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A Reflective Discussion of the Directors' Fiduciary Duties to Creditors under the South African Company Law

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Abstract: A company is a juristic entity possessing the legal capacity to acquire rights and obligations. However, since a company is an artificial person lacking a physical body, there are important functions that only natural persons will inevitably be required to perform on its behalf. A company usually acts through its directors or the board of directors. The interaction between company directors and other stakeholders creates various relationships between them and relevant legal subjects. In this regard, it is no longer debatable whether directors in South Africa owe fiduciary duties to the company or the shareholders as evident from section 76(3) of the Companies Act 71 of 2008 (Companies Act 2008). However, unprecedented global corporate scandals that occurred in the last two decades have triggered law reform in various jurisdictions like Australia and the United Kingdom (UK), to review directors' duties and requiring them to become accountable to creditors. This article discusses the directors' fiduciary duties to creditors under the South African company law in terms of both the Companies Act 2008 and the common law. The discussion of both the common law and the Companies Act 2008 is informed by the fact that the Companies Act 2008 has partially codified directors' duties in South Africa and as such common law principles continue to apply. The article further discusses recent court jurisprudence, academic debates and the prescription of directors' fiduciary duties to creditors in the context of insolvent companies in South African company law.

Keywords: company directors; fiduciary duty; corporate scandals; creditors; insolvency

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1. Introduction

A company is a juristic person and by virtue of that status, it is entitled to act as a legal entity separate from its members (*Salomon v Salomon* [1897] AC 22 (HL) (*Salomon case*). Even if a company has only one director, it has the ability to acquire rights and duties separate and distinct from those of its director (*Salomon case*; s 66(2) of the Companies Act 71 of 2008 (Companies Act 2008); Davies & Worthington, 2016, pp. 29). However, given that a company is a juristic person, it is impossible for it to effectively perform all its functions and duties without the assistance of natural persons (*R v Kritzinger* 1971 2 SA 57 (A) 59; *Financial Mail (Pty) Ltd (1990) v Sage Holdings Ltd* [1993] 2 All SA 109 (AD) 116; Davies & Worthington, 2016, pp. 29; Nwafor, 2013, pp. 81-83). For example, in *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705 (HL) 713, it was held that directors are the controlling mind and will of a company. A company inevitably needs natural persons to act on its behalf because of its juristic nature. The interaction between a company and natural persons will give rise to a special relationship between itself, directors and its shareholders.

Most relationships between legal persons result in the parties acquiring certain rights and duties (Mentjies, 2011, pp. 7). The board of directors is the most important group of natural persons through which a company acts (s 66(1) of the Companies Act 2008; Harner, 2016, pp. 271-273). In South Africa, company directors' duties derive from legislation, a company's Memorandum of Incorporation, the common law, valid pre-incorporation contracts and other agreements that could be entered into between directors and their company (s 66 of the Companies Act 2008; Esser & Jacques, 2007, pp. 346). One of the obligations of company directors is encapsulated in their fiduciary duty which generally refers to the avoidance of a conflict of duty and self-interest, loyalty and acting in good faith (Cassim *et al*, 2012, pp. 534-535; *Canadian Aero Service Ltd v O'Malley* [1976] 10 OR 239). Discretion, power, influence and vulnerability are some of the factors that the courts in South Africa consider when determining whether a fiduciary relationship exists between directors and the company or any stakeholder (*Volvo (Southern Africa) Pty Ltd v Yssel* [2009] 6 SA 531 (SCA) para 16 (*Volvo case*); *Phillips v Fieldstone Africa (Pty) Ltd* [2004] 3 SA 465 (SCA) para 33 (*Philips case*). However, it must be noted that the fiduciary duty of company directors is broad. This calls for a contextual approach when determining its ambit (*BCE Inc v 1976 Debenture Holders* [2008] 69 (SCC) 584 para 38).

Directors in South Africa owe fiduciary duties to the company or the shareholders as a whole by virtue of section 76(3) of the Companies Act 2008 (*Volvo case*; *Phillips case*); Havenga, 1995, pp. 435; Havenga, 2004, pp. 275; Nwafor, 2013, pp. 297; Zarnado, 2018, pp. 869). In terms of the shareholder primacy model, the term "company" includes directors and all its shareholders (Ajibo, 2002, pp. 44). For example, in the case of *Kinsela v Russell Kinsela (Pty) Ltd* [1986] 4 NSWLR 722 (*Kinsela case*), it was held that shareholders' proprietary interests enable them as a general body to be considered as the company when questions of directors' duties arise. Notably, the shareholder primacy model entails that company directors are primarily obliged to enhance and promote shareholder value in order to maximise their wealth and profits. Thus, a company is merely created for shareholders' profit maximisation under the shareholder primacy model. However, taking into consideration the corporate law reforms over the past two decades that have seen several leading common law jurisdictions like the United Kingdom (UK) and Australia becoming more inclined towards either the enlightened shareholder value (ESV) or pluralist models, debates about the plausibility of extending directors' fiduciary duties to company creditors have become topical in South Africa (s 172 of the Companies Act 2006 c 46 "Companies Act 2006"). The Explanatory Notes to section 172 of the Companies Act 2006 provide that the company directors' duty to promote the success of the company could also be modified to oblige them to have regard to the interests of creditors as the company nears insolvency. This article discusses the extension of company directors' fiduciary duties to creditors when a company becomes insolvent in South Africa. To this end, the article discusses the rationale for extending the company directors' fiduciary duties to creditors during insolvency.

2. Creditors and Directors' Fiduciary Duties in the Company Law Context

A creditor is a person or company to whom money or a debt is owed or a person to whom money or goods are owed and/or a person that provides credit. In the company law context, creditors constitute a critical stakeholder group because they provide long and short term funding to companies and can be broadly classified as secured and unsecured creditors. An unsecured or general creditor is defined in the *Black's Law Dictionary* as a creditor who does not assume any rights over any specific property of the debtor (Garner *et al*, 2004, p. 1116). Thus, an unsecured creditor is person that does not have the benefit of any security interests in the

assets of the debtor or individual or institution that provides credit to another person without first obtaining specific assets as collateral in respect thereof. On the other hand, a secured creditor has a right to the debtor's property in the form of collateral security which the creditor can use for repayment of the debt if the debtor defaults (Garner *et al*, 2004, p. 1116). According to Lin, creditors may have fixed claims against the debtor company that entitle them to receive a specific interest rate and repayment of their principal amount at a pre-determined maturity date (Lin, 1993, p. 1488). However, unsecured creditors have a special interest in a company's business but they do not have any security interests and related benefits in the assets of that company or debtor and this poses a huge credit risk to such creditors (Esser & Jacques, 2007, p. 346).

Before insolvency, directors do not owe any fiduciary duty to act in the best interests of creditors (ss 22 and 76 of the Companies Act 2008; Lin, 1993, pp. 1510). The question of whether directors owe, or ought to owe any fiduciary obligations to creditors only arises in the context of insolvency. Considering that insolvency does not happen overnight, the exact point in time at which the directors' duties should or ought to arise has sparked some considerable academic debate (Zarnado, 2018, p. 875; Macey & Salovaara, 2019, p. 907). Andrew Keay has demonstrated the complexity of this debate by enunciating concepts such as "near or the vicinity of insolvency", "doubtful insolvency", "risk of insolvency" and "financial instability" (Keay, 2001, p. 322-329; *Nicholson v Permakrafi (NZ) Ltd (in liq)* [1985] 3 ACLC 453, 459, 463, 464 (*Nicholson case*); *Brady v Brady* [1987] 3 BCC 553 (*Brady case*)). Reference has also been made in the same discourse to a company being "on the verge of insolvency" (*Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch) para 74 (*Colin Gwyer case*)). The precise meaning of financial instability is unclear but the phrase appears to have been used interchangeably with the term "dangerous financial position" in *Facia Footwear Ltd (in administration) v Hinchliffe* [1998] 1 BCLC 218. The term "doubtful insolvency" is a rather more complex concept since it is not defined in legislation and it is very broad giving rise to questions such as who must doubt the insolvency of a company? (Keay, 2001, pp. 327). All these terms indicate how difficult it has been for the courts and company law commentators to determine the exact point in time when company directors should owe fiduciary duties to its creditors. However, for the purposes of this article, the concept of corporate insolvency should be defined in line with the jurisprudence that has been developed when interpreting section 4(1) of the Companies Act 2008. In this regard, various South African courts and academics agree that an insolvent

company is one whose liabilities exceed its assets when fairly valued (*Standard Bank of South Africa Ltd v R-Bay Logistics* CC 2013 para 33; *Booysen and others v Kohrs and others* (59732/2016) [2016] ZAGPPHC 871 paras 36-38; Hamadziripi, 2021, pp. 240-242; Van der Linde, 2009, p. 225).

3. South African Jurisprudence Regarding the Fiduciary Duties of Company Directors

South African case law decided after the Companies Act 2008 came into effect somewhat indicates that directors' fiduciary duties could be extended to their creditors during insolvency. For example, in the unreported case of *Rabinowitz v Van Graan* [2013] 5 SA 315 (GSJ) (*Rabinowitz case*), the plaintiff sought leave of the court to amend her particulars of claim in order to set out a cause of action against the defendant directors on the basis that they were liable for certain losses she had sustained as an unsecured creditor. For the purposes of this article, only the arguments presented on behalf of the fifth and sixth defendants will be referred to. The plaintiff alleged that the defendant directors of certain companies that were trading in insolvent circumstances, which contravened the provisions of section 22(1) read with section 218(2) of the Companies Act 2008. Section 22(1) of the South African Companies Act 2008 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". 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". The court had to determine whether a third party (a creditor), could hold a director liable for breach of the said provisions (Cassim *et al*, 2012, p. 582, argues that section 218(2) of the Companies Act 2008 empowers creditors to seek redress from the company or its directors for fraudulent or reckless trading). The defendants argued that for them to be held personally liable, the plaintiff was required to allege and prove the precise causation between the conduct complained of and the loss suffered (*Rabinowitz case*; see also related discussion by Cassim *et al*, 2012, p. 582). The court upheld the plaintiff's argument that if a company director is found guilty of contravening section 214 of the Companies Act 2008, then such director could also be guilty of contravening section 218(2) of the Companies Act 2008 (*Rabinowitz case* para 17). The court concluded that a creditor could hold a director personally liable for cooperating in conduct that falls within the scope of section 22(1) of the Companies Act 2008 (*Rabinowitz case* para 22).

In *Sanlam Capital Markets (Pty) Ltd v Mettle Manco (Pty) Ltd* [2014] 3 All 454 (GJ) (*Sanlam case*), the plaintiff alleged, *inter alia*, that the third and fourth defendants and directors had contravened section 76(3) of the Companies Act 2008 which caused it to suffer a loss for which they were liable in terms of section 218(2) read with item 7(7) of Schedule 5 of the Companies Act 2008 or in terms of the common law. The affected company was not only insolvent but was, in fact, wound up. Relying on *Bayer v Frost* [1991] 4 SA 559 (A), the court dismissed the defendants' arguments and held that a plaintiff can claim for financial loss suffered if it can prove that the defendant breached a legal duty owed to the plaintiff (*Sanlam case* paras 23 and 44). The court in the *Sanlam case* further indicated that the law of contract provided insufficient protection to the plaintiff but it fell short of explicitly making a direct pronouncement on the nature of the duty that the directors owed to the plaintiff. The authors argue that extending directors' fiduciary duty to creditors could adequately protect creditors' interests in insolvent companies in South Africa.

In *Blue Farm Fashion Limited v Rapitrade 6 (Pty) Ltd* [2016] ZAWCHC 35 para 27, the court, in interpreting section 77(3)(b) of the Companies Act 2008, held that:

"A company is a juristic person. It cannot incur losses, damages or cost without the actions of its directors… In the circumstances of this case, the directors made orders of the clothing, accepted delivery of the same and thereafter did not pay on behalf of the company. In my view, they acted recklessly with the possibility of intent to defraud the plaintiff and cannot escape liability for their actions".

There are at least two reasons to assume that the underlying reasoning in the cases discussed above is not less relevant to the principles pertaining to company directors' fiduciary duties to creditors. Firstly, the fact that the South African courts were willing to hold company directors personally liable to creditors for breach of statutory provisions could be regarded as a strong indicator pointing to directors' fiduciary duty towards creditors under the common law (s 77(2) of the Companies Act 2008). Secondly, the Companies Act 2008 is quite clear that questions pertaining to the liability of directors can be resolved in accordance with the common law principles relating to breaches of fiduciary duty. Section 77(2)(a) of the Companies Act 2008 provides that "a director of a company may be held liable 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 sections 75, 76(2) or 76(3)(a) or (b)". If the legislature intended to abolish the common law

principles relating to directors' liability it would have expressed its intention in clear terms like it did in the case of derivative actions (see s 165(1) of the Companies Act 2008).

Furthermore, in South Africa, the King Code on Corporate Governance 2016 (King IV Report) adopted a stakeholder inclusive approach according to which company directors are expected to balance the interests of shareholders and other stakeholders including creditors over time through prioritising and, in some cases, trading off interests (King IV Report, 2016, pp. 25). Although King IV Report is not a legislative instrument, most of its principles have already been incorporated into contemporary company law legislation such as the Companies Act 2008. Compliance with principles and recommendations of the King IV Report is a requirement for companies listed on the Johannesburg Stock Exchange). The King IV Report further provides that a stakeholder interest that may be primary at one point may become secondary at a later stage (King IV Report, 2016, pp. 26). Furthermore, Principle 16 of Part 5.5 of the King IV Report states that company directors should adopt a stakeholder-inclusive approach to balance the interests and expectations of all stakeholders, in the best interests of the company when discharging their governance duties and functions. It is submitted that due to the special vulnerability of creditors during insolvency, their interests should be made primary and directors of insolvent companies should owe fiduciary duties to such creditors. Esser and Delport argue that a proper interpretation of section 76(3)(b) of the Companies Act 2008 should be done within the lenses of the stakeholder inclusive approach (Esser & Delport, 2016, pp. 1-29). In terms of this approach, company directors must take into consideration the interests of various stakeholders including creditors (Esser & Jacques, 2007, pp. 360). Ultimately, directors' decisions must be made in the best interests of the company even if that means to the disadvantage of shareholders (Esser & Delport, 2016, pp. 1-29).

4. Academic Debate Regarding the Extension of Directors' Fiduciary Duties to Creditors

There are some good academic arguments for the extension of directors' fiduciary duties to creditors in South Africa, especially when companies are either operating in insolvent circumstances or in severe financial distress (Harner, 2016, pp. 283; Keay, 2001, pp. 319-334; Lin, 1993, p. 1513; Flannigan, 2005, p. 373; Havenga, 1997, p. 318). For instance, the circumstances of a solvent company are

significantly different from those of an insolvent one (Zanardo, 2018, pp. 872; *Kinsela case*). A solvent company is one whose assets, when fairly valued, will either equal or exceed its liabilities as fairly valued (s 4(1)(a) of the Companies Act 2008). Additionally, a solvent company is able to pay its debts as they become due in the ordinary course of business for a period of twelve months after the date on which the assessment is done (s 4(1) of the Companies Act 2008). According to the accounting equation, a company's assets are financed by liabilities and the owner's equity (assets = liabilities + shareholders' equity) (Kolitz, 2015, p. 64). This suggests that an insolvent company would have exhausted all of the shareholders' equity and will be operating on creditors' money which technically falls under its liabilities. Accordingly, Keay argues that if a company cannot sustain itself and depends on creditor funds then its interests become the interests of existing creditors alone (Keay, 2001, p 317; Keay, 2003, p. 666). As a company nears bankruptcy, unsecured creditors become progressively vulnerable because they hold no right to the company's assets (Janger, 2018, p. 2). For example, when a company is experiencing financial difficulties, the shareholders and directors stand to lose nothing by engaging in high-risk strategies in a bid to rescue the company (Zwieten, 2018, p. 383; Zanardo, 2018, p. 877). If such strategies work, the company might be saved but if they fail, the creditors, especially unsecured ones, stand to lose everything that the company borrowed from them (Macey & Salovaara, 2019, p. 903; Zwieten, 2018, p. 389). Therefore, when a company is insolvent, the risk of shareholder opportunism is very high (Zanardo, 2018, p. 877).

Unless creditors in financially distressed companies in South Africa are granted fiduciary protection from company directors, the latter may willingly engage in risky undertakings that could result in considerable benefits, but if they fail, they will jeopardise the company's existence (Keay, 2001, p. 318). Creditors' vulnerability in South Africa is even greater when company directors are also major shareholders in the affected insolvent company since they would have lost either most or all of their investment already (Lin, 1993, pp. 1518). Additionally, during insolvency, most creditors in South Africa find it difficult to sue directors because they are shielded from personal liability through the application of the corporate legal personality principle (s 19(1) of the Companies of 2008; Lin, 1993, p. 1518; Zanardo, 2018, p. 879). Furthermore, the protections that creditors usually enjoy from contractual arrangements with the company and related statute-based entitlements are ineffective when a company becomes insolvent (Macey and Salovaara, 2019, p. 902; Keay, 2001, p. 318; Lin, 1993, p. 1518). Therefore, creditors stand to lose more from directors' risky ventures when a company is

insolvent. Accordingly, the extension of directors' fiduciary duty to creditors could enhance the confidence in companies and reduce director misfeasance. Consequently, other scholars have boldly argued that corporate insolvency shifts the role of the residual owner from shareholders to creditors (Barondes, 1998, p. 63; Rao, Sokolow & White, 1996, p. 64 as cited by Harner, 2016, p. 283 footnote 46). The residual owner bears the ultimate risk and should be the beneficiary of the directors' duty of loyalty when a company is insolvent (Janger, 2018, p. 2). Therefore, once a company becomes insolvent, its directors ought to exercise their fiduciary duties for the benefit of the creditors (Zwieten, 2018, p. 383; Zanardo, 2018, p. 878; Harner, 2016, p. 284).

5. Economic Reasons for the Extension of Directors' Fiduciary Duties to Creditors

It is submitted that the directors' fiduciary duties should be extended to creditors in South Africa because of the economic interests and/or claims of creditors during the bankruptcy of the affected companies (Anderson, 2003, p. 229). It is in the company's best interest to have creditors who are well cared for and happy to do business with because they provide both short- and long-term capital or debt financing (Anderson, 2003, p. 229). Debt financing is arguably the most common form of funding for new business entities in South Africa (Rwigema & Venter, 2004, p. 390). Funding start-ups in South Africa through debt financing is attractive and even preferred over equity since debt financing does not require the entrepreneur to surrender any part of his or her ownership in exchange for investment (Rwigema & Venter, 2004, p. 390). With respect to small companies, Berger and Udell argue that the owner or the manager prefers external debt rather than external equity in order to maintain ownership and control of their companies (Berger & Udell, 1998, p. 634; Zwieten, 2018, p. 389). With respect to closely-held small companies, the blurring of the distinction between ownership and control makes the case for the duty-shifting towards creditors during insolvency in South Africa (Zwieten, 2018, p. 389).

Debt financing also plays a pivotal role in South Africa by funding small and medium-sized enterprises (SMEs). Contemporary empirical research shows that SMEs account for 95% of enterprises across the world, including South Africa (Quartey, Turks, Abhor & Iddrisu, 2017, p. 19). These enterprises contribute 60% of private-sector employment in South Africa (Quartey, Turkson, Abor & Iddrisu,

2017, p. 19). In South Africa, SMEs make up about 27% of the Gross Domestic Products (GDP) (Quartey, Turkson, Abor & Iddrisu, 2017, p. 19). In their research paper which was a result of data collected from 5 667 small businesses, Makina *et al* argue that SMEs are key to employment creation, income generation and are pertinent stimulants of innovation and economic growth (Makina *et al*, 2015, p. 1). It has also been noted that 70% of the SMEs in South Africa fail in their first two years of operation. One of the major reasons cited for such a high level of corporate failure in South Africa is that SMEs lack access to debt financing because the costs are prohibitive. Considering all these advantages of debt financing to the economy, it is submitted that creditors are a significant role player in the South African economy, hence they deserve more protection apart from contractual and legislative provisions which are usually ineffective during instances of financial distress (Macey & Salovaara, 2019, pp. 902; Keay, 2001, p. 318; Lin, 1993, p. 1518). Such protection could be satisfied through the extension of directors' fiduciary duties towards creditors during bankruptcy and insolvency proceedings.

Furthermore, the extension of the company directors' fiduciary duties to creditors could be used as a good reason to lower the high interest rates that may limit access to loans for companies in South Africa (Macey & Salovaara, 2019, p. 901-902). High interest rates usually reflect the lender perception of high-risk non-repayment by the borrower (Rwigema & Venter, 2004, p. 390; Macey & Salovaara, 2019, pp. 901-902). This high risk can be translated to mean a lack of adequate accountability standards on the part of borrowing companies. However, if directors have definite duties towards creditors, they will be restrained from acting recklessly due to the threat of personal liability in instances of default.

6. Comparative Analysis

Section 5(2) of the Companies Act 2008 provides that any South African court may consider foreign law when interpreting or applying its provisions. To that end, we will discuss some notable developments in the law relating to directors' duties to creditors in leading common law jurisdictions such as Australia and the UK. Although court decisions from these jurisdictions are not binding on South Africa, they carry very persuasive value which any South African court could consider when faced with the question of whether directors owe any fiduciary duties to creditors in the context of insolvency. After all, foreign decisions from leading common law jurisdictions have influenced the development of South African law

before. For example, the court in *Mouritzen v Greystone Enterprises (Pty) Ltd & Another* 2012 (5) SA 74 (KZD) relied heavily on the Australian case of *Swansson v Pratt* [2002] NSWSC 583 (3 July 2002) to interpret the relevant legislative provisions of the Companies Act 2008.

The question whether directors owed duties to creditors was shrouded in uncertainty until the decision of the High Court of Australia and the now famous golden judgment of Mason J in *Walker v Wimborne* [1976] 137 CLR 1 (*Walker case*). The case was an appeal by the liquidator of Asiatic Electric Company Pty Ltd (company) against the dismissal by the court a *quo* of a misfeasance summons brought by the liquidator under section 376B of the Corporations Act 2001 (Cth). The orders sought by the appellant were, *inter alia*, that the directors should personally remedy the losses sustained by the company consequent to its making certain payments that were authorised by such directors. The company under liquidation was part of a group of companies which the respondents were also directors (*Walker case*). Funds were moved between the subsidiary companies with the approval of directors to meet business exigencies as they arose (*Walker case*). Circumstances that justified the shift of directors' fiduciary duty from shareholders to creditors included the fact that: the company was owed a large amount of money in relation to a hotel construction project and it was having challenges recovering it due to insolvency but the company continued to make suspicious payments of salaries, wages and pensions out of its dwindling cash reserves (*Walker case* paras 10-30). The liquidator argued that under such circumstances of financial distress coupled with director misfeasance, the interests of creditors were sufficiently vulnerable to trigger the protection of a fiduciary nature. His Honour Mason J stated that:

"…it should be emphasised that the directors of a company in discharging their duty to the company must take account of the interest of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them".

Since Mason J's statement was made with respect to an insolvent company, it makes sense to limit the application of the underlying reasoning to insolvent companies. The decision in the *Walker case* marked the genesis of a protracted debate on directors' duties to creditors. For instance, the decisions in *Winkworth v Edward Baron Development Co* [1986] 1 WLR 1512; *In Re New World Alliance Pty Ltd; Sycotex Pty Ltd v Baseler* [1994] 122 ALR 531 550; *Nicholson case*; *West Mercia Safetywear v Dodd* [1988] 4 BCC 30 (*West Mercia case*) all appear to be in

favour of at least a qualified extension of directors' fiduciary duties to creditors during insolvency.

The above statement of Mason J was considered with approval by the New South Wales Court of Appeal in the *Kinsela case*. In *Kinsela case*, the directors entered into a lease of the company's premises on behalf of the company for a three-year period at a rental which was well below market value and at a time when the company was already facing financial challenges (*Kinsela case*). Shortly after the lease was concluded, the company went into liquidation. The court held that:

"this insolvent company, in a state of imminent and foreseen collapse, entered into a transaction which plainly had the effect, and was intended to have the effect, of placing its assets beyond the immediate reach of its creditors...by means of...the terms of [a]...lease [which] were, to say the least, commercially questionable".

Street CJ's views above shows some judicial sensitivity to creditors' interests in circumstances where a company is insolvent (Zwieten, 2018, pp. 382, who argues that English law recognises that when a company becomes insolvent, directors are required to at least consider creditors' interests). In the same *Kinsela case*, the court criticised the directors' conduct of entering into transactions which had the effect of rendering it difficult for creditors to access the company's assets. The authors submit that the wisdom behind such judicial reasoning is that the proprietary interests in a company's assets shift from the shareholders to the creditors when a company becomes insolvent.

In *Winkworth v Edward Baron Development Co* [1986] 1 WLR 1512, Lord Templeman made it clear that:

"…a company owes a duty to its creditors, present and future. [The] company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts. A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors".

Lord Templeman's argument above further supports the idea that once a company becomes insolvent, its assets must be managed in the best interests of creditors. In other words, the practical meaning and effect of corporate insolvency is that the shareholders' capital has been exhausted and therefore they cannot continue to have their interests prioritised whilst their financial contribution has diminished to

almost nothing (*Winkworth v Edward Baron Development Co* [1986] 1 WLR 1512).

In another high profile case, *Westpac Banking Corporation v The Bell Group Ltd (In liq.)* No 3 [2012] 157 (WASCA) (*Westpac Banking Corporation case*), the Supreme Court of Western Australia affirmed the position that when a company is insolvent, the creditors are regarded as having a direct interest in the company. The facts of the case were as follows. In the year 1990, the Bell Group Proprietary Limited (Bell Group Finance Pty Ltd) and one of its subsidiaries, granted a group of banks some collateral securities in order to secure the repayment of debts amounting to about $260 million (*Westpac Banking Corporation case*). Thereafter, Bell Group Finance Pty Ltd went into liquidation the following year which resulted in its subsidiaries being placed under external administration. However, the creditor banks managed to realise their securities. Four years later, the liquidators of Bell Group Finance Pty Ltd, some companies in the Bell Group Finance Pty Ltd and the trustee for some bondholders commenced proceedings against the banks in a bid to set aside the securities and recover the proceeds of their realisation for the benefit of unsecured creditors. At the time the securities were granted to the banks, the major unsecured creditors were bondholders who had claims worth more than half a billion dollars (*Westpac Banking Corporation case*). The court held that when the company reached the point of insolvency or the imminent manifestation of insolvency, it must not prejudice its creditors' interests (*Westpac Banking Corporation case*).

In *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112 (*BTI 2014 LLC case*), it was alleged that the directors' decision to issue dividends to shareholders was conducted in breach of their fiduciary duties to creditors since it had the effect of placing the company's assets beyond the immediate reach of its creditors. It was contended on behalf of the appellant that the directors' fiduciary duty to consider the interests of the creditors is triggered where there is a real risk of insolvency (*BTI 2014 LLC case* para 107). In determining the validity of the appellant's claim, the court considered previous judicial decisions from the UK and other leading common law jurisdictions such as Australia and New Zealand. A majority of these decisions strengthened the view that at insolvency, shareholders' interests may be supplemented or replaced by those of the creditors (*BTI 2014 LLC case* para 206; the *Nicholson case*; the *Kinsela* case which was recently cited with approval in *GHLM Trading Ltd v Maroo* [2012] EWHC 61 (Ch); *Brady case*; *Horsley v Weight*

Ltd [1982] 3 All ER 1045; *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1990] 3 All ER 404).

In *BTI 2014 LLC case*, the court also considered the UK's historical developments of directors' fiduciary duties towards creditors which culminated in the enactment of the Companies Act 2006 (*BTI 2014 LLC case* paras 202 to 210). The court held that the directors' duty to creditors is triggered even when a company's circumstances fall short of actual or established insolvency but when the directors know or ought to know that the company is or is likely to become insolvent (*BTI 2014 LLC case* paras 209 and 220). Although the court rejected the appellant's argument, it must be applauded for providing clarity regarding the directors' fiduciary duties to creditors. Additionally, the court did not decide on whether the directors' fiduciary duties to creditors includes their financial interests. However, in *obiter*, the court held that where the fiduciary duty to creditors arises, "it is hard to see that creditors' interests could be anything but paramount" (*BTI 2014 LLC case* para 222). This demonstrates that creditors' interests eclipse those of the shareholders during a company's insolvency. In *Colin Gwyer case*, the court held that when a company reaches insolvency, its directors ought to consider the interests of the creditors as supreme when exercising their discretion (*Colin Gwyer case* para 74; also see *North American Catholic Educational Programming Foundation, Inc. v Gheewalla* 930 A.2d 92, 101-02 (Del. 2007), where it was held that during insolvency, a company's creditors replace the shareholders as the residual beneficiaries of any increase in value). Thus, corporate insolvency will make creditors the principal stakeholders to be affected by any fiduciary breaches by directors. Therefore, it is hoped that when confronted with the question of whether company directors owe a fiduciary duty towards creditors under the common law, South African courts will be persuaded to borrow the reasoning in the foreign case law as discussed above.

It is further submitted that the Companies Act 2006 has fortified the proposition that directors ought to owe fiduciary duties to creditors. For instance, the words "success of the company" replaced the words "interests of the company" in the Companies Act 2006 (Ajibo, 2002, p. 44; s 172 of the Companies Act 2006). Section 172(3) of the Companies Act 2006 imposes a qualified duty on directors to consider or act in the best interests of creditors (Attenborough, 2017, pp. 195-196; Keay, 2007, p. 579; s 172(3) of the Companies Act 2006 provides that "the duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of

the company"). However, it must be noted that the Companies Act 2006 does not specify the particular circumstances in which the directors' obligation to consider or act in the creditors' best interests exists. Nonetheless, the Companies Act 2006's Explanatory Notes provides that the duty to promote the success of the company could also include the directors' fiduciary duty to consider the creditors' interests during insolvency proceedings of that company. In fact, it has been argued that section 172(3) of the Companies Act 2006 instructs directors in the UK to prefer creditors' interests against those of the company shareholders (Nettle, 2018, pp. 1419-1420).

7. Concluding Remarks

As discussed in this article, the directors' fiduciary duties to creditors have remained a topical matter in the South African company law. Relevant South African case law were examined to investigate the courts' willingness to hold company directors personally liable for any harm inflicted on third parties including creditors, especially during insolvency proceedings (*Rabinowitz case*; *Sanlam case*). Several cases from leading common law jurisdictions like Australia and the UK were also discussed in an effort to buttress the argument that South African should consider foreign case law that recognises the shifting of directors' fiduciary duties from the company and its shareholders to its creditors during insolvency. Therefore, the authors submit that in contemporary company law, the directors' fiduciary duty to act in the best interests of the company obliges them to consider all stakeholders' interests including those of creditors. It is further submitted that both academics and judges have provided some considerable authority to justify the proposition that directors' fiduciary duties ought to be extended to creditors during corporate insolvency in South Africa (Keay, 2001, p. 322; Lin, 1993, p. 1512; Miller, 1993, p. 1485; Zweiten, 2018, p. 382; *Walker case*; *In Re New World Alliance Pty Ltd; Sycotex Pty Ltd v Baseler* [1994] 122 ALR 531 550; *Nicholson case*; *West Mercia case*).

It is also submitted that all creditors' interests should be statutorily recognised and protected through the extension of directors' fiduciary duties to creditors since they play an important role of debt financing in many companies and SMEs in South Africa. This follows the fact that company creditors in South Africa, especially unsecured ones are vulnerable to shareholder opportunism when a company becomes insolvent. Additionally, the protections that creditors usually enjoy from

contractual arrangements with the company and related statute-based entitlements are ineffective when a company becomes insolvent (Lin, 1993, p. 1518; Macey and Salovaara, 2019, p. 902). It was further noted that courts in Australia and the UK have had a difficult time to determine corporate insolvency. In this regard, the authors recommend that the UK and Australia could adopt the concept of insolvency that is applied in South Africa (s 4 of the Companies Act 2008). Nonetheless, the exact time when insolvency commences in the affected company should be carefully determined in South Africa, the UK and Australia. Directors' fiduciary duties should be extended to the company's creditors when it is liquidated in South Africa (*Kinsela case*; Zwieten, 2018, p. 383).

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