue process such that creditors' interests are at risk.⁵⁰² It is also likely that business rescue process may fail since lending institutions may be sceptical dealing with a company that is under business rescue. ***It is also recommended that Department of Trade and Industry (DTI) provides for funding opportunities or at least liaise with banks to assist such companies with funding subject to certain conditions that would ensure that the funding institution's returns are incentivised and guaranteed.*** This would ensure the success of the business rescue plan and eventually attain effective creditor protection.

Another important development in South African company legislation is the adoption of the concept of piercing the corporate veil. The concept also presents itself as a mechanism to protect interests of creditors among other stakeholders. There is however uncertainties as to when courts may pierce the corporate veil as there is no definition of unconscionable abuse in section 20(9) of the 2008 Act. ***It is recommended that section 20(9) be amended to clearly give guidelines as to what conduct may result in unconscionable abuse of the legal personality.*** Moreso, when applying this concept, courts are advised to balance interests of justice against any form of unconscionable abuse of the legal personality with the need to protect the most sacrosanct principle of the company's status as a separate legal person with its own rights and obligations which are divorced from those of its controllers.

⁵⁰¹ See comparably creditor compromises in section 155 (3) of the 2008 Act.

⁵⁰² Conducts such as prohibited in section 22 of the 2008 Act.

5.3. RECOMMENDATIONS FOR FUTURE RESEARCH

This research work examined the effectiveness of creditor protective mechanisms in affording creditor protection under the 2008 Act. Several creditor protective mechanisms were individually assessed and their import in aiding creditor protection cannot be overemphasized. The researcher thus recommends that in future it will be imperative to conduct an in-depth research on each particular subtopic or creditor protective mechanism in a broader and detailed manner so to engage several methods of research, in particular the qualitative method, which would allow for a more personal engagement with directors of companies; business rescue practitioners; company liquidators; and any forum which may be of help to provide information which helps achieve the best results in this area of research. It may also be of essence to deal with this same research area in detailed comparisons with other jurisdictions. Finally, the researcher found that the 2008 Act has introduced additional avenues in which creditors or affected persons may enforce their rights in terms of the Act. These avenues are the Companies Commission; the Companies Tribunal and the Takeover Regulation Panel. The researcher recommends that in future there be an intensive enquiry to find whether these avenues have been of any fruitful help in enhancing access to justice by affected persons including creditors, among others? This would require an engagement with these forums, including the need to examine related judgements of the Companies Tribunal and reports of the Companies Commission and Takeover Regulation Panel.

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