A COMPARATIVE APPRAISAL OF CREDITOR PROTECTION MECHANISMS UNDER SOUTH AFRICAN COMPANY LAW

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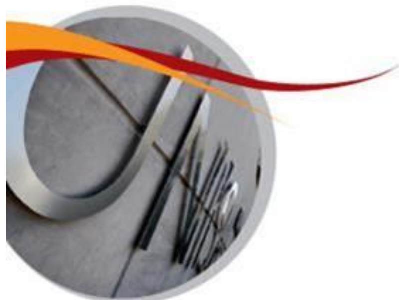
Research submitted in accordance with the requirements for the degree of

DOCTOR OF LAWS (LLD)

In the subject of

Corporate Law

at the College of Law; Department of Mercantile Law; University of South Africa



SUPERVISOR: PROF A. O. NWAFOR

MAY: 2024

ABSTRACT

The study comparatively scrutinised creditor protection mechanisms entrenched in South African Corporate law to determine their effectiveness in advancing creditor interests in company affairs. The enquiry was triggered by the need for corporate laws to adapt to and align with the pace of global economic changes in open and democratic societies. The 2004 DTI Policy document on South African Corporate Law Reform (SACLR) proposed a shift from the traditional shareholder-centric view, which espouses shareholder importance in corporate governance, to a model that retains the supremacy of shareholder interests while simultaneously catering to the interests of other stakeholders (the enlightened shareholder value approach). In light of the DTI policy proposal, the parliament, in enacting the South African Companies Act 71 of 2008 (the Companies Act), reflected on the need to provide appropriate redress to investors' and third parties (creditors`) rights in the preamble to this piece of legislation. It was based on the forgoing expositions that this research work sought to establish whether the South African Corporate law had been adequately modelled to protect creditors and to look beyond the traditional company's goal of profit maximisation for the shareholder at the expense of other stakeholders, such as the creditors, who equally have stakes in the success and continuation of the company. Thus, a comparative doctrinal and critical analysis of creditor protection laws from selected cognate jurisdictions was undertaken to determine the efficacy of the protection mechanisms accorded to creditors under the South African corporate jurisprudence. It is thus the researcher's findings that the South African provisions on mechanisms to protect creditors are set in motion and are, therefore, effective to a greater extent, subject to legislature dealing with some discrepancies as per lessons drawn from comparator jurisdictions and recommendations. Conclusively, the Companies Act should clearly include the creditor's interests in those of the company and thus give a secondary duty to directors to ensure creditor interests, among other non-member stakeholders, are assertively safeguarded.

Keywords

Company, corporate entity, corporate law, company law, corporate veil, creditors, creditor interests, creditor protection mechanisms, credit systems company

controllers, directors, employees, investors, third parties, shareholders, stakeholders, stakeholder constituencies, stakeholder interests.

ACKNOWLEDGEMENTS

In a nutshell, the support I received from various avenues has inevitably culminated in the ultimate success of this research work. Firstly, I give honour to God Almighty for His grace and loving embrace that carried me through to the ultimate completion of my LLD degree. Secondly, I appreciate my supervisor, Professor A. O. Nwafor, whose endless efforts in providing guidance, instruction, encouragement, and support throughout this study cannot be downplayed. Thirdly, I acknowledge the support of my research assistant, Mr Mhuru, who was hands-on in ensuring information/ or research data was in place for its ultimate processing. Finally, words of gratitude are directed to all my people: my wife, children, mother(s), brothers, uncles, cousins, nieces, brethren, pastors, friends, and colleagues who all stood with and by me in different ways to this end. God bless you all!

DEDICATION

I dedicate this work to my offspring, Brandon Power Sibanda, Brenda Rejoice Sibanda & Brendan Gabriel Sibanda; they are my motivation for hard work and will forever give meaning to my life. I also dedicate this work to all legal scholars who have a keen interest in this area of study, specifically those who would take it upon themselves to research further from various angles or facets of this area of study.

TO GOD BE THE GLORY AND HONOUR!

LIST OF ABBREVIATIONS AND ACRONYMS

BBLJ-	Berkeley Business Law Journal
BLIJ-	Business Law International Journal
CBRDCJ –	Corporate Board: Role, Duties & Composition Journal
CGSO-	Consumer Goods and Services Ombud
CLWR -	Common Law World review
COCJ-	Corporate Ownership & Control Journal
CSLJ-	Company and Securities Law Journal
CUP-	Cambridge University Press
DJCL-	Delaware Journal of Corporate Law
DTI –	Department of Trade and Industry
EBOLR-	European Business Organization Law Review
ECFLR-	European Company and Financial Law Review
EMIJ-	Economics Management Innovation Journal
HLR-	Harvard Law Review
ICLQ-	International and Comparative Law Quarterly
JBTL-	Journal of Business and Technology Law
JCCLP-	Journal of Corporate and Commercial Law and Practice
JCLEA-	Journal of Commercial Law in East Asia
JCLS-	Journal of Corporate Law Studies
JCRDL-	Journal of Contemporary Roman-Dutch Law
JEL-	Journal of Economic Literature
King codes -	King Code of Governance Principles
MLR -	The Morden law Reform
NCA-	National Credit Act
NZULR-	New Zealand Universities Law Review
OUP-	Oxford University Press
PELJ -	Potchefstroom Electronic Law Journal
RSA –	Republic of South Africa
SABRL-	Southern African Business Review
SACLR-	South African Corporate law Reform
SAJ-	Sabinet African Journals ()
SER-	Socio-Economic Review
SLR-	Stellenbosch Law Review
UK-	United Kingdom
UNISA-	University of South Africa
USA –	United States of America
WLLR-	Washington and Lee Law Review
YLJ-	Yale Law Journal

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CHAPTER ONE: INTRODUCTION

1.1. Background to the study

The enactment of the South African Companies Act 71 of 2008 (the Companies Act) was a response to the much-needed reform in South African Company law. The reform process was galvanised by the enactment of the South African Constitution, 1996, which triggered the need for transformative constitutionalism in various legal spheres, including Corporate Law.[1] The main objective of the reform was primarily to align South African Company law with the new constitutional dispensation and to adapt to the ever-changing international standards of corporate governance systems that had since then been adopted in the Institute of Directors of South Africa *King Report on Corporate Governance*, 2009 (the King III) and the Institute of Directors of South Africa *King Report on Corporate Governance*, 2016 (the King IV).[2] Before the enactment of the Companies Act, South African company law was guided mainly by the Companies Act 61 of 1973 (the 1973 Companies Act), a piece of legislation replete with archaic common law Corporate law concepts and burdened with the influence of the apartheid regime. In 2004, the Department of Trade and Industry (DTI) issued a policy paper meant to set guidelines for a more detailed technical consultation to draft a new Companies Act (the Companies Act).[3]

Regarding the DTI Policy paper, South African company law was to be reviewed 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] Further, Mpahlwa reveals that "the decision of the DTI to review and modernise company law in South Africa was based on the need to bring South African law in line with international trends and to reflect and accommodate the ever-changing environment for business, both in South Africa and globally."[5] As the South African corporate laws were modelled to the framework and general principles of English law,

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1 Department of Trade & Industry, *DTI Policy Document: South African Company law for the 21st Century Guidelines for Corporate law Reform* (2004) 4.
2 King Codes (iii) 2009 & (iv) 2016.
3 DTI Policy Document: (n1) 4.
4 ibid.
5 ibid.

the very same English law was subject to a critical review,[6] and the need for South Africa`s laws to be reviewed to meet global standards became inevitable.[7]

Consequently, the suggested reforms were adopted in the Companies Act, which would see company law moving from just being an instrument to advancing economic goals to catering to the socio-economic goals of the nation and the citizens. The interests of various stakeholders were to be catered to create a workable framework between corporate entities and their stakeholders.[8] To that end, a fundamental question was posed in the DTI policy paper; "In whose interest should a corporation be run?"[9] That question stemmed from an understanding that one of the directors' common law fiduciary duties was to exercise their powers to benefit the company.[10] In light of the preceding, the Companies Act also includes a provision requiring directors to exercise their powers and perform their functions in the company's best interests.[11] The provision left interpreters of the law with the need to find the meaning of the "interests of a company," given that the Companies Act left a gap. At common law, directors owe their duties to the shareholders as a collective.[12] Common law thus holds the traditional shareholder-centric view.[13] Modern corporate laws promote the need to cater to other stakeholders who invest in the success of a corporate entity in different ways.[14] A corporation cannot be successful with shareholders alone. It is imperative to make certain arrangements to ensure mutual benefit between the corporation and

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6 See the two reports of UK`s Company Law Review Steering Group (2001); also Report from UK`s DTI, a white paper, titled '*Modernising Company Law (*2002) which had proposals and even draft clauses for legislation in the wake of the Company Law Review and also the final report, white paper, titled *Company Law Reform* (2005) which was then followed by the *Company Law Reform Bill* introduced in the House of Lords on 1 November 2005. The whole review process went on for approximately 8 years prior to the enactment of UK`s Companies Act of 2006. See also Bachner T *Creditor protection in private companies: Anglo- German Perspectives for a European Legal Discourse* (CUP, Cambridge 2009)17-18.

7 DTI Policy Document (n1) 4.

8 ibid, 22.

9 ibid, 20.

10 *Re Smith & Fawcett Ltd* [1942] Ch 304, 306.

11 s 76 (3) *(b)* of the Companies Act.

12 In *South African Fabrics Ltd v Millman* 1972 (4) SA 592 (A) the court held that a company's "interests" were only those interests of the company itself as a corporate entity and those of its members.

13 A view that a company should be in terms of company law run in a profitable way for the benefit of its shareholders. See Chokuda BT 'Advancing and Protecting the Interests of Creditors and Employees under the Companies Act' (LLM Dissertation, UCT 2012)17.

14 Preamble to the Companies Act; s 172 of UK`s Companies Act of 2006.

other corporate stakeholders, such as creditors, employees, consumers, and the community, thus reflecting sustainability codes.

The DTI policy paper appreciated that much protection was needed for shareholders who happened to bear the ultimate risk of company failure [15] This, however, stemmed from the principles of the shareholder value approach. The school of thought of the contractarian theory influences the shareholder value approach, which holds that contract laws protect non-stockholder parties like creditors and thus do not need any protection from corporate laws.[16] This research aligns with the firm's communitarian theory, which suggests that creditors, amongst other stakeholders in the company, remain vulnerable and should be protected by mandatory rules.[17] Further, contract law does not assist creditors in certain circumstances. For instance, where the company undergoes liquidation or business rescue proceedings or where directors engage in transactions or conduct that may prejudice the interests of creditors. Creditors cannot curtail such abuse or misuse of power under contractarian theory. Still, creditors can easily challenge them under mandatory corporate legislation specifically crafted to protect the interests of creditors.

According to Nwafor, the law has been developed to ensure 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.[18] Nwafor`s argument is also supported by the DTI policy paper, which proposes that a company should have as its objective the conduct of business activities to enhance the economic success of the corporation, taking into account, as appropriate, the legitimate interests of other stakeholder constituencies.[19] For this cause, the DTI had to ensure that the Companies Act was enacted to replace the 1973 Companies Act and reform various areas of South Africa`s company law to align with international standards. Given that

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15 DTI Policy Document (n1) 35.

16 Those who rely much on contractual protection are supporters of the contractarian theory which suggests that the market and freedom of contract are adequate factors to protect creditors. See Millon D ‘New Directions in Corporate Law: Communitarians, Contractarians and Crisis in Corporate Law’ [1993] 50 WLLR 1378.

17 ibid.

18 Nwafor AO ‘Fraudulent trading and the protection of company creditors: the current trend in company legislation and judicial attitude’ [2013] CLWR 298.

19 DTI Policy Document: (n1) 26.

the proposers of the Companies Act had wanted an extension of the duty of directors to include the protection of the interests of all stakeholders in the corporate enterprise, the Companies Act was enacted having as one of its goals to seek appropriate redress for investors, which, as explained in the DTI policy paper, includes the creditors.[20] It is thus imperative to examine the effectiveness of the mechanisms established by the Companies Act and other legislation as improvements on the common law to protect creditor interests in company affairs. This research aim will be achieved using a comparative study of the mechanisms adopted in selected cognate jurisdictions such as the United Kingdom (the UK), the United States of America (the USA), and Australia that have been specifically chosen for this research.

1.1.1. Reasons for the choice of jurisdictions for a comparative study

The UK, USA, and Australia are used in this thesis for comparative studies. These countries are all advanced "first world economies" with highly developed corporate laws and regulatory frameworks. An analysis of different literature in this study has revealed that the English common law system is more market-friendly in that it provides higher levels of shareholder and creditor protection, and this legal support has led to increased financial development.[21] Various legal systems, including the legal systems of the USA, Australia, and South Africa, have adopted a significant aspect of the English common law concept. This ensures some similarities in Corporate Law applications in the respective countries. In addition to more advanced corporate practices in those other countries, that disposition vantagely positions the corporate jurisprudence in those countries for a comparative study with that of South Africa.

Like South African Corporate law, English corporate law also envisages adopting the enlightened shareholder value approach as a theory for corporate governance, which justifies creditor protection in both jurisdictions.[22] In pursuit of creditor protection, one would learn that English courts developed the concepts of the lien, set-off, trust, and mortgage to provide for multiple and overlapping security interests over a company`s

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[20] Preamble to the Companies Act. According to the DTI policy paper Investors in companies can be described broadly as equity investors, employees and creditors. See DTI Policy Document (n1) 37.

[21] La Porta R, *et al*, 'The Economic Consequences of Legal Origins' [2008] 46 JEL 286.

[22] s 172 of UK`s Companies Act 2006; DTI Police Document (n1) 23.

assets from an early stage of the UK`s industrial development.[23] Notwithstanding these developments, it is recorded that since the 1980s, there have been numerous legislative changes, some triggered by concern over the effects on creditors of director misconduct, others driven by a perception that rules designed primarily for closely-held firms were not working well in the context of the liquidation of big firms.[24] Thus, legislation from the mid-1980s created new rescue-driven procedures. In the early 2000s, creditors' rights and expectations were revised, culminating in the trampling of the right of secured lenders to initiate liquidation, making rescue-orientated administration a preferred procedure.[25]

On the flipside, the USA law inherited from the English common law a flexible approach to the recognition of creditors' security interests.[26] Diverging from the original English model, the American bankruptcy law developed unique doctrines allowing company controllers to actuate a protective reorganisation procedure before the company became insolvent, granting super-priority to new lenders during a moratorium on claims.[27] The USA thus developed a mostly statute-led bankruptcy code that required consideration of the interests of incumbent management, together with those of creditors where insolvency or bankruptcy was envisaged.[28] The USA model inspired various jurisdictional versions of a "rescue culture," with English law eventually being remodelled by legislative interventions, its common-law heritage ultimately superseded.[29] In the continued battle for excellence between the USA and

[23] Dennis V & Fox A, *The New Law of Insolvency: Insolvency Act 1986 to Enterprise Act 2002* (Gardners Books Publishers London 2003) 10.

[24] Ratford W & Smith R, *A Guide to the Insolvency Act 1985* (London Financial Training Publications 1985) 56.

[25] See Dennis & Fox (n23): Rescue-oriented proceedings became more preferable than outright liquidation; only when a rescue had failed that's when liquidation could be considered.

[26] Deakin S, *et al*, 'Varieties of creditor protection: insolvency law reform and credit expansion in developed market economies' [2017] (15) 2 SER 365.

[27] ibid.

[28] The first modern Bankruptcy Act in America, sometimes called "the Nelson Act" was initially entered into force in 1898. The current Bankruptcy Code was enacted in 1978 by s 101 of the Bankruptcy Reform Act of 1978, and generally became effective on October 1, 1979. It is regularly revised to allow for recent legal developments in this regard.

[29] See UK`s Insolvency Act 1986 which repealed the Insolvency Act of 1914 which was based mainly on common laws and the 1986 Regulatory rules that have been repealed by the 2016 Insolvency Rules. Since the Cork Report of 1982, the modern policy of UK Insolvency law has been an attempt to rescue a company that is in difficulty, to minimise losses and fairly distribute the burdens between the community, employees, creditors and other stakeholders that result from enterprise failure. If a company cannot be saved it is "liquidated", so that the assets are sold off to repay creditors according to their priority.

the UK, both of these legal systems gradually revised their capital maintenance rules by allowing certain previously prohibited transactions, subject to an assurance that the company would be able to pay its debts as they become due and payable after such envisaged transaction, thus reflecting on South Africa`s solvency and liquidity test which is imperative for creditor protection and for economic development.[30] Given the preceding, it is clear that the two big economies, the UK and the USA, have had substantial gradual developments in their corporate laws and are preferably benchmarked and juxtaposed against each other, which then makes it appropriate to learn something from both of them for the development of South African corporate laws in so far as creditor protection is concerned.

Australia also possesses a strong scent of well-developed corporate laws globally, becoming another preferred comparator jurisdiction in addition to the UK and the USA.[31] Australian creditor protection laws have developed over time. Its primary legislation for companies, the Corporation Act, has been promulgated and revised several times to achieve a more effective and efficient corporate operations and practices regulation.[32] The prioritisation of creditor protection in Australia dates back to 1976, when the High Court of Australia in *Walker v Wimborne*[33] recognised that, as part of directors' duty to act in the interests of the company, they should consider the interests of creditors when a company is nearing insolvency. Having the interests of creditors considered in certain circumstances, simultaneous with the need to ensure the company's best interests, signals the enlightened shareholder value approach to corporate governance and is identical to the approach recognised in South African Corporate law.

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30 See Vella J & Prentice D, 'Some aspects of capital maintenance law in the UK' in Tison M *et al* (eds), *Perspectives in Company Law and Financial Regulations* (CUP 2010) 295. Capital maintenance rules however still have some hold in English laws and also that their phasing out is not an ultimate one as remnants of them are visible in these jurisdictions. According to Vella & Prentice (n30), "….Section 678 of UK`s 2006 Act thus continues the proscription of financial assistance but only with respect to a public company or the subsidiary of a public company providing such assistance. The two regulatory features for protecting creditor interests in private companies (a solvency declaration of directors and external verification) were both jettisoned in the 2006 Act…" See also restrictions in s 6 of US`s Model Business Corporation Act as revised from time to time.

31 Anderson H *et al* 'Shareholder and creditor protection in Australia: A leximetric analysis' [2012] 30 (6) CSLJ 366.

32 Australian Corporation Act 2001 *(Cth)* as amended from time to time.

33 (1976) 137 CLR 1.

There is also longstanding authority that courts would pierce the corporate veil where the company had been set up as a sham or fraud.[34] The court could pierce the veil where directors trade to deceive third parties such as creditors.[35] This concept was later developed in 2001 into legislation such that a holding company could now be held liable for the insolvent trading of its subsidiary company.[36] Such a provision reflects the concept of piercing the corporate veil, thus seeing beyond the veil of the subsidiary company and holding the holding company liable for its negative influence on its subject. South African laws recently adopted this concept in general terms in the Companies Act,[37] pointing to the need for South African Company law to test itself against its Australian counterpart, which had been long-standing and revised several times to meet international standards.

Moreover, Australian creditor protection laws previously allowed suppliers of goods on credit to retain a technical title and entitlement to the goods that are in the hands of the purchaser (debtor company), such that the purchaser would keep the proceeds of the sale of those specific goods separate from the proceeds of goods supplied by different suppliers to ensure that the particular supplier is paid before any other interest.[38] Although this was good for the creditor, it was unsuitable for the purchaser because the practice was cumbersome and anti-business oriented, thus hindering economic growth. Recent developments in Australian Corporate laws under the Personal Property Securities Act of 2009 *(Cth*) disqualify the seller`s right in certain circumstances to claim title on the goods sold and proceeds thereof, as such title automatically vests in the purchaser. However, the law insists that the seller must register its security interest to protect itself and follow the enforcement process specified in the Act, except to the extent the parties have expressly contracted out of the enforcement provisions.[39] These provisions and practices are uncommon in South African Corporate law and may need to be proposed. In the premises, all the preceding expositions motivate and justify the researcher`s choice of comparator jurisdictions.

34 *Gilford Motor Co Ltd v Horne* [1933] Ch 935; *Jones v Lipman* [1962] 1 WLR 832; *Creasey v Breachwood Motors Ltd* (1992) 10 ACLC 3052.
35 ibid, see *Gilford Motor* case.
36 s 588v of the Australian *Corporations Act 2001* (Cth).
37 s 20(9) of the Companies Act.
38 *Chattis Nominees Pty Ltd v Norman Ross Homeworks Pty Ltd (in liq)* (1992) 28 NSWLR 338.
39 s 19(5) and s 12(2) *(d)* of the Personal Property Securities Act 2009 (*Cth*).

This research is essential for the further development of South African Corporate laws regarding creditor protection.

1.2. Scope of the thesis

The study will explore the creditor protective mechanisms in South African corporate laws to explore the provisions of the statutes that protect creditors in company affairs. Lessons will be drawn from the selected cognate jurisdictions, and an analogy will be drawn from the comparative study. The creditor protective mechanisms shall be identified in corporate laws. In this research, "corporate laws" shall refer to mainly "primary company legislation," such as the Companies Act in South Africa, and also other relevant laws or provisions in any other legislation as far as they relate to the protection of creditors in company affairs.[40] Corporate laws shall also include common law meant to protect creditors in company affairs. They may be developed into company legislation if it is found that they are valuable for creditor protection in the company's operations. This research is limited to scrutiny of the protection afforded to creditors in company affairs and will not consider the protection of creditors in general. This research shall be limited to the protection of creditors only[41] and not to other company stakeholders such as shareholders[42] and employees. However, comparative analogues may be drawn from laws protecting such other stakeholders.

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40 In South Africa, other relevant legislation where some pertinent mechanisms may be extracted from are the National Credit Act 34 of 2005 (the NCA), the Consumer Protection Act 68 of 2008 (the CPA), the Insolvency Act of 1936 and the Labour Relations Act 66 of 1995 (the LRA).

41 "Creditors" in this research shall mean a party (whether legal or natural person) to whom money or something of equivalent value is owed, maybe as a result of having lent money or invested money or any assert in a legal person (debtor company) or as a result of having supplied goods and services on credit to such debtor company. 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 [Nwafor (n18)]. Common classifications of creditors include: (i) Secured creditors: a creditor who has a legal right to take a specific property of the borrower and sell it in case of a default; (ii) 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; (iii) Preferential creditor: a creditor who takes precedence over other creditors in laying claim to a bankrupt borrower's property. See Business Dictionary <http://www.businessdictionary.com/definition/creditor.html#ixzz3ouvrIhLG > accessed 18 October 2020.

42 In terms of s 57(1) of the Companies 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. Shareholders are thus entitled to dividends where a company has made a profit and/ or is in a liquid and solvent state to warranty such declaration of dividends. Although a company exist independently from its shareholders, incorporators or directors, shareholders are technically regarded as owners of companies and thus have control rights through their voting powers which they exercise in meetings concerning the affairs of the company. See

1.3. Research problem

The corporate laws in different jurisdictions are increasingly being transformed from a traditional shareholder value approach to a mode or approach of corporate governance that seeks to strike a balance between the interests of shareholders and those of other stakeholders who contribute to a corporate entity's success and existence.[43] In this research, creditors` interests are the key focus. This is borne out of the realisation that the creditors also have a financial stake in running corporate entities. Creditors provide funds and sometimes goods and services, which galvanise corporate operations. Creditors, however, do not enjoy control rights in corporate entities, unlike the shareholders, who could exert control over management decisions by resolutions passed at general meetings. Creditors thus cannot closely monitor their investments in companies, hence the need for them to be protected by mandatory corporate laws from any possible abuse of their investments by those who control corporate operations.

In addition to the preceding, it has also been argued that contractual arrangements confirming creditors` investments are insufficient to protect creditors as they may be unable to monitor the internal administration of such investments. The power to administer the investments is vested in the directors.[44] Creditors are, therefore, third parties who deal with companies from an outsider`s position and thus require internal protection of their interests. For instance, when a company is insolvent, and directors recklessly decide to keep on trading under insolvent conditions, such a stance may affect the interests of creditors because they may have difficulty recouping their investment from an insolvent company. Corporate laws should set mandatory laws that prohibit trading under insolvent conditions.[45] Where a company is undergoing liquidation processes, shareholders are only entitled to the residue after all creditors

Maasdop v Haddow 1959 (3) SA 861 (C) 866; *Stellenbosch Farmers Winery Ltd v Distillers Corporation SA Ltd* 1962 (1) SA 458 (A), 472; *Dadoo Ltd v Krugersdorp Municipality Council* 1920 AD 530.

43 The all stakeholder approach and the enlightened shareholder value approach stand as threats to the old shareholder value approach. See Spisto MP, 'Legal Aspects of Corporate Governance in the Republic of South Africa: Towards a Possible Model for Improved Stakeholder Relations within the Corporation' (LLD Thesis, University of the Witwatersrand 2011) 87.

44 s 66 of the Companies Act.

45 s 22 of the Companies Act prohibits trading fraudulently, recklessly and under insolvent conditions and thus holds directors personally liable for such illegal trading.

have been duly paid.[46] Despite the preceding, it is possible that shareholders, through their powers, may influence directors and liquidators` decision-making powers to the effect that a company`s financial books are manipulated, resulting in some creditors having little or nothing to recover from the ailing company.[47] In Australia, some liquidation process measures allow the liquidator to approach the court and recover all unjustified pay-outs to preferred creditors, which may occur within six months before liquidation so that such funds are administered for the benefit of all creditors.[48] Such a protective measure is of the essence in the given circumstances. Thus, this research compares it with other selected cognate jurisdictions to fill the gaps in South African creditor protection laws.

Another problem company creditors face is the forums set in place by corporate laws for creditors to enforce creditor protection laws. Courts have always been the means to the desired end. In contrast, the court avenue is limited by vital constraints such as congested rolls resulting in protracted litigation, high cost of litigation, and the unavailability of resources that creditors may rely on to pursue their rights.[49] Also, creditors, being third parties/ or outsiders in companies, may face a challenge where they enter into contracts without knowing inside information in the debtor company, which could have helped them to decide whether or not to enter into such a contract or to choose otherwise in pursuit of their interests. Laws should be set to protect creditors in such circumstances, allow for necessary disclosures, and restrain debtor companies from any defence where such important disclosures were not made.[50]

Having briefly explored the research problems, the researcher believes that corporate laws have a pivotal role in ensuring creditors are protected in company affairs. It is thus imperative to study South African creditor protection laws comparatively to

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46 *Stellenbosch Farmers Winery Ltd v Distillers Corporation SA Ltd* 1962 (1) SA 458 (A), 472.

47 It is in such circumstances where wrong decisions have been taken to the detriment of third parties that concepts like piercing the corporate veil; derivative actions etc. may find place for creditors` relief. These concepts shall be duly discussed in this research; see a brief summary in paragraph 1.6.2.6.

48 Australian Investment commission (ASIC), '*Liquidation: A Guide for Creditors*' <https://asic.gov.au/regulatory-resources/insolvency/insolvency-for-creditors/liquidation-a-guide-for-creditors/ > accessed 20 October 2020

49 s 156 of the Companies Act extended such avenues to the Companies Commission; Companies Tribunal; Alternative Dispute Resolution however the efficiency of such forums in so far as creditor protection is concerned is yet to be tested in comparison with their counterparts in selected cognate jurisdictions.

50 See the *Turquand* rule discussed briefly in 1.6.2.1.

ascertain the extent to which corporate legislation in South Africa exhibits an inclination for creditor protection, with lessons drawn from jurisdictions like the UK, the USA, and Australia.[51] The efficacy of the mechanisms enacted in the mandatory corporate laws in South Africa for creditor protection would be tested by comparison with similar provisions in cognate jurisdictions.

1.4. Purpose and objectives of the study

1.4.1. Purpose

This research aimed to assess the efficacy of the protective mechanisms accorded to creditors by the South African corporate laws, discover areas that required improvements, and suggest the appropriate remedial measures to enhance creditor confidence in corporate operations.

1.4.2. Specific objectives

To achieve the purpose of this research, the following objectives were pursued:

I. The researcher had to determine whether it was justified to protect creditors by mandatory corporate laws beyond the protection afforded to them by contract laws.
II. The researcher had to critically examine the sufficiency and effectiveness of creditor protective mechanisms under South African laws in advancing creditors' interests.
III. The researcher had to compare the efficacy of South Africa`s creditor protective mechanisms with those of comparable legal systems to determine whether South Africa`s mechanisms were congruent with international standards.
IV. The researcher had to assess the overall effectiveness of corporate laws in advancing creditor interests among the interests of other stakeholders in company affairs.
V. The researcher had to identify creditor protection laws' flaws and recommend legal improvements.

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[51] See the Preamble of the Companies Act; "…the need to provide appropriate redress for investors and third parties with regard to companies…."

1.5. Justification of the study/ point of departure

Research on the need to protect the interests of non-equity stakeholders simultaneously with those of shareholders could not have come at a more auspicious time than in the 21st century, which has continued to witness tremendous transformation in the mode of global commercial activities that are primarily actuated at the press of a button. The archaic laws that emphasized the need for directors to protect shareholders` interests, leaving other stakeholders` interests, no longer have a place in the modern commercial era. Creditors are among the stakeholders that play an integral part in the success of corporate entities. The creditors supply the resources needed for a business to thrive as a going concern and hence have a financial stake in a corporation`s operations that is analogous to that of shareholders.[52] In light of the preceding, South Africa`s corporate laws had to be reformed to give meaning to the rights and interests of investors in an era driven by the new democratic dispensation and the pace of change in the global economy.

To that end, the DTI policy proposed the need to give due regard to investors' (creditors) interests in company affairs.[53] The DTI policy fuelled the need to replace the 1973 Act with a new reformed statute, the Companies Act. The preamble to the Companies Act espouses the need to provide appropriate redress to investors and third parties. Among the stated purposes of the Companies Act is the need to continue to provide for the creation and use of companies in a manner that enhances the economic welfare of South Africa as a partner within the global economy.[54] Pursuing this purpose, the Companies Act demands that the South African corporate laws be aligned with the international best practices in creditor protection.[55] Several works have been written by renowned authors on creditor protection from diverse fields of law and commerce; however, this research specifically focuses on South African corporate laws. A comparative, doctrinal approach adopted in this study demonstrates

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52 Wishart D, 'Models and Theories of Directors' Duties to Creditors' [1991] 14 NZULR 348. The school of thought that extremely favours creditor protection in equal setting with shareholders is the Associativism theory. 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. 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 provide the debt capital in times of need and hence they form part of the company`s membership.

53 DTI Policy Document (n1) 26.

54 s 7(e) of the Companies Act.

55 DTI Policy Document (n1) 26.

the work's uniqueness as the aim is to ensure that the creditor protective mechanisms envisaged under the South African corporate laws are aligned with international best practices.

1.6. Theoretical and legal justification for creditor protection

In this section, the researcher briefly explored the literature on the theoretical and legal justification for creditor protection. In so doing, the researcher had to shed more light on this research work and thus ascertain and substantiate its viability.

1.6.1. The theoretical justification for creditor protection

The justification for creditor protection by mandatory corporate laws is determined by whether corporate laws should protect creditors and any other protection they derive from contractual agreements. To find an answer to that question, one would need to explore the main theories of corporate governance and the schools of thought behind them and validate their applicability by weighing them against the scales of the pace of change in the global economy and the needs of open and democratic societies. The following main theories of corporate governance are thus discussed to justify the need for creditor protection:

- The shareholder value approach;
- The enlightened shareholder value approach and
- The pluralist approach.

A predisposition of a model, theory, or approach of corporate governance depends on what a particular jurisdiction adopts as its preferred corporate governance model. Each corporate governance model has a school of thought that influences its adoption.[56] These models thus define relationships between the company and its stakeholders. They determine the extent to which the interests of specific corporate constituencies may be regarded by a company`s directors, as discussed below.

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[56] These theories are: contractarianism, communitarianism, dual-concessionarism and associativism, among others. See Dine J, *The Governance of Corporate Groups* (CUP, Cambridge 2000) 28. See also Wishart (n52) 323.

1.6.1.1. The Shareholder centric (value) approach

The shareholder-centric approach is a corporate governance model that requires directors to act in the best interests of shareholders.[57] This model values the interests of shareholders above those of any other corporate constituency. Traditionally, company laws seek to protect the interests of shareholders, propelling directors to maximise profits for the benefit of shareholders.[58] Corporate laws have been reluctant to extend the protection afforded by directors' fiduciary duties to all the stakeholders in corporate operations.[59] The researcher considers the notion geared at encouraging investment and economic growth through incentivising shareholders' expectations, which will culminate in more companies being established on that strength.

The genesis of this corporate governance theory can be traced back to the USA case of *Dodge v Ford Motor Company.*[60] In that case, it was held that the business corporation is organized and carried on primarily for profit maximisation to benefit its stockholders. Thus, until recently, the main goal of business in the USA was mainly to maximise profits for a higher earning of dividends by the company's stockholders. According to Spisto, corporate governance in the USA involves a unitary board structure with shareholders being the corporation's owners.[61] Shareholders thus retain priority even to the present day in the USA. However, now, as in the UK, there is a move towards accommodating the interests of other stakeholders, but the primary interests remain those of shareholders.[62]

Those in support of this model embrace the contractarian school of thought that focuses on the contractual relationships between stakeholders in a company and thus holds to the principle of the ultimate importance of contract.[63] Contractarianists argue that there is no need to extend directors` duties to cater to the interests of creditors as

57 DTI Policy Document (n1) 24.
58 *Greenhalgh v Ardene Cinemas Ltd* [1951] Ch 286, 291.
59 Spisto (n43) 87.
60 170 N.W. 668 (Mich. 1919).
61 Spisto (n43) 87.
62 Sommer Jr AA, 'Whom should the corporation serve? The Berle-Dodd debate revisited sixty years latter' [1991] 16 DJCL 33. 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. See s 172 of the UK Companies Act 2006.
63 Keay A 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' [2003] MLR 672.

it is conceived that the creditors are protected by the contract between them and the company. A similar argument extends to the employees expected to be covered by labour laws and employment contracts.[64] Critics of this model suggest that directors` duties should be extended to other corporate constituencies, given that shareholders. However, they initiate the formation of a company and are not the only contributors to its success.[65] It is thus argued that the shareholder value approach negatively impacts the beneficial long-term goals of a company that would arise from regard to the interests of all stakeholders *in place* of short-term goals, which may only aim to promote shareholder interests by profit maximisation. A predisposition of the shareholder value approach in South Africa places the interests of creditors at stake as there is no formal recognition of the interests of non-shareholder constituencies. Thus, the approach is not favoured in this research.

1.6.1.2. Enlightened shareholder value approach

The "enlightened shareholder value approach" is an alternative version of the shareholder value approach. This approach to corporate governance 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 the interests of other stakeholders. In contrast, the pluralist approach is an extreme side of recognising the interests of all stakeholders. It seeks to vest directors with a duty to consider the interests of all stakeholders in performing their duties.[66] The enlightened shareholder value approach, however, permits directors to have regard, where appropriate, for the interests of other stakeholders in the company, but with shareholders' interests retaining primacy.[67] The interests of different stakeholders are thus to be appreciated only insofar as they would promote the interests of the company and members as a whole. In terms of the enlightened shareholder value approach,

64 ibid.

65 Nwafor opines that 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. See Nwafor AO 'Shareholders Profit maximisation and Stakeholders Interests in Corporate Governance' [2014] 11 (4) COCJ 670.

66 See Spisto (n43*)* 87- 88; Nwafor (n65) 676.

67 DTI Police Document (n1) 23.

the company's interests include the interests of shareholders and extend to the interests of other stakeholders.[68] The school of thought that inspires the enlightened shareholder value approach is the Dual-Concessionarism theory. That theory considers a company`s separate legal existence. It holds that the company's interests, once incorporated, can no longer be assumed to be those of the original contracting partners as the company now has a separate existence. The corporate enterprise allows shareholders and other stakeholders to consider their interests as a separate entity. However, shareholders still retain the priority of their economic goals above the state`s social goals.[69]

The UK has since shifted to the enlightened shareholder value approach. Its legislators clearly outlined the need to extend directors` duties to cater to the interests of non-stockholder stakeholders to promote long-term goals that guarantee long-term benefits for company members.[70] Also, one of the US states, Massachusetts, has a convincing provision in its general laws that depicts an acceptance of the enlightened shareholder value approach.[71] It is argued in support of this approach that a company cannot maximize shareholder value by systematically exploiting its non-equity stakeholders.[72] It is further argued 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 accrue from goodwill.[73]

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68 DTI Police Document (n1) 23.

69 Dine (n56) 28.

70 In terms of s 172(1) of the UK`s Companies Act of 2006, 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.

71 See the 2006 Massachusetts Code; General laws; Ch 156B s 65 where it is provided that in determining what he or she reasonably believes to be in the best interest of the corporation, a director may consider the interests of the corporation's employees, suppliers, creditors and customers; the economy of the state, region and nation; community and societal considerations; and the long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation.

72 Nwafor (n65) 676.

73 ibid.

Given that South Africa has much of its company laws influenced by English laws, the DTI, before the Companies Act, had made proposals that support a shift to the enlightened shareholder value approach.[74] Although the preamble to the Companies Act suggests an acceptance of the enlightened shareholder value approach,[75] the relevant provisions in the Companies Act that restated the common law fiduciary duties of directors are not compared explicitly to their counterpart provisions in the UK and USA.[76] It is proposed that section 76(3)*(b)* of the Companies Act should be reformulated in the fashion as its UK counterpart, section 172(1) of the 2006 Companies Act, to vent to the broad side of the intention of the legislature in providing that directors should exercise their duties in the "best interests" of the company. It is, however, the view of this researcher that South Africa`s corporate laws have also been aligned with these global changes and somehow adopted the enlightened shareholder value approach given the following justifications;

- The proposal of the DTI policy was evident in this regard.[77]
- King IV guides South Africa`s corporate practices. He is also evident in directors considering socio-economic goals, giving due regard to the surrounding environment for sustainability purposes.[78]
- The Ministerial Regulations to the Companies Act empowers public companies and any other type of company to appoint a Social and Ethics Committee that monitors the company`s activities regarding good corporate citizenship and social responsibility.[79]

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74 ibid. See also DTI Police Document (n1) 26, where the DTI Policy 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."

75 The preamble to the Companies Act provides for the need to avail appropriate legal redress for third parties and investors.

76 See s 172(1) of the UK Companies Act of 2006; s 65 of the Massachusetts Code 2006; General laws; Ch 156B. Compare s 76(3) of the Companies Act.

77 See DTI Police Document (n1) 26.

78 See "King IV", it provides that "…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…"

79 s 72(4) of the Companies Act; reg 43 of the Companies Regulations, 2011.

- The preamble to the Companies Act is explicit on the need to provide appropriate legal redress for third parties and investors. This is followed by several creditor protective mechanisms entrenched in the Companies Act, such as the application of the solvency and liquidity test, the business rescue provisions, the indoor management rule, the principle of piercing the corporate veil, and other enforcement mechanisms.[80]
- The purpose of the Companies Act, as stated in section 7*(a),* is to promote compliance with the Bill of Rights as provided for in the Constitution in the application of company law; section 7*(d)* reaffirms the concept of the company as a means of achieving economic and social benefits; and section 7*(k)* recognises the need to provide efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders.

Given the preceding justifications for adopting the enlightened shareholder value approach in South Africa, it is apparent that South Africa`s corporate laws are crafted to protect creditors/ or investors beyond the protection they receive from contract laws. Thus, a predisposition of the enlightened shareholder value approach in South Africa would entail subjective protection and advancement of creditor interests among other stakeholders. The thesis will explore at length in the succeeding chapters the extent to which South Africa`s corporate laws are armed to protect the interests of creditors as espoused by the enlightened shareholder value theory of corporate governance.

1.6.1.3. Pluralist approach

The pluralist approach to corporate governance is also called all stakeholder approach to corporate governance.[81] This approach calls for a statutory imposition of enforceable obligations on directors to consider the interests of all the stakeholders in their rights in performing their duty.[82] A predisposition to this approach would almost invariably necessitate changing the traditional legal position to define “interests of the company” as being identified with shareholders and other stakeholders.[83] The pluralist

[80] These mechanisms shall be discussed extensively in chapter 2 & 3 of this thesis.
[81] Freeman RE & Mcvea J ‘A Stakeholder Approach to Strategic management’ [2001] SSRNEJ.
[82] Nwafor (n65) 676.
[83] DTI Police Document (n1) 23.

approach asserts that “cooperative and productive relationships will only be optimised where directors are permitted (or required) to balance shareholders’ interests with those of stakeholders in the company.”[84] 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. In contrast, with the enlightened shareholder approach, other interests are subordinated to those of shareholders.

This approach is strongly reflected in Indian corporate laws.[85] The approach draws its basis from the communitarian school of thought, which accommodates a state`s political goals with a possible negative influence and diffusion of a company`s commercial goals.[86] 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 as the companies may seem to be relieving the government of its responsibilities. Thus, the opponents of this theory contend that the government must procure taxes from corporate entities and then use such revenue to perform its duties to improve the living standards of its citizens.[87]

Drawing conclusions from the above discussions, the researcher argues that a moderate application of the pluralist model, which presupposes a blending of the enlightened shareholder value approach with the pluralist approach, would be appropriate. The suggested approach would ensure that the interests of all stakeholders are considered and more priority placed on shareholders, hence retaining the traditional goals of the company but in a considerably more economically

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84 DTI Police Document (n1) 23.

85 See the Indian Companies Act of 2013 as it expands directors` duties to include all stakeholders. Its s 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, and the community and for the protection of the environment. Its s 135(1)(5) 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 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 2006 Act provision in s 172 and South Africa`s reg 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 stakeholder.

86 Dine (n56) 17.

87 ibid.

developed mode. The researcher prefers the enlightened shareholder value approach to the pluralist approach because the former does not lose the essence of the company`s traditional goals. Yet, it allows companies to extend their arms to a considerable recognition of non-equity stakeholders` interests, including creditors` interests, which are the subject of this inquiry.

1.6.2. Legal justification for creditor protection

The preceding discussions sought to justify creditor protection by exploring the main theories of corporate governance. It is considered pertinent at this point to give a compendium of the creditor protective mechanisms entrenched in South Africa`s corporate laws to illuminate the reason for the proposed research interest.

1.6.2.1. The *Turquand* Rule

One of the creditor protective mechanisms entrenched in the Companies Act is the *Turquand* Rule.[88] The *Turquand* Rule states that it is permissible for a third party contracting with the company to presume that the internal procedures about such contract have been complied with.[89] Where such internal procedures have not been followed, and the person contracting on behalf of the company does not have the authority to do so, such a contract is referred to as a limping contract. It is unenforceable and capable of being cancelled by a third party.[90] Goitse and Ross acknowledge that under the new regime, protection has been afforded to both third parties and the company; they noted that the *Turquand* Rule was legislated in a modified version, thus affording better protection to creditors.[91] Creditors can now trade freely, without fear of the unknown, except when dealing with ring-fenced companies with which the doctrine of constructive notice still applies.[92] This creditor protective mechanism will be explored extensively in succeeding chapters.

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88 The genesis of this principle is an English case *Royal British Bank v Turquand* (1856) 6 E & B327, 119 ER 886.

89 s 20(7) of the Companies Act.

90 *Royal British* case (n88).

91 Goitse P and Ross F, ‘A New age for the *Turquand* Rule and the Doctrine of constructive notice’ <http://www.legalcity.net > accessed 30 June 2020.

92 See Van der Linde KE, ‘Aspects of regulation of share capital and distribution to shareholders’ (LLD Thesis, University of South Africa, 2008) 4. 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

1.6.2.2. The sanctioning of directors and prohibition of reckless trading

The sanctioning of directors upon breach of their fiduciary duties is one of the protective mechanisms used by South Africa`s corporate laws to protect the interests of creditors. Section 77(2) of the Companies Act provides as follows:

> 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

Sanctioning directors and imposing certain statutory obligations deters them from conducting themselves in a manner that undermines the rights and interests of other stakeholders, like creditors who do not have control powers in the company.[93] Cassim avers that under the Companies Act, directors' fiduciary duties are mandatory, prescriptive, and unalterable and apply to all companies.[94] The Companies Act strictly prohibits reckless trading and imposes sanctions against fraudulent trading or trading under insolvent circumstances.[95] Directors cannot, therefore, contract outside these duties, and the object of these duties is to raise the standards of corporate and directorial behaviour. Under the enlightened shareholder value approach, directors have a duty to pursue the company's best interests, which includes primarily shareholder interests, together with a subjective consideration of the interests of other stakeholders, such as creditors.[96] Directors thus have instances where they are statutorily bound to consider the interests of different stakeholders. For example, when a company is in financial distress, its directors owe duties to creditors and could be liable for reckless trading. A director shall be held personally liable for losses,

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constructive notice only safeguards the interests of the companies however it has now been dominated by the *Turquand* Rule which protects third parties/ or creditors except for those that deal with ring-fenced companies.

93 The Companies Act imposes both criminal and civil sanctions against directors and/ or any officers who act abruptly to undermine the best interests of a company. See s 214 and s 218 of the Companies Act.

94 Cassim FHI, 'The Duties and Liabilities of Directors' in Cassim FHI *et al* (eds) *Contemporary Company Law* 2ed (Juta & Co, Cape Town, 2012) 583.

95 s 22 of the Companies Act.

96 See para 1.6.1.2.

damages, and costs if he acquiesces in carrying on the company's business despite knowing it is prohibited in section 22.[97] Section 22 of the Companies 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.

Insolvency trading mainly affects creditors who may keep supplying goods or investing in a company without knowing 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. Under section 77(3)*(c)* of the Companies Act, a director will be explicitly held 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 trading in a way that negatively affects a company`s stakeholders results in creditor protection in company affairs.

1.6.2.3. Business rescue

Another exciting development in South Africa`s company laws is the introduction of the concept of business rescue, another envisaged creditor protective mechanism. Section 128(1) *(b)* of the Companies Act defines business rescue 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;
> (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.

Farouk outlines that the underpinning approach of the statutory provisions relating to creditors of a company during the business rescue process is essential that as a result of the *moratorium,* which freezes the rights of creditors, they should, in return, be

[97] s 77(3) *(b)* of the Companies Act.

formally given *quid pro quo*, a right to influence how the affairs of the company are regulated and a right to vote on the business rescue plan.[98] However, it must be noted that the business rescue process is not easy; it is complex and prone to manipulation for the benefit of a particular group of a company`s stakeholders and, thus, to the detriment of creditors in whose favour this concept originated. The goal for business rescue is thus to resuscitate a financially ailing company for the benefit of all stakeholders, and in the event business rescue fails, the ultimate goal will be to statutorily supervise a company in a way that it will at least be able to realise a better outcome to pay-out creditors where liquidation becomes inevitable.[99] A comparative analysis shall thus be carried out to assess the efficacy of this concept in advancing the interests of creditors.

1.6.2.4. The Solvency and liquidity test

Another notable provision in the Companies Act that seeks to protect the interests of creditors is the solvency and liquidity test that seems to have replaced the common law capital maintenance rules. Van de Merwe asserts that the Companies Act dramatically expands the scope of applying the solvency and liquidity test requirement and presents itself as a critical protective device in transactions influencing the rights of creditors.[100] In brief, this concept demands that a company`s assets exceed its liabilities, and it must appear that the company will be able to settle its debts as they become due and payable twelve months after the day of determining its financial status.[101] Thus, the test for solvency and liquidity will be an accounting exercise carried out in terms of the guidelines set in the Companies Act.[102] The “solvency status” relates to the assets of the company being fairly valued, equal to or exceeding the company's liabilities.[103] The “liquidity status” relates to the company being able to pay its debt as it becomes due in the ordinary course of business for twelve months.[104] Corporate laws thus prohibit certain transactions from being concluded unless the

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[98] Cassim FHI, ‘Business Rescue & Creditor Compromises’ (n94) 861.

[99] ibid.

[100] Van der Merwe CP, ‘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’ (LLM Dissertation, Stellenbosch University, 2015) 51.

[101] CIPC, ‘The Solvency and Liquidity test’ <http://www.cipc.co.za/index.php/manage-your-business/manage-your-company/solvency-and-liquidity-test > accessed 20 August 2020.

[102] Tomlinson Mnquni James Attorneys, ‘Solvency and Liquidity’ <http://www.tmj.co.za> accessed 30 June 2020.

[103] ibid.

[104] ibid.

solvency and liquidity requirements are met to protect the creditor's interests.[105] A deeper look into this subject will have to be to counter-check these assertions and, above all, assess the effectiveness of this protective mechanism in protecting creditors.

1.6.2.5 The derivative action

A company is a juristic person capable of suing and being sued in its name.[106] Consequently, when a wrong is done to a company, the action is brought by the company itself and not by its shareholders. On the contrary, a derivative action is an exception to this rule; it is brought by a shareholder, predominantly minority shareholders, and another applicant on behalf of a company to protect its legal interests.[107] This is distinct from the situation where shareholders wish to enforce their shareholder rights, in which case they would have personal redress and would not have to rely on a derivative action.

The need for a minority shareholder and another applicant to bring a derivative action on behalf of the company to redress a wrong done to the company generally arises when the company fails or refuses to institute legal action to redress that wrong.[108] Section 165 of the Companies Act has introduced a new statutory derivative action available to a much broader class of applicants than just minority shareholders.[109] Creditors may also use the derivative action avenue, with the leave of the court, to secure their legal rights, which may be prejudiced if the perpetrators undermine the company's interests.[110] Since it's not directly linked to creditor protection, this mechanism shall not be discussed at length in this thesis.

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105 s 44-46, s 48 and s 113 of the Companies Act.

106 s 19(1) *(b)* of the Companies Act.

107 s 165(2) of the Companies Act. See also *Prudential Assurance Co Ltd v Newman Industries Ltd* (No 2) [1982] 1 All ER 354, 364.

108 s 165(5) *(a)* (i) of the Companies Act.

109 s 165(2) of the Companies Act.

110 s165(2) *(d)* of the Companies Act provides that a person may serve a demand upon a company to commence or continue legal proceedings, or take related steps, to protect the legal interests of the company if the person — …. (d) has been granted leave of the court to do so, which may be granted only if the court is satisfied that it is necessary or expedient to do so to protect a legal right of that other person.

1.6.2.6. Liquidation or winding up

Liquidation of a company is another concept that corporate laws employ to safeguard the interests of creditors among other stakeholders.[111] The 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 the remaining assets to the members or shareholders.[112] The process also involves appointing a liquidator responsible for ensuring that a company winds up effectively to benefit all interested parties.[113] What makes this concept a creditor protection measure is that the liquidator is duty-bound to ensure that the creditors of a company are paid to the extent of available assets and that the residue, if any, be distributed amongst shareholders. The process thus prefers a pay-out to creditors who are outsiders in company affairs, and the equity owners are to bear the consequences of their company`s failure. Corporate laws should also provide measures to safeguard against potential abuse of this concept by those with control powers at the expense of creditors.[114] This concept shall thus be fully discussed compared to its application in other comparable jurisdictions.

1.6.2.7. Creditor compromise

A compromise is an agreement between a company and its creditors or a class of creditors that terminates a dispute over the parties' rights that are to be compromised for their enforcement.[115] A compromise is a direct - step away from the contractarian theory 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. According to Cassim, a compromise is an appropriate way of reaching an

111 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. s 345 of the 1973 Companies Act and s 80, s 81 of the Companies Act read together with the Insolvency Act 24 of 1936.

112 ‘Winding Up’ <https://www.investopedia.com/terms/w/windingup.asp> accessed 30 June 2020).

113 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 Yeats, ‘Winding Up’ (n94) 921 - 2.

114 *Walker v Wimborne* (1976) 137 CLR 1.

115 Cassim (n94) 910.

agreement between a company and its creditors where normal mechanisms are unavailable.[116]

Compromises are dealt with in section 155 of the Companies Act. The compromise process commences with a company (or a liquidator of a company) proposing an arrangement of compromise of the company's financial obligations to all creditors or the members of any class of creditors.[117] Creditors are presented with a proposal in line with the layout outlined in the Companies Act with transparent terms and a straightforward course of action designed to assure creditors that despite the temporary moratorium of their claims, they will eventually be paid their dues. The ultimate goal should thus be to give enough air for the company to breathe so that, eventually, it can meet its obligations as they become due and payable without straining itself. In so doing, creditor interests are thus secured, given that the outcome should be to ensure the company's and its stakeholders' best interests. The researcher believes that any compromise designed to deceive creditors or any person should call for personal liability against the company's directors.[118] An examination of this mechanism shall also be conducted for a detailed version to assess its effectiveness measured against its application in comparable jurisdictions.

1.6.2.8. The piercing of the corporate veil

A company is a legal person that exists separately from its owners or controllers.[119] The rights and obligations ascribed to a company are limited to such a company and cannot be extended to its owners. The assets and liabilities of a company belong to that company and not to its shareholders and directors.[120] At common law, an imaginary veil is assumed to have been placed between the company and the incorporators upon incorporation.[121] The corporate veil, therefore, shields shareholders and directors as they may not be held liable for the company's actions or actions performed by them in good faith on behalf of the company.[122]

116 Cassim (n94) 910.
117 s 155 of the Companies Act.
118 s 22 of the Companies Act.
119 s 19(1) of the Companies Act.
120 s 19(2) of the Companies Act.
121 See *Salomon v Salomon & Co Ltd* [1897] AC 22.
122 The limited liability principle shields directors and shareholders from personal liability where they act in good faith on behalf of the company. In *Airport Cold Storage (Pty) Ltd v Ebrahim*

On the contrary, where there is *mala fide* action, where there is negligence, where there is reckless and fraudulent trading, gross abuse of the legal person, etc., courts are bound to look beyond the corporate veil and hold accountable the real culprits who are behind a company`s acts and thus disregards the protection afforded by the limited liability principle.[123] This then culminates in the piercing or lifting of 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 and directors can be held personally liable for the actions executed by them seemingly on behalf of the company.[124] Common law has now been developed and adopted statutorily by the Companies Act. Section 20(9) of the Companies Act empowers the court to lift the veil of incorporation where it is found that there is an unconscionable abuse of the company's separate legal personality. This concept protects creditors in that it deters directors from abusing creditors' investments while hiding behind the shield of the corporate veil. A detailed critical exploration of this concept shall be undertaken to evaluate its effectiveness in creditor protection in South Africa and its use in other comparable jurisdictions.

1.6.2.9. Enforcement mechanisms available to creditors

The provisions that seek to guarantee protection to creditors in corporate laws would be of minimal significance unless the creditors are given access to appropriate forums to invoke such mechanisms to enforce their rights and interests. Regarding section 156 of the Companies Act, there are now four avenues that creditors or any affected or interested person may use to address complaints on alleged contraventions of the Act or to secure or enforce their rights. These are:

2008 (2) SA 303 (C) para 6, it was held that with limited liability, shareholders are as a general principle not liable for the debts of the company.

123 In *Knoop NO & Others v Birkenstock Properties (Pty) Ltd & Others* (FB) (unreported case no 7095/2008, 4-6-2009) (Nxusani AJ) stated that '…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"..'

124 ibid, where it is made clear that shareholders can be held personally liable under certain circumstances regardless of the limited liability doctrine. This happens mostly when shareholders are involved in fraudulent activity, as found in *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd & Others* 1995 (4) SA 790 (A); or if shareholders are improperly using the separate legal personality, as held in *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168.

- Applying to the High Court for any orders necessary to enforce one`s rights;
- Filing a complaint with the Companies and Intellectual Properties Commission (CIPC) or the takeover regulation panel;
- Applying to the Companies Tribunal for adjudication; or
- Adopt alternative dispute resolution measures.

It should, however, be noted that the High Court remains the primary forum for dispute resolution, interpretation, and enforcement of the Companies Act.[125] Including the other three channels or alternatives for addressing complaints and enforcing rights under the Companies Act helps reduce the burden on the courts and saves costs and time or other relevant resources.[126] Depending on the circumstances of each case, one may not need to approach court but lodge a complaint with the Commission, approach the tribunal, or engage the opponent directly *via* alternative dispute resolution, which may be effective and less costly.[127] These avenues shall also be explored separately and in detail to assess their effectiveness in influencing creditor protection. Their operation shall be measured against the operations of their counterparts in selected cognate jurisdictions. It shall further be investigated if other forums are left out in South African corporate laws yet being used in comparable jurisdictions, which could promote the need for efficiency in enforcing creditor protective mechanisms.

Having explored several creditor protective mechanisms for a legal justification of creditor protection, it was submitted that the researcher had briefly motivated the viability of this research. It should be noted that the researcher could not limit this research to creditor protective mechanisms and enforcement avenues outlined above but had to explore any such mechanisms and enforcement forums discovered in the study of creditor protection laws in selected cognate jurisdictions. Thus, a thorough investigation was anticipated to achieve the purpose of this research work.

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125 Memorandum on the Objects of the Companies Bill, 2008, Companies Bill [B61D-2008] para 3.
126 Cassim, 'Enforcement and Regulatory Agencies' (n94) 826.
127 ibid.

1.7. Description of planned research methods

The research method employed in this research is the doctrinal approach. This approach is also called the "Black-letter law" research methodology.[128] This means this research is based mainly on literature from primary and secondary legal sources, including legislation, case law, textbooks, journal articles, and reports that must be critically examined. To pursue the doctrinal approach method of research, relevant physical libraries had to engage for hard copy study materials. In addition to that, and of recent developments in this 21st century, is the desktop research avenue where information, mainly, had to be extracted from internet sources. The desktop research avenue, however, required that all extracted information be verified for reliability, accuracy, and authenticity, where necessary, to avoid a distortion of information. A comparative approach was also adopted to determine the existing corporate trends in the context of credit protection mechanisms in the United Kingdom, the United States of America, and Australia.[129] In pursuing that aim, the researcher had to studiously and critically analyse the available statutory instruments in the various jurisdictions selected for this research work to enable the researcher to arrive at the most principled creditor protective mechanisms recommended for adoption in South Africa.

1.8. Limitations of the study

Given the doctrinal approach research method chosen in this research work, it is trite that reliance was placed mainly on the primary and secondary sources of legal information such as statutes, case law, textbooks, and journal articles. There was no direct interaction with the companies that have implemented such creditor protective mechanisms or with specific creditors to gain first-hand information on practical

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128 See 'Black letter law' <https://legal-dictionary.thefreedictionary.com/Black+Letter+Law > accessed 09 November 2020.

129 In implementing the doctrinal approach legal research method, the researcher shall use mainly the comparative research study technique which shall however be backed by the descriptive, critical/ or analytical and prescriptive techniques. The descriptive technique will be used in that there will be an overall overview of the historical background of company law *vis-à-vis* protection of creditors, thus looking into the evolution of various protective mechanisms that have been employed in various jurisdictions to protect the creditors. The critical and/ or analytical technique will be used to evaluate and examine the effectiveness of various creditor-protective mechanisms that have been employed in corporate laws of various jurisdictions. Lastly, the prescriptive technique shall be utilised in order to propose recommendations for the development of creditor protection laws or for possible amendments to curb any flaws that may be identified in the SA`s corporate law and that in line with what may be found favourable from other jurisdictions.

experiences. The scope of the research does not extend to physical interactions with personnel that preside on such forums for enforcement mechanisms, such as the Companies and Intellectual Property Commission, the Companies Tribunal, and the courts. Therefore, the researcher relied on recorded and reported decisions and opinions expressed by such judicial and administrative establishments to draw conclusions on the issues arising from the focus of this research work. However, these limitations were not a train smash given that decided cases are practical and realistic, and most of them are reported in detail to ensure precedents are set without ambiguity.

1.9. Structure (overview of chapters)

Chapter 1: Introduction

This chapter introduces the theme of this research work; it outlines the background, problem statement, scope, purpose, and objectives of the study, justification of the study/ point of departure, legal and theoretical justification for creditor protection, planned research methods, and the study's limitations.

Chapter 2: creditor protection in South Africa: Insolvency responsive mechanisms

This chapter explores South Africa`s creditor protection laws and creditor protective mechanisms employed to advance the interests of creditors in company affairs. The mechanisms discussed in this chapter are specifically those responsive to insolvent situations. A background of each mechanism is given; its present and possible future developments is/ are also stated. Comparisons are made between common law and statutorily enacted laws. An objective analysis of each mechanism for adequate creditor protection is thus undertaken.

Chapter 3: Ad rem provisions and mechanisms for South African Creditor Protection Laws

This chapter explores South Africa`s creditor protection laws and creditor protective mechanisms that are not set to address insolvent situations. It further discusses specific provisions not part of company laws but relevant to creditor protection. It also explores enforcement platforms provided by South African laws to enhance creditor access to justice. Thus, each mechanism for adequate creditor protection is analysed objectively.

Chapter 4: The UK Legal Framework for Creditor protection

This chapter explores creditor protection laws in the UK. A critical comparison with South African creditor protection laws is made, much of the emphasis being on measuring the efficacy of South African creditor protective mechanisms against those implemented in the UK to draw useful conclusions for developing South African laws in this regard.

Chapter 5: Creditor protection in the USA

This chapter explores creditor protection laws in the USA. A critical comparison with South African creditor protection laws is undertaken, the objective being to measure the effectiveness of South African creditor protective mechanisms against those implemented in the USA to draw useful conclusions for developing South African laws.

Chapter 6: Creditor protection in Australia

This chapter explores creditor protection laws in Australia. A critical comparison with South African creditor protection laws is executed, aiming to measure the efficacy of South African creditor protective mechanisms against those implemented in Australia to draw useful conclusions for developing South African laws.

Chapter 7: Conclusion and recommendations

This chapter gives a brief overview of the whole thesis. It reconciles all fruitful conclusions drawn from selected legal systems compared to South African corporate laws on creditor protection for recommendations that may influence future directions and possible developments to South Africa`s corporate laws.

1.9. Conclusion

In pursuit of the aims and objectives of this research work, the researcher shall, therefore, outline his findings in succeeding chapters. The immediate succeeding chapter is thus a thorough investigation of RSA`s creditor protection laws, which will be juxtaposed or benchmarked against their counterparts in selected cognate jurisdictions in the later chapters. In the premises, a comparative critical appraisal of the efficacy of creditor protective mechanisms in RSA`s legal system is inevitable.

CHAPTER 2: CREDITOR PROTECTION IN SOUTH AFRICA: INSOLVENCY RESPONSIVE MECHANISMS

2.0 Introduction

A credit system allows consumers to borrow or incur debt and defer repayment over time. Also, having credit enables consumers to buy goods or assets without paying them in cash at the time of purchase. Moreover, having a good credit record means a person has an established history of paying back 100% of their debts within set time bounds. A person with a good credit record can borrow more quickly and with better terms in the future. On the other hand, having a bad credit record means that a person has not been consistent in the past concerning paying back all the money they owe or making payments on time. Lenders are less likely to loan more money to a person with bad credit, making it difficult for that person to procure any assets on credit. Access to credit is a valuable benefit that a person should protect and manage wisely.

It is well-established that creditors are essential to the company's stakeholders. It is crucial to enhance the ongoing concern by supplying other companies or businesses with various goods and services they may need occasionally to ensure their smooth operations. Creditors could be corporate entities, partnerships, sole proprietorships, etc., and they can supply goods and services to any mode or structure of business enterprise. This research focuses on protecting creditors when dealing with debtors who are corporate entities or companies (debtor companies). It is worth noting that creditors are essential for the survival of the business of debtor companies to which they supply goods and services. Creditors may supply goods of any type as required by debtor companies or according to their specialty and services, such as financial services (loans and financial investments), skills or expertise, operations, etc. These creditors are usually disadvantaged because they do not have control over the affairs of the debtor companies with which they contract. They cannot readily ascertain whether their input, through credit supply of goods and services or lending money, will be treated for a good cause, enabling debtor companies to pay their debts as they become due and payable.

These concerns expose creditors to risks, hence the need for some level of protection in their dealings with the debtors. While securities can provide creditor protection, the

protection is not complete or available in all cases. Sometimes, the security may not be realisable, can diminish, and can be intentionally destroyed or disposed of in any malicious way, leaving the creditor at the mercy of the debtor[130]. One of the risks that creditors face in dealing with debtor companies is unjustified expropriation. Expropriation can take a variety of forms. Sometimes, company controllers may withhold what is due to outsiders so that they can pursue their interests.[131] They may also sell the output or the assets of the firm they control, which outsiders have financed, to a different entity they own at below-market prices.[132] In worse situations, some companies may vest controlling powers on possibly unqualified family members, and some may overpay their executives in a way not justified by their production output, reducing the probability of creditors repaying their debts under their contractual terms.[133] In an American case, *Rodgers v Hill,*[134] the Supreme Court ruled that overall executive compensation needs to be reasonable in proportion to the value of services rendered. The court further opined that if a bonus payment has no relation to the value of services rendered, it is benevolent, and major shareholders have no power to donate corporate property against the disgruntlement of minority shareholders. The preceding examples reflect the expropriation risk that outsiders such as creditors face. The risk of expropriation impacts one of the essential avenues for business growth and development, the credit system. Suppose extensive expropriation undermines the functioning of the credit system. How can it be controlled to reckon the import of the credit system and thus protect creditors in company affairs?

Expropriation is a form of abuse of a company`s legal person.[135] A company is supposed to be run in its best interests and not for the advancement of individual

130 Hertig G *et al*, *The anatomy of Corporate Law: A comparative functional approach* (OUP, 2004) 80.

131 It is not only creditors who are affected by the expropriation risk but also minority shareholders may fall victims of the acts of major controlling shareholders who divert profits for own benefit and thus reduce dividend pay-out ratios.

132 Such a stance is prejudicial to creditors who may struggle to recover their debts when their security (in form of sales output and assets financed by them or pre-owned by them) for debt repayment vanishes into thin air. See forms of security in Naumann <https://uk.practicallaw.thomsonreuters.com/2-3846156?transitionType=Default&contextData=(sc.Default)&firstPage=true > accessed 07 July 2021.

133 This also supresses minority shareholders who may have little to say against this. See Scholtz HE & Smit A, 'Executive remuneration and company performance for South African companies listed on the Alternative Exchange' [2012] 16 (1) SABRL 28.

134 *Rogers v. Hill* (1933) No. 732.

135 Legal personality is ascribed once the incorporation of a company has been registered. See s 19(1)(b) of the Companies Act which 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,

motives of those in control.[136] "The best interests of a company," in this twenty-first-century realm, cannot exclude a reasonable consideration of the affairs of all critical stakeholders who participate in the company's overall success.[137] How can creditors be protected if expropriation impacts creditor rights amongst other stakeholders? When creditors contract with companies, they primarily rely on terms and conditions stipulated in such contractual agreements. The question is whether such contractual provisions can protect creditors from risks such as expropriation and abusing the company`s legal person at the expense of other stakeholders. One of the findings is that contract laws are insufficient to protect creditors' interests.[138] Mandatory corporate laws or principles, herein termed "creditor protection mechanisms," are needed to afford better protection to the interests of creditors who are outsiders in company affairs.

The Companies Act, the South African primary legislation on corporate laws, focuses on providing appropriate legal redress to investors and third parties (creditors).[139] In so doing, it adopted several creditor-protection mechanisms from its predecessor[140] and new mechanisms from common law and other jurisdictions with well-developed corporate law jurisprudence. The effectiveness of such creditor protection mechanisms shall be holistically examined to determine the extent to which South African Corporate laws advance the protection of creditors in company affairs. Also, this chapter shall examine creditor-protection mechanisms germane to insolvent circumstances and entrenched in the Companies Act. The following mechanisms are thus explored in this chapter:

- "Solvency and liquidity test"
- "Liquidation"
- "Compromise"

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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.

136 See s 76(3) (b) of the 2008 Act.

137 Sibanda M, 'A Critical Appraisal of Creditor Protective Mechanisms the Companies Act of 2008' (LLM thesis, Univen 2019) 35.

138 ibid 40.

139 See preamble of the Companies Act.

140 The Companies Act of 1973.

- "The Business Rescue Concept"

2.1. Solvency and liquidity test concept

2.1.1 Scope and meaning of this concept

One of the mechanisms adopted by the Companies Act to protect the interests of creditors is the solvency and liquidity test *in place* of the capital maintenance rules.[141] 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 twelve months from the day of determination of its financial status. Thus, the test will be an accounting exercise based on the guidelines set in the Companies Act.[142]

The "solvency status" relates to the assets of the company being fairly valued, equal to or exceeding the company's liabilities.[143] The solvency concept measures the amount of debt and other expense obligations used in the firm business relative to the amount of owner equity invested.[144] Solvency ratios indicate the business's ability to repay all financial obligations if all assets were sold and continue operations as a viable firm after a financial adversity. Solvency is a necessary condition for a business to operate. If a company cannot meet its obligation, it is considered insolvent and must either be liquidated or restructured through business rescue procedures as provided in the Companies Act.[145] The formula used to measure an enterprise's ability to meet its debt and other obligations is applying the Solvency Ratio method (calculated by dividing a company's after-tax net income – and adding back depreciation– by the sum of its liabilities (short-term and long-term).[146] The solvent ratio indicates whether a company's cash flow is sufficient to meet its short-term and long-term liabilities. Thus,

141 Capital maintenance rules shall be discussed below in paragraph 2.1.2.

142 TMJ Attorneys, 'Solvency & Liquidity test' <http://www.tmj.co.za > accessed 15 October 2015.

143 CIPC, 'Solvency & Liquidity test' <http://www.cipc.co.za/index.php/manage-your-business/manage-your-company/solvency-and-liquidity-test > accessed 26 August 2016.

144 Mueller, 'Liquidity' <https://www.investopedia.com/articles/basics/07/liquidity.asp > accessed 22 Nov 2021.

145 BDO SA, 'Solvency & Liquidity test' <https://www.bdo.co.za/en-za/insights/2017/audit/measuring-solvency-and-liquidity-to-assess-business-strength > accessed 22 November 2021.

146 ibid.

the lower its solvency ratio, the greater the probability it will default on its debt obligations.[147] The solvency ratio is a comprehensive measure of solvency, as it measures cash flow – rather than net income – by including depreciation to assess a company's capacity to stay afloat. It measures this cash flow capacity concerning all liabilities rather than only debt.[148]

On the other hand, a company's "Liquidity status" relates to its ability to pay its debt as it becomes due and payable in the ordinary course of business for 12 months.[149] In other words, liquidity focuses on hard cash or liquid cash or cash that is readily ascertained and available to settle the company`s debts. Thus, liquidity for companies typically refers to a company's ability to use its current assets to meet its current or short-term liabilities.[150] A company`s liquidity is also measured by the amount of cash it generates above and beyond its liabilities to cater to other necessities of business than the usual liabilities.[151] A company`s liquidity status is measured by either applying the current ratio or working capital ratio (calculated by dividing current assets with current liabilities) and applying the "quick ratio," sometimes called the "acid-test ratio" (it is identical to the current ratio) except that the ratio excludes inventory since it is believed that inventory is not easily converted into cash.[152] The last method used to calculate the liquidity status of a company is the "operating cash flow ratio" (calculated by dividing the operating cash flow by the current liabilities), which measures how well current liabilities are covered by the cash flow generated from a company's operations.[153] Thus, the operating cash flow ratio is a measure of short-term liquidity by calculating the number of times a company can pay up its current debts with cash generated in the same period; in other words, a higher number is better since it means a company can cover its current liabilities more times.[154]

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147 ibid.

148 ibid.

149 CIPC (n143).

150 Mueller (n144).

151 ibid. A company that makes more cash than its liabilities is in a better position to give better financial returns to its shareholders and to re-invest some for-business growth and expansion which in turn puts all stakeholders at safety trading with the company.

152 Mueller (n144).

153 ibid.

154 Ibid.

The difference then between the solvency status and the liquidity status is that while the former focuses on the totality of the company`s assets, whether fixed or current, measured against the company`s total liabilities, the latter focuses on how much realisable cash assets the company have to facilitate timed and consistent disposal of a company`s debts. Thus, a solvent company owns more than it owes; in other words, it has a positive net worth and a manageable debt load. On the other hand, a company with adequate liquidity may have enough cash available to pay its bills. Thus, Solvency and liquidity are equally important, and healthy companies are solvent and possess adequate liquidity.

Having distinctively described the concept of solvency and liquidity, it is imperative to note that companies would use the computing mentioned above methods to measure both these concepts and a company`s financial status. The result from the above-described computing methods is “the solvency and liquidity test.” It is thus worth noting that the solvency and liquidity test concept has now been legislated much broader in the Companies Act compared to its previous existence in the Companies Amendment Act of 1999. That concept in the present dispensation is an essential tool in creditor protection and ensuring companies maintain their financial status healthily to secure all stakeholders' interests in the short and long term. *Van de Merwe* opines that the Companies Act dramatically expands the scope of applying the liquidity and solvency test requirement. It is a critical protective device in transactions influencing creditors' rights.[155] Thus, a deeper look into this subject will be undertaken to assess the effectiveness of this protective mechanism in terms of the protection of creditors.

2.1.2. Historical background to the Solvency and Liquidity test concept

In South Africa, the solvency and liquidity test concept was introduced as an amendment to the 1973 Companies Act by the Companies Amendment Act of 1999. Its introduction heralded the more extensive reform wrought by the Companies Act and the juxtaposition between the statutory rule and the common law doctrine of capital maintenance that prevailed before the 1999 Amendment Act. The capital maintenance rule originates in English law, dating back to a century ago in *Trevor v*

155 Van de Merwe (n100) 51.

Whitworth.[156] The underlying object of this rule was to grant creditors protection in that they looked to the company's equity to pay their debts. The capital was viewed as fixed and readily ascertained, and its purpose was to stand as the absolute hope for the company's creditors. It is a "permanent fund" and a "form of security" or a "guarantee" for repayment of their debts.[157] Thus, Lord Halsbury L.C, in *The Ooregum Gold Mining Company of India Ltd v Roper,*[158] declared that "the capital is fixed and certain, and every creditor of the company is entitled to look to that capital as his security."

That principle was reiterated by the South African court about a decade later in *Cohen NO v Segal,*[159] where the court, while prohibiting the payment of dividends out of the company's capital, stated that;

> "[w]whatever 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."

Regarding the "limited liability" principle, creditors have no recourse to shareholders when a company cannot pay their debts, forcing them to rely on a company`s assets. Funds raised through the issuing of shares are thus assets of the company, which shareholders cannot claim back at the expense of creditors. Expecting creditors to rely on an asset that diminishes as business operations demand cash is anomalous. The court in *Cohen's case* noted that capital may be spent and lost in business.[160] This leaves the researcher questioning the rationale behind expecting creditors to have a guarantee based on something possibly unrealistic or a mirage projecting what may not be there. The fact that figures of the equity structure remain untainted or unchanged does not entail that the funds shareholders contributed are still there. The main reason for issuing shares is to raise capital, which will be used to run specific business operations. Thus, it is unlikely that any funds will remain when shares have been issued, as such money aims to achieve it. In this case, creditors are left to hope for the unknown. This was also depicted in *Trevor's case,* where creditors were

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156 [1887] 12 App CAS 409 (HL).

157 Cassim FHI & Cassim R, 'The Capital Maintenance Concept and Share Repurchases in South African Law' [2004] 15(6) ICCLR 188-191.

158 [1892] A.C. 125 at 133.

159 1970 (3) S.A. 702 (W) at 705H.

160 ibid.

expected to rely on the assumption that capital funds would not be paid out except in the ordinary legitimate course of business.[161] What remains is, whether the legitimate or illegitimate course of business, the funds raised from the capital are always meant to be used up, especially when there are losses. 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.[162]
- It was unlawful for a company to acquire shares or shares of its holding company.[163]
- It was unlawful for par value shares to be issued at a discount except under stringent conditions.[164]
- It was unlawful for a company to provide financial assistance to acquire its shares or shares in its holding company.[165]

It was thus difficult for a company under the 1973 Companies Act to engage in certain transactions that would diminish its capital base. The company`s capital was deemed as the company's strength, hence a protected territory where restraints were placed to deter any unlawful encroachment. The capital maintenance rule was initially partially

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161 *Trevor`s case* (n156) 423-4; 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".

162 Jooste, 'Corporate Finance' (n94) 264.

163 ibid.

164 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.

165 In terms of s 38 of the 1973 Companies Act no company was allowed to 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.

removed from South African company law from the 1973 Companies Act by the Amendment Act 1999. This amendment was juxtaposed between the middle 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. Hence, the amendment did not abolish the capital maintenance rule altogether.

In favour of the American solvency and liquidity rule, the amendment permitted the company to pay its shareholders from its capital under certain conditions.[166] The conditions include that the distributions were done only if the articles of association provided for such. Further, there had to be a reasonable belief that after such payment, the company could pay its debts as they become due in the ordinary course of business and that its consolidated assets, fairly valued, exceed the consolidated liabilities of the company.[167] Also, companies could now be allowed to re-purchase their shares and those of their holding companies as long as their articles of association permitted it and the solvency and liquidity test was met.[168] 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 the interests of the company and other stakeholders. Most transactions that are meant to affect the company`s financial position undergo this test to ensure that the financial interests of creditors are safeguarded. However, the application of this concept was limited in the 1999 Amendment Act as it also required that a company`s articles of association had to approve of such a transaction despite the solvency and liquidity test being met. This is no longer the position under the Companies 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 below.

2.1.3. The Companies Act and the solvency and liquidity test concept

The American`s liquidity and solvency test was effectively assimilated into the South African corporate laws in 2011 when the Companies Act became operational. The test in the Companies Act became dominant as it trumped the common law capital

166 Shabangu MA, 'A critical analysis of capital rules in the Companies Act' (LLM Dissertation, UP, 2010) 10.

167 That is the solvency and liquidity test- s 90 of the 1973 Act as amended by the Amendment Act 1999.

168 s 85 of the 1973 Act as amended by the 1999 Amendment Act.

maintenance doctrine and the limitations 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 may be needed. It is left to the board of directors to ensure that the company meets the solvency and liquidity test.[169] Applying the solvency and liquidity test under the Companies Act does not require that the company objectively be solvent and liquid in all circumstances. The determination of solvency and liquidity of a company are now government by the Companies Act, which provides in section 4 as follows:

> (1) For any purpose of this Act, a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time:
> (a) The assets of the company, as fairly valued, equal or exceed the liabilities of the company, as fairly valued; and
> (b) it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of —
> (i) 12 months after the date on which the test is considered; or
> (ii) in the case of a distribution contemplated in paragraph
> (a) of the definition of "distribution" in section 1, 12 months following that distribution.
> (2) For the purposes contemplated in subsection (1)—
> (a) any financial information to be considered concerning the company must be based on—
> (i) Accounting records that satisfy the requirements of section 28; and
> (ii) Financial statements that satisfy the requirements of section 29;
> (b) Subject to paragraph (c), the board or any other person applying the solvency and liquidity test to a company —
> (i) must consider a fair valuation of the company's assets and liabilities, including any reasonably foreseeable contingent assets and liabilities, irrespective of whether or not arising as a result of the proposed distribution, or otherwise; and
> (ii) may consider any other valuation of the company's assets and liabilities that is reasonable in the circumstances; and
> (c) unless the Memorandum of Incorporation of the company provides otherwise, when applying the test in respect of a distribution contemplated in paragraph (a) of the definition of "distribution" in section 1, a person is not to include as a liability any amount that would be required, if the company were to be liquidated at the time of the distribution, to satisfy the preferential rights upon liquidation of shareholders whose preferential rights upon liquidation are superior to the preferential rights upon liquidation of those receiving the distribution.

The test is premised on ensuring that any transaction that a company engages in will not, in a set period, affect the company`s ability to pay its creditors as the debts become due and payable. As much as companies must freely trade without restrictions, such trade deals must be embarked on to safeguard all stakeholders, and primarily, in this case, creditors. However, the test relies on the person who consented to the duty to keep the company`s accounting records in the manner contemplated in

169 Jooste, 'Corporate Finance' (n94) 265.

section 28 of the Companies Act.[170] It further places reliance on accounting officers vested with the mandate of preparing a company's financial statements.[171] All these personnel are controlled by directors, who are ultimately responsible for all the company's actions. It is thus the researcher`s view that in as much as the solvency and liquidity test is an essential tool in creditor protection, it has flaws in that a company may engage in a prohibited transaction and to the prejudice of the creditors based on an inaccurate or deliberately falsified accounting records and financial statements.[172] This submission stands parallel to the decision of the court in *Cumming v Nuvest Chemicals (Pty) Limited,*[173] which suggests that the solvency and liquidity test is based on the principle that as long as the test is satisfied, creditors will not be prejudiced if the "capital" of the company is used other than for the ordinary business purposes of the company.

The test requires two types of solvency: factual and commercial solvency. Factual solvency (it must appear, based on all reasonably foreseeable financial circumstances, that assets are more than liabilities) is purely a balance sheet test. In contrast, for liquidity (commercial solvent aspect), it must appear that the company can pay its debts as they fall due in the ordinary course of business for 12 months after the test was applied.[174]

An application of the solvency and liquidity test by the relevant directors differs in different sections of the Companies Act. For instance, if a company wants to provide financial assistance in connection with the acquisition of its shares, the Companies Act does not require that the company be solvent and liquid but rather that the board of the company apply the test be "satisfied" that the company would satisfy the solvency and liquidity test.[175] When pursuing a distribution, it must reasonably appear that the company will satisfy the solvency and liquidity test and that the board of the

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170 s 28 of the Companies Act requires a company to keep accurate and complete accounting records and to ensure that such records are not falsified with intention to defraud any person (creditors or third parties in this case).

171 s 29 of the Companies Act requires that the company prepares its financial statements according to approved accounting standards and also in a fair manner reflecting the true position of a company`s finances, assets and liabilities etc.

172 This is however deterred somehow in the Companies Act through both criminal and civil avenues although not easy to prove where calculated moves are taken by those in control powers of the company.

173 [2017] ZAGPJHC 180 (19 May 2017.

174 ibid.

175 s 44(3) (b) of the Companies Act.

company must acknowledge, by resolution, that it has "applied" the solvency and liquidity test and "reasonably concluded" that the company will satisfy the test.[176]

In *Firstrand Bank Ltd v Wayrail Investments (Pty) Ltd,*[177] Vahed J held that the provision contained in section 4 concerning the solvency and liquidity test has nothing to do with defining solvency or insolvency for purposes of winding up proceedings. He asserts that[178];

> As best as I can make out, the sections of the Companies 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.

The paragraphs referred to by the judge cover the various sections or provisions in the Companies Act where the solvency and liquidity test is supposed to be applied. In terms of the Companies Act, the solvency and liquidity test has to be applied in the following circumstances:

- Distributions (as defined in section 1 of the Companies Act) to shareholders;[179]
- The provision of financial assistance to third parties for the acquisition of the company's shares;[180]
- Loans or other financial assistance to related parties, including subsidiary companies, holding companies, and directors; [181]
- Acquisition by a company of its shares[182]
- An amalgamation or merger with another company;[183] and
- Transfer of registration of a foreign company.[184]

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176 s 46(1) (b) & (c) of the Companies Act.
177 [2012] ZAKZDHC 91; [2013] 2.
178 ibid para 34.
179 s 46 & s 48 of the Companies Act.
180 s 44 of the Companies Act.
181 s 45 of the Companies Act.
182 s 48(2) of the Companies Act.
183 s 113 of the Companies Act.
184 s 13 of the Companies Act.

Each of these transactions shall be discussed in detail to elucidate how the tests' applications on these aspects necessitate the protection of creditors. The test is only applicable to directors of the relevant company.[185] Thus, the directors must consider "all reasonably foreseeable financial circumstances of the company at that time." This envisages a predictive element requiring the directors to consider matters that may not be reflected in the company's accounting records and financial statements but are instead based on elements such as how the economy or political circumstances may impact the company's financial state in the future.[186]

Directives are given to company directors such that any "financial information" concerning the relevant company to be considered by the directors must be based on the accounting records and financial statements that satisfy the requirements of the Companies 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 reasonable in the circumstances.[187] However, the requirements for fulfilling the test differ from one transaction to another, as discussed in the succeeding paragraph. It must, however, be noted that despite the Companies Act's expansive scope of the solvency and liquidity regime, it unfortunately does not provide concrete principles to assist directors 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 Companies Act.[188] However, deterrence measures are necessary against directors who fail to vote against a transaction that does not pass the solvency and liquidity test,[189] as will be discussed later.

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185 Pretorius K *et al,* **'**The solvency and liquidity test: Where did we come from? Where do we go from here?' <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 10 October 2016.

186 King (iv).

187 Grove C, 'How will South Africa's new liquidity and insolvency test affect your company?' (2012) <http://www.gaaaccounting.com/how-will-south-africas-new-liquidity-and- solvency-test-affect-your-company/ > accessed 20 October 2016.

188 ibid.

189 s 77 read with s 162(7) of the Companies Act.

2.1.3.1. Distributions

Distributions are governed by sections 46 and 48 of the Companies Act.[190] Distributions are among those transactions where the solvency and liquidity test shall apply under the Companies Act. Distributions are defined in section 1 of the Companies 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 or 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 s 47;
> (iii) is consideration for the acquisition-
> *(aa)* by the company of any of its shares, as contemplated in s48; 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 or 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 the transactions that qualify as distributions except those exempted by section 48(1) of the Companies Act[191] cannot be performed unless a liquidity and solvency test is satisfied, among other prerequisite requirements. Regarding distributions, section 46 requires the board of directors to ensure that the test has been performed and that a resolution acknowledges that a company will satisfy the test immediately after the completion of the proposed distribution has been reasonably concluded.[192] These requirements are supposed to be met unless the distribution is according to a board resolution, an existing obligation, or a court order.[193] Only directors must

[190] s 46 of the Companies Act provides; (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 provides that a company may not acquire its shares or that of a holding company unless it meets the requirements of s 46 i.e. the solvency and liquidity test among other conditions.

[191] s 48(1) of the Companies Act, exempted transactions

[192] s 46 of the Companies Act.

[193] Jooste, 'Corporate Finance' (n94) 269.

authorize a distribution; shareholders should not participate in such an exercise.[194] This protects creditors and minority shareholders from significant shareholders' abuse of their interests. It is essential that when it comes to distributions, the solvency and liquidity test is to be applied more objectively. For instance, section 46 provides that for distributions to be authorized, the board of directors must be satisfied with 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
- the board of the company 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.[195]

In brief, the directors' duties concerning this test on distributions come in two parts; one entails the actual test has been carried out, and secondly, 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, after that, prejudice the interests of creditors and the company itself. Also, section 4 of the Companies 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.[196] Comparably, section 6.40(d) of the American statute 1984 gives the same guidelines as in section 4 of the Companies Act on what directors must rely on when applying the solvency and liquidity test.[197] Leaving directors with a choice of which course of action

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194 ibid, 246.

195 s 46 of the Companies Act.

196 Van Der Linde K, 'The Insolvency and Liquidity approach in the Companies Act 2008' [2009] JSAL 231. The author argues 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.

197 s 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.

to pursue places the interests of creditors at risk in instances where directors will apply their accounting standards, which they deem reasonable (although unreasonable), to achieve their desired goal. However, this may only favour their intended transaction and not creditors. There is thus a gap in both the American laws and the Companies Act in this regard; at least more clear guidelines could have been laid out to determine a straightforward course of action when applying this test than merely placing directors in a position where they enjoy the leverage to decide what would in their views entail a reasonable apprehension of the application of the test.

Furthermore, to ensure that the company still abides by the required test, if it does not complete a distribution within 120 days after it has objectively carried out the test, the board must reconsider the solvency and liquidity test before proceeding with the proposed distribution.[198] Scholars, however, criticize the 120 days as literally; as long as it is within the 120 days, a proposed distribution should be performed even though the position might have changed from the day the test was made.[199] It is suggested that the pros and cons of the treatment of distributions within the 120-day required period be revisited to consider business dynamics in applying the solvency and liquidity test. 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 changes before a distribution is effected. It is proposed that once a test for solvency and liquidity has been met, the envisaged distribution should be completed expeditiously. Requiring a distribution to be effected within 120 days compromises the standard set in section 46 of the Companies 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 to cause a distribution be imposed once the solvency and liquidity test has been carried out to avert a situation where much delay will invite changes that affect the determined financial position.

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198 s 46(3) (a) of the Companies Act.

199 Van Der Linde (n196) '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.'

Despite the above discrepancies concerning the solvency and liquidity test application, the test has significantly changed South African corporate law. It remains in the hands of legislators to take note of comments and recommendations to develop South African corporate laws for the best interest of companies and all stakeholders. The researcher cannot overemphasize the significance of the solvency and liquidity test; however, it is essential to examine how it strengthens the position of stakeholders when applied to specific types of distributions, taking into cognisance that distributions are defined in section one of the Companies Act to include the transfer of consideration for acquisition by a company of own shares or shares in any company in its group. While section 48 of the Companies Act deals with acquisitions by a company of its shares and shares in its holding company, section 46 deals generally with distributions, among other issues that include acquisitions by a company of own shares or shares in its holding company (both section 46 and 48).

a) ***Dividends***: As has been said earlier, before the statutory interventions, directors were not allowed at common law to declare dividends out of the company`s capital as enjoined by the capital maintenance doctrine. This was meant to abide by the distinct legal personality principle, which suggests that a company's capital is its asset, and the shareholders' entitlement relates only to the profits that emanate from their investments. In *Verner v General and Commercial Investment Trust,*[200] 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.[201] The real reason for this judicial attitude

200 [1894] 2 Ch 239, 264 (CA).

201 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.'

is to protect the interests of creditors, as capital is what the creditors could look up to for repayment of debts owed to them by the company. Protecting the interests of creditors should be balanced with safeguarding the company's interests and other vital stakeholders, such as shareholders, who are the engine behind economic growth and corporate development. When one starts a business, expect justifiable benefits at some stage. Hence, the solvency and liquidity test seeks to balance the interests of the shareholders and the creditors. Under the solvency and liquidity test, shareholders can receive some dividends out of capital if the test is passed. A company could trade at a profit over a period without declaring dividends if the directors, whose duty is to declare dividends, decide to reinvest the profit for business expansion purposes. The shareholders' anxiety in such a situation could be assuaged by setting down some funds for distribution once the directors have applied their minds to the law's requirement on the company's solvency and liquidity.

b) ***Share repurchases***: As has been said earlier, share repurchases as a form of distribution,[202] whether directly by the company buying from its shareholders or indirectly by the subsidiary company buying from its holding company, was prohibited in the 1973 Companies Act. The United States of America lifted that prohibition so long as *Firstrand Bank Ltd v Wayrail Investments (Pty) Ltd* satisfies the solvency and liquidity test. Other jurisdictions such as Canada,[203] the United Kingdom,[204] Australia,[205] New Zealand,[206] and, of late, South Africa[207] have followed suit. The following compelling reasons were advanced by the Law Commission to motivate the need to amend company laws to allow companies to acquire their 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

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202 s 1 of the Companies Act; a (iii) of the distribution definition.

203 Canadian statute: established in s 39 of The Business Corporations Act of 1970

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

205 Australian Legislation: s 257A-257J of the Corporations Law 1989.

206 See the New Zealand Companies Act 1993 s 58-67C.

207 First, in the 1999 Companies Amendment Act and fully fledged in the Companies 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.

> 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…'[208]

One can note the advantages of abandoning the capital maintenance rules from the preceding. Flexibility should always be preferred over rigidity, guaranteeing economic benefits for the company`s stakeholders. Jooste stated the benefits of allowing companies to purchase their shares as including;[209]

- They are helpful because the company has an employee share incentive scheme that enables it to purchase employees' shares when they leave their employment;
- They can be used to buy out dissenting shareholders;
- 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, and Leverage Ratio: a financial ratio indicating the relative proportion of shareholders` equity and debt used to finance company assets.[210]
- 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 engage in takeovers and mergers by removing shares from the market and re-issuing them as a consideration in takeovers and mergers without dramatically increasing the company`s issued shares.[211]
- They help management gradually ensure control of their company by buying out others and minimizing the number of shares that must be acquired to gain complete control.[212]

It is thus established that allowing share-buybacks on the strength of the solvency and liquidity test is like killing two birds with one stone. While the test protects the creditors, shareholders achieve several economic goals, as indicated above.

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208 See Memorandum on the Objects of the Companies Amendment Bill, 1999.
209 Jooste, 'Corporate Finance' (n94) 296-298.
210 Drake PP & Fabozzi JJ, *Analysis of Financial Statements* (3rd edn, John Wiley & Sons Inc, New Jersey, 2012) 92.
211 Blackman M et al, *Commentary on Companies Act* (loose Leaf, Juta, RSA 2002) 5-55.
212 ibid 5-61.

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 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 distribution: Another form of distribution is the capitalization of shares,*** generally meant to give more shareholding value to existing shareholders to promote the company`s shareholders.[213] In terms of section 47 of the Companies Act, as per the limitations and provisions of the Memorandum of incorporation, the board may resolve and approve the issue of any authorized shares of the company as capitalization shares on a pro-rata basis to the shareholders of one or more classes of shares. Among other vital sub-provisions is that such entitled shareholders of any class may be entitled to receive the award of distributed capitalization share in the form of cash payment for the value as determined by the board. However, this concept does not benefit creditors but shareholders; it should not be implemented to prejudice creditor interests. Capitalization of shares enhances a company's financial strength and thus affords greater assurance to the creditors that they will be paid when their debts are due. 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 if it satisfies the solvency and liquidity test, which is ultimately meant to strike a balance between the company`s interests, shareholders, and the interests of creditors;[214]

- 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

213 Capitalisation of shares is whereby new shares are issued to existing shareholders in proportion to their existing shareholding. See <https://en.m.wikipedia.org/wiki/Capitalisation-shares > accessed 24 of September 2018.

214 (b) & (c) of the definition of "distributions" under s 1 of the Companies Act.

- 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 distribution need no further explanation as they are self-explanatory. As earlier stated, when shareholders are impressed, it motivates further investment and the propping up of new investors. It may entail more business opportunities for creditors, hence striking balances for all stakeholders' interests in a healthy and growing economy.

To sum it up, it is essential to consider the contribution of the solvency and liquidity test to several forms of distribution. Most distributions were barred under the common law capital maintenance rules, but now they are entertained subject to their compliance with the solvency and liquidity test as required by statute. The solvency and liquidity test has become the primary basis for determining the lawfulness of a distribution. A distribution that falls short of this test is unlawful and is subject to be reversed. In addition, it sanctioned directors who participated in such an unlawful distribution at the expense of creditors and other stakeholders.[215] The protection of creditors by the solvency and liquidity test cannot be overemphasized; however, several discrepancies discussed above should be addressed to enhance the efficacy of the law. For instance, section 48 provides that where an acquisition or distribution occurs contrary to section 46, it may be reversed by an order of a court not more than two years after the day of acquisition or distribution, ensuring the affected persons/stakeholders are also restored as well as apportioning liability in this regard to directors of the company who were present and participated at the meeting where the resolution was taken.[216]

[215] Jooste, 'Corporate Finance' (n94) 282, 287, 306 & 311. The strive by corporate laws to give courts powers to reverse unlawful distributions and to sanction directors who authorize unlawful distributions shows how serious the law regards the need to protect creditors and the company interests.

[216] Jooste R, 'Issues Relating to Regulation of Distribution by the Companies Act' [2009] *SALJ* 650.

2.1.3.2. Financial assistance versus creditor protection

The common law and the subsequent statutory interventions up to the 1973 Companies Act have always prohibited companies from giving financial assistance to persons to facilitate the purchase of the company's shares.[217] This position has now changed, first by the 1999 Amendment Act and subsequently by the Companies Act, subject to certain conditions which shall be canvassed below. Financial assistance is not defined in the 1973 Companies Act. However, the Acts give examples of what constitutes financial assistance.[218] A literal meaning of financial assistance is 'the act of helping someone either financially or in relation thereto.'[219] The judicial position as expressed by Hoffman J in *Charterhouse Investments Trust Ltd v Tempest Diesel Ltd* is to the effect that when determining if financial assistance has been given, the commercial realities of a transaction must be considered, and the financial assistance must be given to someone with the view to providing aid or help.[220] It is not financial assistance when the direct object of the transaction is to give another what they are entitled to in any event, even when the transaction involves a net transfer of value from the company.[221] 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.[222] Be that as it may, the Companies Act provides for two forms of financial assistance as follows;

- Giving financial assistance to anyone so that they buy shares of the company;[223]

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217 See generally the 1999 Amendment Act and the changes in the Companies Act.

218 See s 38 & s 226 of the 1973 Companies Act, and s 44 & s 45 of the Companies Act.

219 ibid. See also <https://en.m.wikipedia.org/wiki/Financial_assistance_(Share_purchase)> accessed 01 October 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.

220 In *Charterhouse Investments Trust Ltd v Tempest Diesel Ltd* (1986) 1 BCLC 1, Hoffman J, referring to a UK Equivalent of s 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.

221 *Sterileair (Pty) Ltd v Papallo* (1998) 29 ACSR. A proper distribution of a dividend is not financial assistance. See also *Brady v Brady* 1989 AC 755 at 783.

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

223 s 44 of the Companies Act.

- Giving financial assistance to directors or any prescribed officers for any reason whatsoever.[224]

It is thus essential to deal with each form of financial assistance to establish the law's position concerning creditor protection in company affairs.

a) Financial assistance to purchase shares versus creditor protection

Before the 1999 Companies Amendment Act, financial assistance to purchase a company`s shares, or those of a holding company, to either existing or prospective company shareholders was strictly prohibited by section 38 of the 1973 Companies Act.[225] The rationale behind the prohibition was to avert 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.[226] Thus, the object of section 38 was to ensure that corporate funds were to be used for their legitimate purpose and nothing else.[227] However, according to Nwafor, companies aim to raise capital through invitations to subscribe to their shares, as the capital directly guarantees the company's security. [228] Creditors generally focus on the capital profile as a form of security for advancing towards a particular company.[229] One of the legitimate purposes of a company's funds 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

224 s 45 of the Companies Act.

225 s 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 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'.

226 Jooste, 'Corporate Finance' (n94) 306.

227 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.

228 Nwafor AO, 'Contrasting Approaches on Financial Assistance between UK and South Africa' [2019] 20 (1) BLIJ 25.

229 ibid.

stakeholders. This was explained in *Lewis v Oneanate (Pty) Ltd,*[230] where Nicholas AJA stated as follows:

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 legislature's purpose was to avoid that fund being employed, depleted, or exposed to possible risk due to transactions concluded for or in connection with the purchase of its shares.

Lewis's reasoning concerning creditor protection is purely a progeny of capital maintenance rules, where it was believed that a company`s capital should not be tempered for any purpose other than that it is intended for in the ordinary course of running business operations.[231] However, This position was provisionally changed in the 1999 Amendment Act, where financial assistance is allowed subject to conditions premised on securing the interests of creditors and other stakeholders. Section 38 (2A) of the 1973 Companies Act, as a result of the 1999 Companies Amendment, marks the legislature's original intention to safeguard creditors' interests. The section provides 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 s 38(2A) favours the solvency and liquidity test, although it lacks the detail and particularity evident in s 44 of the Companies Act. Section 44 of the Companies Act takes greater caution against this partial liberty to financial assistance to avert any abuses of liberty. Section 44 firstly allows financial assistance only to the extent that the memorandum of incorporation permits.[232] In other words, if the memorandum of incorporation prohibits financial assistance, it may not be given under

230 1992 (4) SA 811 (A) 818.
231 See capital maintenance rules under paragraph 2.1.2 above.
232 s 44(2) & (4) of the Companies Act.

any circumstances. Secondly, section 44 provides the ultimate power to directors concerning the authorization of financial assistance.[233] A special resolution by shareholders to approve financial assistance will still need to go through the final discretion of directors for such financial aid to be ultimately given.[234] 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 according to an employee share scheme that is compliant with section 97 of the Companies Act.[235] or
- The financial assistance must be according 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 particular recipient falls within the category.[236]
- The solvency and liquidity test should precede the envisaged financial assistance;[237]
- The best interests of the company should be considered when giving financial assistance.[238]

Nwafor argues that the abolition and adoption of differing legislative provisions that have changed the common law threshold in the UK and South Africa, with regards to granting of financial assistance, has brought about commercial upheavals that threaten the commercial security and profile of companies by which companies manage to acquire several advances from creditors, based on a guarantee of the capital profile.[239]

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233 s 44(2) & (4) of the Companies Act.
234 s 44(3) (a) (ii) of the Companies Act.
235 s 44(3) (a) (i) of the Companies Act.
236 s 44(3) (a) (ii) of the Companies Act.
237 s 44(3) (b) (i) of the Companies Act.
238 s 44(3) (b) (ii) of the Companies 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.
239 Nwafor (n228).

The main thrust of these provisions is to protect the interests of various stakeholders, especially the creditors who do not have control over the company's affairs. Although corporate laws aim to promote an investor-incentive economy by allowing company members to trade freely, the need remains to protect other stakeholders from abusing such liberty. The position of the Companies Act concerning financial assistance caters to the interests of creditors, shareholders, employees, and the company's best interests.[240] Further, directors are obliged to act in good faith and ensure that they do not incur personal liability due to the current reprimands of the law on directors who participate in a resolution meeting concerning possibly invalid financial assistance.[241] The researcher thus concludes that the solvency and liquidity test and its application have allowed for the provision to leave gaps regarding financial assistance for purchasing a company`s shares, which, previously, on the common law threshold, was 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. The evolution in company laws seems to have taken a more conservative and protective approach that opens companies to commercial realities, as argued by Nwafor, wherein the viability of companies under such restraining conditions becomes a critical limiting factor for commercial growth in general.

b) Financial assistance to directors and others

Regarding the 1973 Companies 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
> *(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.

240 See enlightened shareholder value approach & the pluralist approach; Sibanda (n137) 35, 38.
241 s 44(6) read together with s 77(3) (e) (iv) of the Companies Act.

The 1973 Companies Act prohibited such financial assistance 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.[242] Directors or managers could procure loans from the company they control at any time, and it could be that they would not typically qualify for the same if the affordability test was to be considered. That will then risk the liquidity state of the company to the detriment of creditors if they fail to pay back the loans as arranged. The same is true when they use the company`s assets as security for their financial obligations and eventually fail to meet them. This will then risk the company's assets and thus not be in the company`s best interests, as well as those of essential stakeholders such as creditors who look up to those assets as security for their debts.

The stance of the 1973 Companies Act on financial assistance, although it was meant to protect creditors, disregarded the interests of directors and other essential 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 interests without compromising the company`s financial status. This would benefit the company, given that a happy employee realizes his best potential at work. The Companies Act brings a solution aimed at protecting the financial interests of these directors and prescribed officers while protecting the company's and creditors' best interests. Section 45 of the Companies Act allows financial assistance to directors and prescribed officers subject to specific requirements being met. Most of those requirements are the same as those in section 44 in paragraph 2.1.3.2.1; hence, the researcher shall not discuss them hereunder. Again, ensuring that the company passes the solvency and liquidity test before the board of directors approves any financial assistance to directors and prescribed officers is essential.[243] This again stresses the need to protect creditors through the solvency and liquidity test while approving certain transactions such as “financial assistance” to benefit other stakeholders. Thus, what remains for the legislature is to ensure that there are strict rules or policies, guidelines, and procedures set in motion to avert any abuses of this privilege by those on the company's steering wheel.

[242] Jooste, ‘Corporate Finance’ (n94) 306.
[243] s 45(3) (b) of the Companies Act.

2.1.3.3 Creditor protection during amalgamations or mergers and other fundamental transactions

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

An amalgamation or merger aims 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.[244] An amalgamation or merger will affect the interests of all stakeholders from amalgamating or merging companies. This then creates a 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 Companies Act, involves five steps[245] , which are, among others, the need to ensure the resulting company passes the solvency and liquidity test immediately after its formation[246] 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.[247] Creditors must be further given a right to approach the court within 15 business days of receiving the notice above only when they hold that the proposed merger or amalgamation will materially prejudice their interests.[248] Thus, the Companies Act

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244 Cassim & Yeats, 'Fundamental Transaction, Takeovers & Offers' (n94) 677.
245 ibid 684.
246 s 113(4) (b) read with section 115 of the Companies 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.
247 s 116(1) (a) of the Companies Act.
248 s 116(1) (b) &(c) of the Companies Act.

does indeed have the interests of creditors at heart when it comes to this fundamental transaction, as it provides a double-barrel approach 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. However, the researcher is perplexed by the silence of the Companies Act on creditor protection concerning other fundamental transactions, such as where a company has to dispose of a greater, all or part of its assets,[249] where a scheme of arrangement[250] is to be effected, and on takeovers.[251] The researcher believes that something was supposed to be strictly provided to ensure that the interests of creditors are well secured when these fundamental transactions are being affected.

2.1.3.4 Transfer of registration of a foreign company

Section 13 (5) & (6) of the Companies Act, as inserted by the Amendment, reads as follows;

> (5) Subject to subsections (6) and (7), a foreign company may apply in the prescribed manner and form, accompanied by the prescribed application fee, to transfer its registration to the Republic from the foreign jurisdiction in which it is registered, and thereafter exists as a company in terms of this Act as if it had been originally so incorporated and registered.
> (6) A foreign company may transfer its registration as contemplated in subsection (5) if-
> (a) the law of the jurisdiction in which the company is registered permits such a transfer, and the company has complied with the requirements of that law in relation to the transfer;
> (b) the transfer has been approved by the company's shareholders-
> (i) in accordance with the law of the jurisdiction in which the company is registered, if that law imposes such a requirement; or
> (ii) by the equivalent of a special resolution in terms of this Act, if the law of the jurisdiction in which the company is registered does not require such shareholder approval;
> (c) the whole or greater part of its assets and undertaking are within the Republic, other than the assets and undertaking of any subsidiary that is incorporated outside the Republic;
> (d) the majority of its shareholders are resident in the Republic;
> (e) the majority of its directors are or will be South African citizens; and
> (f) immediately following the transfer of registration, the company-
> (i) will satisfy the solvency and liquidity test; and
> (ii) will no longer be registered in another jurisdiction

[249] s 112 of the Companies 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.

[250] s 114 read together with section 115 of the Companies Act.

[251] s 117 -127 of the Companies Act.

Subsection 6(f) (ii) of section 13 requires that, in addition to many other qualifying requirements, a foreign company meet the solvency and liquidity test requirement before it is domesticated and registered as a South African Company. The researcher is of the view that this is in line with the Department of Trade and Industry and also the Home Affairs' requirements that before granting a business permit to a company or an individual, one needs to prove their financial capabilities to the extent of the threshold gazetted by the relevant Minister from time to time. For economic growth and investment incentivisation, it is prudent to have foreign companies that are financially astute have their registration transferred into the RSA, as their investments would be helpful without affecting the rights of any stakeholder. In this case, the solvency and liquidity test requirement is set to protect the interests of creditors in that company`s country of origin and creditors in the RSA who might have been engaged before the transfer of registration or after such domestication. The requirement also averts having to register a company that is both factually and commercially insolvent or a company that is fleeing from its obligations in the country of its origins. Either way, allowing the domestication of foreign companies is an essential tool for economic growth and development, ultimately benefiting the RSA citizens.

2.1.4. A summary of the solvency and liquidity test concept

Liquidity is vital in ensuring a company's stability, and researchers have established that liquidity is an essential factor in any company[252]. In addition, liquidity can be defined as the ability or ability of a company to settle current liabilities (short-term) on demand. If a company cannot meet the demand, it will make it difficult to survive in the long term. Liquidity refers to the available cash for the near future after considering the financial[253] obligations corresponding to that period. It is the amount of capital that is available for investment and spending.

A company that cannot pay its creditors on time and continues not honouring its obligations to the suppliers of credit, services, and goods can be declared a sick or bankrupt company. The inability to meet the short-term liabilities may affect the

252 Yusoff HB 'The Effect of Liquidity and Solvency on Profitability: The case of Public-Listed Consumer Product Companies in Malaysia' (Master's thesis, University Tun Hussein Onn 2017) 77.

253 Khidmat W & Rehman M, 'Impact of Liquidity and Solvency on Profitability Chemical Sector of Pakistan' [2014] 6 (3) EMIJ 34-67.

company's operations and, in many cases, its reputation. A lack of cash or liquid assets on hand may force a company to miss the incentives given by credit, services, and goods suppliers. Loss of such incentives may result in a higher cost of goods, affecting the business's profitability. Liquidity management is crucial for every organization that expects to pay current obligations on business, such as short-term operating and financial expenses[254]. Liquidity, therefore, helps ensure that a person or business always has a reliable supply of cash close at hand and is a powerful tool in determining the financial health of future investments. Under critical conditions, insufficient liquidity can even result in a firm's bankruptcy. The liquidity ratios that have been highlighted for this research are the current ratio and quick ratio. The researcher thus welcomes the importance of the solvency and liquidity test, which cannot be overemphasized.

From the preceding, it is undeniably acknowledged that the solvency and liquidity test is a restricting measure that must be passed before most transactions affecting creditors can be approved. Thus, the test has helped remove barriers to several transactions and, therefore, promote an investor-friendly environment for economic growth with the interests of shareholders taken care of while at the same time promoting the 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 requirements, which vary from transaction to transaction.[255] However, the flaws in the solvency and liquidity test and its application cannot be ignored because if no close follow-up is given to its application, then it can end up being an academic exercise where books are cooked to have the company pass the test and thus to the detriment of other stakeholders. In the subsequent chapters, this mechanism shall be further explored compared to its counterpart application in other competing jurisdictions.

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254 Wainer H, 'The insolvency conundrum in the Companies Act' [2015] 132 (3) SALJ 509-517.
255 This is reflected in sections 13, 44; 45; 46; 47 & 48, 113 of the Companies Act.

2.2. Liquidation/ winding up versus creditor protection

Liquidation of a company is another concept that corporate law employs to safeguard the interests of creditors among other stakeholders.[256] The 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 the remaining assets to the members or shareholders.[257] The process also involves appointing a liquidator responsible for ensuring that a company winds up effectively to benefit all interested parties.[258] 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 also been submitted to and approved by the Master before deregistration.[259] A company can be wound up when it is either insolvent or solvent.[260] When a company is insolvent, and its prospects of resuscitation are slim, any interested party (this includes creditors) may enforce liquidation.[261] When a company is solvent, it can be liquidated voluntarily by a special resolution or a court order on specific grounds.[262] Among other stakeholders, creditors are given *locus standi* to approach the court for an application to liquidate a company regardless of whether the company is solvent or insolvent. That position of the law shows how creditor interests are also valued, especially in proceedings where their interests may be affected. Where another stakeholder other than a creditor moves a motion to liquidate a company, creditors will be entitled to adequate notice of such proceedings for their participation therein.[263]

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256 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. s 345 of the 1973 Companies Act and s 80 & 81 of the Companies Act read together with the Insolvency Act of 1936.

257 'Winding Up' <https://www.investopedia.com/terms/w/windingup.asp > accessed 07 October 2018, also referred to as company dissolution or liquidation.

258 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 Yeats, 'Winding Up' (n94) 921-2.

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

260 ibid 914 for solvent companies and 918 for insolvent companies.

261 ibid 914.

262 s 81 of the Companies Act.

263 s 81 of the Companies Act.

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.[264] 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.[265] Companies are a means to ensure economic growth; hence, having to dissolve them is counter-economic development, so creditors must take greater caution when utilizing this remedy to recoup their entitlements. Proper employment of the liquidation process will, however, ensure that creditors recover something from either a solvent company, a financially distressed, or an insolvent company, as the case may be. Thus, the legislation provides for the liquidation of a company when it is insolvent and even when it is solvent, which shall be discussed below.[266]

2.2.1. Winding up of solvent Companies

Winding up of solvent companies is regulated by the Companies Act[267] , whereas winding up of insolvent companies is still governed by the 1973 Companies Act. The Companies Act does not define the meaning of a solvent company or an insolvent

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264 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 Vos <http://www.mondaq.com/southafrica/x/53216/Insolvency+Bankruptcy/Misuse+Of+The+Liquidation+Process/> accessed 31 August 2018.

265 ibid.

266 s 79-81 of Part G, Chapter 2 of the Companies Act deal with winding up of solvent companies and chapter XIV of the 1973 Companies 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 Companies 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.

267 Although a solvent company is wound up by the Companies Act, still there are some remnants of the 1973 Companies Act that still apply to solvent companies to the extent they are applicable to consolidate the Companies Act. Item 9 of Schedule 5 of the Companies Act provides as follows "…(2) Despite sub-item (1), s 343, s 344, s 346 and s 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."

company. In the *Boschpoort Ondernemings (Pty) Ltd v ABSA Bank Ltd*,[268] it was held that the inclusion of section 345 of the 1973 Companies Act when it comes to the winding-up of solvent companies under sub-item 9(1) of schedule 5 of the Companies Act and the subsequent exclusion of section 344 of the 1973 Companies 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 Companies Act was retained in sub-item 9(1) to enable a determination to be made in terms of section 79(3) of the Companies 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 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 Companies 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 Companies Act of the deeming provisions as to when a company is unable to pay its debts as contained in section 345 of the 1973 Companies Act, is a clear indication of what is meant by an insolvent company in the Companies Act. It can only mean a commercially insolvent company. Therefore, a solvent company must be the opposite: a commercially solvent company.[269] The factual solvency of a company is not a determinant of whether a company should be placed in liquidation; accordingly, it is not a defence against an application to wind up a commercially insolvent company in terms of the 1973 Companies Act. It will, however, always be a factor in deciding whether a company cannot pay its debts. Thus, a commercially solvent company (whether factually solvent or insolvent) may be wound up in terms of the Companies Act only; a solvent company cannot be wound up in terms of the 1973 Companies Act.

2.2.1.1 Voluntary winding up of solvent companies

Having defined the meaning of a solvent company, it should now be noted that it may be wound up in two ways: voluntary winding up by a special resolution and winding up by court order.[270] Where a special resolution voluntarily winds up a company, such resolution shall provide whether the company will be wound up by its creditors or the

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268 (936/12) [2013] ZASCA 173.
269 Ibid.
270 s 79(1) of the Companies Act.

company itself. The resolution must be filed with the 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 the commencement of winding up or to obtain consent from the Master to dispense with security where a sworn statement by a director 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.[271] A liquidator appointed by a resolution procedure has the same powers given by the 2008 Act as one appointed by a court where winding up is initiated through a court order.[272] During the winding-up period, the company remains a legal person. It 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.[273] There is not much difference between the provisions of the 1973 Companies Act concerning voluntary dissolution by shareholder or creditor resolution. This research is essential to the power both pieces of legislation give creditors to enforce the dissolution of a company by way of a resolution to ensure that their interests are protected when a company has to cease operations under any given circumstances.

2.2.1.2 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 Companies 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 the court to have its voluntary winding up continued by the court.[274] As discussed above, a voluntary wind-up also serves creditors' interests as creditors may be given powers through a special resolution to oversee the flow of the liquidation process to protect their interests.

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[271] s 80 of the Companies Act.
[272] Yeats, 'Winding Up' (n94) 915.
[273] ibid.
[274] s 81(1) (a) of the Companies Act.

- The company was under business rescue, and the practitioner applied to the court in terms of section 141(2) (a) for winding up because there was no reasonable prospect of the company being rescued.[275] The 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.

- One or more of the creditors have applied to court because 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 wound up.[276] Creditors are allowed to participate in and monitor the progress of the business rescue process. When they fail to resuscitate the company, creditors may apply to the court to enforce liquidation to protect their interests.

- Where the company, one or more directors, or one or more shareholders have applied to court because 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 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 the company's wind-up is just and equitable.[277] Shareholders and directors also have a right to approach the court where there is a deadlock in company affairs to protect their interests and those 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

275 s 81(1) (b) of the Companies Act. s 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.

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

277 s 81(1) (d) of the Companies Act.

leeway/ *locus standi* to approach court when they learn of a stalemate that affects their financial interests.

- Where a shareholder has applied, with leave of the court, for an order to wind up the company because 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,[278] It is recommended that this circumstance be revised also to 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 the company`s assets are misused, yet creditors look up to those assets as security for their debts. Regarding section 22 of the Companies Act, creditors as interested parties may report to the Companies Tribunal to investigate such issues.

- The Commission has applied to court because the company or its controllers are acting or have acted in a fraudulent or otherwise illegal manner, and the Commission or panel has issued a compliance notice. However, the company has still 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 were taken against the company or its controllers for substantially the same conduct, resulting in an administrative fine or conviction of an offence.[279] Establishing the Companies Tribunal by the Companies Act as an outside eye to the company's affairs helps outsiders, such as creditors who may not have *locus standi*, to approach the 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 by studying case law related to the same. Chapter 4 shall also deal with importing the Companies' Tribunal as a new concept forum to resolve trade disputes in company affairs.[280]

278 s 81(1) (e) of the Companies Act.
279 s 81(1) (e) of the Companies Act.
280 s 193-5 of the Companies Act.

Compared with section 344 of the 1973 Companies Act, the above circumstances clearly show a substantial change in circumstances where 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 Companies Act, which had a lot of other circumstances that were archaic and unsuited for the 21st-century corporate laws, save for those in s344(f)&(h), which are repeated in the Companies Act in one way or the other.[281] To reconcile both Acts in this regard, s344 (h) of the 1973 Companies Act seemingly stands as a determining factor for the court to grant liquidation under most circumstances in section 81 of the Companies Act.[282] There is a repetition of section 344(h) in section 81 of the Companies Act of the need to ensure that there are just and equitable grounds to justify a liquidation order. What determines equitable grounds is not a closed list, but case law has this stage developed the following guidelines;[283]

- Where the company`s substratum has disappeared, the company`s objects cannot be pursued.
- Where the company has been pursuing illegal objects and fraudulent purposes.
- A deadlock in the company`s administration renders the company incapable of doing business.
- Where there is irretrievable destruction of the relationship in a domestic company (or *quasi*-partnership).

The above meanings of just and equitable grounds have now been legislated in section 81 of the Companies Act, clearing the air on what legislation previously meant by those grounds as interpreted by courts over the years. The ambiguous provisions

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

282 s 81(c) (ii); s81 (d) (iii) of the Companies Act.

283 *Apco Africa (Pty) Ltd v Apco Worldwide Inc.* 2008 (5) SA 615 (SCA).

of the 1973 Companies Act have now been propounded, bringing certainty to circumstances that may invite the dissolution of a solvent company by court order. Thus, there is no doubt that creditor interests are safeguarded mainly by the new provisions, although a bit of touch-ups need to be done as recommended by the researcher above.[284]

2.2.2. 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.[285] Such an application may be initiated by a combination of any of the stakeholders mentioned above. “insolvency” describes a situation where a company cannot pay its debts.[286] In exploring the meaning of insolvency, the court differentiated between commercial and actual insolvency in *Standard Bank of SA Ltd v R-Bay Logistics CC Logistics.*[287] It held that a company with excess assets over liabilities could not discharge its debts as they arose in the ordinary course of business and were commercially insolvent. Thus, "commercial insolvency" insinuates that a company cannot meet its obligations when they fall due, regardless of its actual state. Whereas with actual insolvency, a company would have its assets exceeded by its liabilities in addition to its failure to meet debts as they become due and payable. The court further noted that such commercial insolvency requires applying a test that is quite different from that which one must apply to establish actual insolvency.[288] It is thus clear under section 345 of the 1973 Companies Act that courts would entertain cases of mainly commercial insolvency rather than actual insolvency because one can be insolvent but able to dispose of their debts as they become due and payable. The grounds laid out in the provision are

[284] 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.
[285] s 346 of the 1973 Companies Act.
[286] s 345 of the Companies Act of 1973.
[287] [2012] ZAKZDHC 69.
[288] ibid.

centred on the failure to pay debts and the subsequent execution of a writ for those unpaid debts. A company is thus deemed to be unable to pay its debts if;[289]

- 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.

In light of the preceding, creditors who can prove any of the above circumstances that deem a company unable to pay its debts are vested with *locus standi*, *inter-alia*, to approach the court by way of application to liquidate an insolvent company to protect their interests. The application takes the form of a notice of motion and an affidavit supporting the facts on which the applicant relies for relief.[290] In *Breetveldt v Van Zyl*[291], the judge explained that the purpose of the application is to place before the 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.[292] 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.[293]

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 concursus creditorium* but is *mala fide*, the court

289 s 345 of the Companies Act of 1973.
290 s 347 of the 1973 Companies Act.
291 1972 (1) SA 304 (T) 314.
292 s 346 of the 1973 Companies Act.
293 s 386 (4) of the 1973 Companies Act.

will not grant a winding up order.[294] Moreover, the court will not grant liquidation when winding up is used to enforce debt repayment for a debt disputed by a company in good faith on reasonable and substantial grounds.[295] The court thus has discretion on whether or not to allow liquidation, especially when the company is factually insolvent.[296] Conclusively, winding up an insolvent company is a process meant to protect the interests of creditors, such that shareholders should not abuse available assets at the expense of creditors, and 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 believes that creditors are well protected by the 1973 Companies Act when it comes to liquidating an insolvent company as they have locus standi to approach the court and 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 Companies Act after the Minister of Trade and Industry has reformed insolvency laws; perhaps cumbersome requirements such as the need to furnish the Master with security of liquidation costs may be done away with.[297] Not all creditors may have enough funds to provide such security, yet they will have a just cause to move a motion for liquidation.

2.2.3. Summary of the liquidation mechanism

It has already been provided above that the researcher believes that the Companies Act has made helpful changes to promote creditor interests in the liquidation of solvent companies. The Companies Act has done away with ambiguous circumstances under which a solvent company could be wound up and has made the law clear and certain. The researcher has already proposed minor amendments 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 to ensure adequate creditor protection.

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[294] Yeats, 'Winding Up' (n94) 919.

[295] ibid.

[296] *Boschpoort Ondernemings (Pty) Ltd v ABSA Bank Ltd (n167).* The company has to be actually commercially insolvent.

[297] s 346 of the 1973 Companies Act.

2.3. 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 aiming at catering to the company's well-being. Compromises are dealt with in section 155 of the Companies Act. Previously, they were dealt with under section 311 of the 1973 Companies Act. Both these sections permit a company (or a liquidator of a company) to propose an arrangement or compromise of the company's financial obligations to all creditors or 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.[298] 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 the parties' rights through an arrangement agreed to by both parties amicably.[299] A compromise, inter-alia other mechanisms, is direct - step away from the contractarian theory[300] 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. According to Cassim, a compromise is appropriate in reaching an agreement between a company and its creditors where standard mechanisms are unavailable.[301]

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 Companies Act.[302] A compromise may be undertaken even when the company is liquidating; however, it cannot be engaged while undergoing business rescue processes.[303] In the 1973 Companies Act, there was a need to obtain both leave to propose a compromise to creditors and an order sanctioning the commencement of a compromise from the

298 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.

299 Cassim, 'Business Rescue and Compromises' (n94) 910.

300 Sibanda (n137) 25.

301 Cassim, 'Business Rescue and Compromises' (n94) 910.

302 s 155(1) of the Companies Act.

303 Cassim, 'Business Rescue and Compromises' (n94) 910; Putting a company under business rescue processes will automatically stop compromise negotiations.

court.[304] Under the Companies Act, there is no requirement that the leave of the court must be obtained before the compromise is proposed to the creditors. Yet, the court must still sanction the compromise to protect the interests of creditors and the company.[305] 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 meeting notice must be accompanied by a copy of the compromise proposal, which must be sufficiently detailed to help creditors prepare.[306] The proposal will be considered adopted if at least 75% (in value) of the creditors present and voting vote in favour of the proposal.[307] Once the proposal has been approved through voting, directors or the liquidator may approach the court to sanction the compromise proposal. The court has the final say on whether or not to sanction a compromise, although most creditors have voted for it. However, once the court has sanctioned the compromise, it will be binding on all or classes of creditors and the company or, if applicable, the liquidator.[308] A compromise order for a company being liquidated goes simultaneously with an order discharging a liquidation order.[309] The final step in validating a compromise will be to file a court order sanctioning the compromise with the companies' commission within five business days of the order.[310]

2.3.1. Enforcement of creditor rights during compromise procedures

Firstly, it is imperative to consider the aspect of *locus standi* when proposing a compromise. As pointed out above, under the Companies Act, only directors and liquidators (as the case may be) have *locus standi* to propose a compromise.[311] In the 1973 Companies Act, creditors and shareholders had *locus standi* to propose a compromise.[312] The rationale behind streamlining stakeholders with *locus standi* is unknown to the researcher. Still, the researcher believes this position limits creditors` rights for this mechanism. Creditors will have to convince directors or the liquidator to propose a compromise to them, which makes it a complicated process compared to

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304 s 311 of the 1973 Act.
305 s 155(7) of the Companies Act.
306 s 155(3) outlines what should constitute a proper compromise proposal.
307 s 155(6) of the Companies Act.
308 Loubser A, 'Comparative Aspects of Corporate Rescue in South African Company Law' (LLD Thesis, UNISA) 148.
309 ibid.
310 s 155(8) of the Companies Act.
311 s 155 (2) of the Companies Act.
312 See s 311(1) of the 1973 Companies Act.

the 1973 Companies Act, in which they could 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 proposed by people in control of the company who have a more objective assessment of the company`s records to 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 Companies Act, which outlines a compromise proposal.[313] Most of the information forming the basis of a compromise proposal will need someone with direct access to company records or information to compile the proposal.[314] It is recommended that legislation also gives creditors *locus standi* to propose a compromise provided they have sufficient information to lay the basis of their proposal.

Secondly, unlike the 1973 Companies Act, the Companies 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 Companies 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 that will help a creditor make an informed decision on whether or not to accept a compromise proposal. This development is thus essential to protect creditor interests so that they do not have to jump into what they do not have much clarity on, which may prejudice their interests in the 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 accurate, complete, and up to date and declaring that the projections provided are estimates made in good faith based on factual information and assumptions as set out in the statements.[315] The researcher believes liability for

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

314 See s 155(3) of the Companies Act.

315 s 155 (5) of the Companies Act.

costs, losses, and damages may apply to a director or liquidator who provides a false statement to justify a proposal of defrauding creditors into accepting a grossly fallible compromise proposal.[316]

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 the position in the 1973 Companies Act; perhaps some analysis may deduce some change under the Companies Act. The practical understanding is that creditors cede their rights regarding their contractual debt repayments rights to the company or the proposer and hope for the success of the compromise agreement.[317] In *Ex Parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (In Liquidation),*[318] Stegmann J had to decide whether creditors, in applying s 311 of the 1973 Companies Act for an order that classes of creditors hold meetings 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 Companies Act.[319] 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.[320]

It is essential to explore the application of section 424 on this aspect in that this section is crucial as it was premised on holding directors liable for damages and costs as a result of reckless and fraudulent trading, which creditors could, later on, identify at

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316 s 20; s 22; s 218 of the Companies Act may apply under the circumstances.

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

318 1992(2) SA 95 (WLD).

319 s 424 of the 1973 Companies 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.."

320 *Ex Parte De Villiers* case (n318) at pp 107F-107G.

proceedings such as liquidation or judicial management or otherwise.[321] Thus, In *Ex Parte De Villiers case,* Stegmann J further made the following *dictum* contending that the existence of 'debts and liabilities' was a prerequisite for the operation and functioning of s 424(1) of the 1973 Companies 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.[322]

When 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 because the creditor has ceded the *locus standi* of being a creditor. Moreover, section 424 applies when a company has debts and liabilities. Yet, once a compromise is entered, such debts and liabilities will be considered extinguished, meaning invoking section 424 will be futile. 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 Companies Act, were extinguished.[323] It was further held that whether creditors' claims against the company were "deemed" to be ceded or

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[321] s 424 of 1973 Companies 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.

[322] *Ex Parte De Villiers* case (318) at pp 107G-108B.

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

"actually" ceded was accordingly of little moment.[324] Thus, this position has not been favourable for creditors, especially when they find that a compromise was just proposed to defray them from their right to approach court where the company was being recklessly and fraudulently managed against their interests.

The almost equivalent of section 424 of the 1973 Companies Act is section 22 of the Companies Act. It should be noted that section 424, being in chapter 14 of the 1973 Companies Act, still applies to the extent that it is consistent with the Companies Act.[325] Section 424 shall apply to companies that are in winding up/ liquidation since judicial management provisions have been repealed. Section 22 of the Companies Act applies in all circumstances, in the ordinary course of business and during liquidation.[326] Section 22 is more comprehensive than Section 424; unlike Section 424, it will not apply only to companies under liquidation.[327] It will apply to any company that is still a going concern, irrespective of whether it is being wound up.[328] Thus, since the protection of section 22 of the Companies Act is not limited to companies in liquidation, it will accordingly apply to the compromise process. However, this remains to the courts for interpretation of these provisions.

The just rationale is that where a compromise is preceded by reckless and fraudulent activities which affect creditor interests and the 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 proposed in bad faith or misrepresentation or without sufficient information placed before them for their informed decision? The same line of questioning should be asked: Where, during a compromise, do 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 such activities would occur during compromise processes.

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324 ibid.

325 See under liquidation above where s 345 of the 1973 Companies Act still governs liquidations of insolvent companies.

326 Cassim, 'The Duties & Liability of Directors' (n94) 588.

327 ibid.

328 ibid.

2.3.2. Summary of creditor compromises

To a large extent, the researcher appreciates the advantage creditors may have when compromise proceedings are brought into the picture without any hidden agenda or in utmost good faith. Section 155 of the Companies Act clearly outlines what should be included in a proposal for a compromise to help a creditor(s) make an informed decision on whether to accept a compromise. The criticism laid by the researcher is that creditors are not given locus standi to propose a compromise where necessary. Reference is also made to the protection of creditors while on the "compromise period" despite having forfeited their rights in terms thereof. The researcher believes that creditors who notice previous or ongoing traits of reckless, fraudulent, and insolvent trading may utilize remedies in section 22 and sections 214 and 218 of the Companies Act against any responsible director even though a company is undergoing compromise proceedings.

2.4. Business rescue concept and creditor protection

2.4.1. Introduction and background

One of the purposes of the Companies 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.[329] This has been achieved by introducing a completely new business rescue concept to facilitate the rehabilitation or reorganization of a company in financial distress.[330] The merits of a well-executed business rescue process have proven that it offers a handy alternative to the liquidation process in most jurisdictions.[331] In the ordinary course of doing business, a company fails to meet its financial obligations as they become due and payable. Creditors consider it suitable for liquidation to recover their debts, and new corporate laws prefer the business rescue process to the liquidation process.

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[329] s 7(k) of the Companies Act.

[330] Cassim, '*Business Rescue & Creditor Compromises'* (n94) 861.

[331] ibid. See United Kingdom Cork`s Report ( Cork "Insolvency Law and Practice" 8558) where emphasis is made concerning the perseveration 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.

As has been said above, the liquidation process is to be used as a last resort avenue; that is, where a company has undergone the business rescue process, and the attempt has proven unsuccessful to warrant the closure of the business. The term 'rescue' has been defined as a major intervention necessary to avert eventual company failure or reorganization to restore it to a profitable entity and avoid liquidation.[332] In a United States Case, *NLRB v Bildisco*,[333] 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 product[334] , 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*,[335] it was held that the purpose of Chapter 11 of its Bankruptcy Code[336] was to provide a debtor with legal protection to allow it to reorganize and thereby to give the creditors a going concern value rather than a more meagre satisfaction. This again shows that business rescue proceedings are premised on ultimately protecting the interests of creditors and the company, among other stakeholders. A successful business rescue process will ensure the company has recovered or restored, regaining its solvency and liquidity status and meeting creditors` obligations. However, this may not always be the case.[337] In *Merchant West Working Capital Solutions (Pty) Limited`s case*,[338] 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

332 Cork "Insolvency Law and Practice" 8558.

333 465 US 513 (1983) 528.

334 see 'Gross domestic product' <https://en.m.wikipedia.org/wiki/Gross_domestic_product > accessed 22 October 2018; 'Gross domestic product' is a monitory 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.

335 66 F.3d 1436 (Ohio, 1995).

336 Bankruptcy Code: Bankruptcy Reform Act of 1978.

337 Casim, 'Business Rescue & Creditor Compromises' (n94) 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.

338 *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 para 4.

> 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 result will be that during business rescue proceedings, the company would be managed 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 enshrined in the 1973 Companies Act. A judicial management process entailed the following;

- An application be launched in the High Court for judicial management as a requirement;[339]
- A court order of judicial management was not easily granted. It was an extraordinary remedy and was also treated by the courts as such;[340]
- 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 thriving concern and[341]
- A court-appointed judicial manager had to investigate the company's affairs and the likelihood of a successful rehabilitation. The court then considered his report and creditors' views when considering whether or not to grant the final order for judicial management.[342]

Comparably, in or during business rescue proceedings, it is no longer necessary for a company to get or obtain the court's approval first to obtain the protections offered by business rescue, including freezing creditors' claims. All that is now required to get the machinery in motion is a directors' resolution[343] that effectively declares that the

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339 ibid para 11.
340 ibid para 11.
341 ibid para 11.
342 ibid para 11.
343 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

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 judicial management process.[344] A business rescue practitioner has to investigate the company's affairs and then decide whether or not there are any reasonable prospects of rehabilitating the company.[345] Suppose the rescue practitioner decides or believes that there is such a prospect. In that case, he must prepare a business rescue plan, which must be approved by shareholders, creditors, and all affected or interested parties or persons.[346] Once approved, the business rescue practitioner must oversee its implementation. There is again no need to place the plan before the court for any approval unless, on just cause, one of the affected persons objects to the implementation of the plan and wishes to challenge it in court.[347] This sums up a background to the new business rescue concept, and below, the researcher shall endeavour to deal with it specifically in terms of the Companies Act.

2.4.2. Business rescue under the Companies Act

Section 128(1) (b) of the Companies 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;
> (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;

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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.

344 In *Ex Parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (In Liquidation) 1992(2) SA 95 (WLD)* para 12.

345 s 141(1) of the Companies Act.

346 s 140(1) (d) of the Companies Act.

347 Casim, 'Business Rescue & Creditor Compromises' (n94) 906.

- 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[348] or

- It appears to be reasonably likely that the company will become insolvent within six months.[349]

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 on the verge of insolvency or face liquidity problems.[350] A business rescue process will thus be employed to help the company meet its liabilities. It is, therefore, illegal to trade even where one reasonably foresees that the company is close to insolvency or where it is insolvent, as this will affect the interests of several financial stakeholders, including creditors.[351] Further, a company must meet its debts as they become due and payable. Under the above circumstances, a company must be placed under business rescue in an attempt to its financial rescue. Professor Nwafor opines this in his analysis of the goal of the business rescue provisions, in particular section 128 of the Companies 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…[352]

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

348 s 128(1) (f) (i) of the Companies Act.
349 s 128(1) (f) (ii) of the Companies Act.
350 Casim, 'Business Rescue & Creditor Compromises' (n94) 864.
351 s 22 of the Companies Act.
352 Nwafor A, 'Exploring the Goal of business rescue through the lens of South African Companies Act' [2017] 28 (3) SLR 600.

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.[353] 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.[354] There are two ways rescue proceedings may be initiated, which shall be discussed below.

2.4.2.1. Voluntary resolution of the board

A company may be placed under business rescue by resolution of the company's board of directors 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.[355] Cassim holds the view that the Companies Act, as influenced by Chapter 11 of the US Bankruptcy Code,[356] introduces a debtor-friendly environment as it allows the debtor to act within time, allowing the board of directors to cleanse their hands by placing a company under rescue assistance before it is too late to do so.[357] As a debtor, a company is thus given leverage to put its house in order before outsiders intervene.

It is of great importance to this research 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 the affected persons.[358] Creditors are, *among other things,* 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

353 s 128(1) (b) (iii) of the Companies Act.
354 s 128(1) (b) of the Companies Act.
355 s 129(1) (a) & (b) of the Companies Act.
356 Cork "Insolvency Law and Practice" 8558.
357 Cassim, 'Business Rescue & Creditor Compromises' (n94) 866.
358 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 s 128 (1) (a) of the Companies Act.

may begin to actively participate in the process to ensure their rights are safeguarded.[359] Moreover, suppose 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. In that case, the board of directors will have to notify each affected person, setting such grounds as in section 128(1) (f) of the Companies Act and why such a board would not adopt the resolution to place the company under rescue processes.[360] The underlying reason for this provision is to enable affected persons, creditors in this case, to lodge an application for business rescue processes to court, which would protect their interests. Although section 129 (7) does not explicitly provide for any sanction for the failure of 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.[361] Creditors as affected persons are thus protected by voluntary rescue processes despite them not having *locus standi* to commence these voluntary rescue processes.

2.4.2.2. Application by an affected person

An affected person may apply to a court for an order to supervise the company and commence 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.[362] An applicant must serve a copy of the application on the company and the Companies Commission and notify each affected person of the application in the prescribed manner.[363] Importantly, each affected person has the right to participate in the hearing of an application without the need to apply to the court for leave to intervene.[364] Since rescue proceedings are favoured over 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 this case, a company may be placed under rescue proceedings even though it is

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359 Cassim, 'Business Rescue & Creditor Compromises' (n94) 867.
360 s 129(7) of the Companies Act.
361 s 218(2) of the Companies Act holds liable anyone who contravenes the provisions of the Act.
362 s 131(1) of the Companies Act.
363 s 131(2) of the Companies Act.
364 s 131(3) of the Companies Act.

undergoing liquidation.[365] In terms of section 131 (4) (a) of the Companies Act, the court would not grant a business rescue application unless it is satisfied that;

- the company is financially distressed or
- the company has failed to pay over any amount in terms of an obligation under or in terms of public regulation or contract for 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 the 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 the date of order.[366] Thus, It is crucial to this research to applaud the Companies Act`s stance in giving creditors, among other affected persons, *locus standi* to approach the court on the above grounds to ensure 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 participate, although informally, in the rescue process to protect their interests through rescue proposals.[367]

2.4.3. Post Commencement Finance

Post-commencement finance is one of the essential requirements of the business rescue procedure. A financially distressed company will most likely need additional funding and credit supplies from merchandise supplies to keep up the trade while endeavouring to stabilise the company's financial situation. In *National Labour*

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365 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. Cassim, 'Business rescue and compromises' (n94) 873.

366 s 131 of the Companies Act.

367 Cassim, 'Business Rescue & Creditor Compromises' (n94) 902.

Relations Board v Bildisco, Debtor-in-Possession et al.,[368] the court stated that reorganisation might only be successful in some cases if new creditors infuse the ailing company with additional capital finance to fund its resuscitation operations. Where most assets are already encumbered against certain creditors, the company could not realise the same to pay some debts save for assets not encumbered as security. In such a case, a financially distressed company would need to outsource further funding to revive the distressed company. What then becomes the question is the ranking of such debts procured during the implementation stage of the rescue process against those existing before the business rescue.

In recognition of the importance of post-commencement finance, s364 of the US Bankruptcy Code provides that any credit extended to the company during reorganisation enjoys priority over unsecured claims incurred before the rescue process. The prioritisation of post-commencement creditors thus motivates lenders to assist an ailing company in the hope that they are preferred over existing creditors and, hence, a guarantee of their payment. The SA Companies Act has also adopted this concept from the US Bankruptcy Code. It thus ensures that post-commencement creditors may safely be secured against assets that are not encumbered.[369] Section 135(3)(b) outlines how post-commencement creditors are ranked in preference against other liabilities and existing creditors. It prioritises the rescue practitioner's remuneration, different administrative costs, and post-commencement employment-related financial obligations over the post-commencement creditors, who are ranked third in this regard, surpassing only unsecured & secured pre-existing creditors. In my opinion, employee remuneration owed by the company before or during post-commencement should be treated equally as company debt rather than rescue operational costs. Thus, such outstanding payments would make employees company creditors for rescue proceedings. This is premised on the view that it would not incentivise a post-commencement creditor to know that internal stakeholders such as employees have priority over them in repaying debts. The legislature should reconsider section 135(3) on ranking these financial obligations in line with the US Bankruptcy Code, which prioritizes post-finance commencement creditors over all

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368 465 US 513 (1983) 528.
369 s 135 (2) of the Companies Act.

other categories of creditors. Thus, this would then incentivise post-commencement creditors and help ensure a successfully funded and functioning rescue process.

2.4.4. 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 reinstated to its solvent status 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.[370] This is confirmed in the *Anglo Irish Bank Corporation Ltd`s case*,[371] 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 the business rescue process as the process diverts a business from a profit goal orientation to that of focusing on dealing with its financial obligations.[372]

Notably, during rescue proceedings, creditor rights/ or claims are frozen by a moratorium, which is aimed at allowing a business rescue practitioner to resuscitate the financially ailing company if possible. Regardless of the latter, creditors still have a right to approach the court and deal with any outstanding issues as long as they acquire consent from the business rescue practitioner or should they acquire leave from the court on any grounds the court deems suitable.[373] This may give creditors grounds to approach court where, during the business rescue process, a business rescue practitioner or any influential employee begins to abuse the process or trade in circumstances prohibited in section 22 of the Companies Act. However, obtaining leave from the court may not be a straightforward exercise as one must justify the need for such leave. This is supported by Kgomo J in the following *obiter dictum*

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[370] s 128(1) (b) (iii) of the Companies Act.

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

[372] Nwafor (n352).

[373] s 133(1) (a) & (b) of the Companies Act.

concerning justifying the need for leave of court to deal with the 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.[374]

Thus, one has to place the court in the light of his grounds to seek such leave, yet it is the court`s discretion to consider such grounds suitable. This entails that no specific grounds are laid down that 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 the 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 preceding, 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.[375] This again gives creditors leeway in terms of section 214 of the Companies Act to instigate the laying of criminal charges against any criminal acts which prejudice their interests during rescue proceedings.

It should be noted that this gives effect to creditor rights. However, such rights are frozen by a moratorium that ensues from business rescue, and the temporary setback is equivocally compensated by the fact that creditors are given a right to participate in or influence the business rescue process actively.[376] Thus, to a certain extent, creditors automatically acquire the right to act as insiders to company affairs to monitor the flow of the business rescue plan to protect their interests.[377] On the premises, the

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374 *Merchant West Working Capital Solutions (Pty) LTD v Advanced Technologies and Engineering Company (Pty) Ltd and Another* (13/12406) [2013] ZAGPJHC 109 (10 May 2013) at para 67.

375 s 133(1) (d) of the Companies Act.

376 Cassim, 'Business rescue and compromises' (n94) 902.

377 ibid; where it is alluded that creditors acquire same rights as those of employees during business rescue processes.

company's creditors have a right to vote to amend, approve, or reject a proposed business rescue plan; if rejected, they may suggest an alternative plan.[378]

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.[379] Creditors also have a right to form a joint committee constituting independent creditors, which would directly deal with business rescue practitioners to safeguard creditor interests.[380]

Moreso, it should be noted that business rescue proceedings should be completed within a short 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.[381] The reason for such time bars is to ensure that the enforcement of the creditor's rights, including their right to institute legal proceedings against the company, is not unnecessarily or unreasonably prolonged or kept in abeyance.[382] It is for the same reason that the business rescue practitioner will have to compile a report for assessment to justify the need to extend the three months or any period the court may have initially granted.[383] On that same token, the business rescue practitioner is charged to immediately communicate to affected parties and to the court where the business rescue plan has failed or where it is reasonably foreseen that the business plan will fail.[384] In *Gormerly v West City Precinct Properties (Pty) Ltd,*[385] Traverso DJP cautioned that the moratorium provisions could be subjected to

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378 s 145(2) of the Companies Act.

379 s 145(1) (a) - (d) of the Companies Act.

380 See Cassim, 'Business rescue and compromises' (n94) 902, 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.

381 s 132 of the Companies Act.

382 Nwafor A, 'Moratorium in business Rescue Scheme and Protection of Company's Creditors' [2017] 13 (1) CBRDCJ 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'.

383 s 132 of the Companies Act.

384 s 81, s 132 and s 142 of the Companies Act. A business rescue process is preferred alternative to the liquidation process hence its failure mostly welcomes the liquidation process.

385 [2012] ZAWCHC 33, para 15.

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 the legislature in incorporating the business rescue concept into South African company legislation, which is to ultimately safeguard the interests of creditors while at the same time allowing for economic development through allowing financially struggling companies to revive.

Finally, compared with proposals for creditor compromises where the contents of a compromise plan are clearly outlined, there is no specific/or detailed outline of how a business rescue plan should be, leaving uncertainties in that regard.[386] It thus follows that what is constituted in a business rescue plan should be informative enough to allow creditors to decide whether or not to adopt such a plan and that such content depends on the merits of every situation that attracts the need for the rescue process.

2.4.5. Summary of the business rescue concept

The business rescue concept has brought an exciting mechanism/avenue for creditors to safeguard their interests where a company unreasonably fails to meet its obligations or is insolvent. A properly designed business rescue plan would help the company rescue for the company's and its creditors' benefit. It is most likely that the business rescue process may fail as lending institutions may be sceptical about dealing with a company under business rescue. Be that as it may, it is also a goal of the business rescue process that even when it fails, 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 the same employee rights. Therefore, the researcher believes that creditor interests are protected mainly 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.[387]

[386] s 155 (3) of the Companies Act.
[387] The UK, the USA etc.

2.5. Conclusion

It has been the primary inquiry of chapter 2 of this research thesis to evaluate the effectiveness of creditor protective mechanisms in South African corporate legislation, the main focus being mechanisms set to deal with insolvent or its possibilities as entrenched in the Companies Act. Concerning the “solvency and liquidity test” mechanism, the legislature is reckoned to ensure a step away from capital maintenance rules in preference to it and thus adjust to global trends as reflected in most comparable jurisdictions. The Companies Act has dramatically expanded the scope of the solvency and liquidity test, unlike in the 1999 Amendment Act to the 1973 Companies Act, such that many transactions that are good for healthy corporate governance are now allowed as long as they pass the solvency and liquidity test.[388] The solvency and liquidity test, although it has been found that its application should be revisited in some circumstances, has helped ensure 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.[389] Creditors' interests are also safeguarded during liquidation processes and compromises under the Companies Act.

The newly statutorily adopted business rescue process allows a company to revive its financial stamina as a going concern while creditor rights are temporarily frozen. The goal of this mechanism is to restore the company`s financial stamina. However, it is generally accepted that even when competition for revival fails, the result should at least be a better output than creditors and shareholders would get in the event of outright employment of liquidation processes. Conclusively, although the legislature has to deal with some discrepancies in some of these mechanisms, significant development of creditor protection laws is evidenced by the statutory adoption of the business rescue process, the solvency and liquidity test, the reformation of liquidation laws in as far as solvent companies are concerned and also how creditor compromises or arrangements are clearly articulated in Companies Act.

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

389 Sibanda (n137) 35.

CHAPTER 3: *AD REM* PROVISIONS & MECHANISMS FOR SOUTH AFRICAN CREDITOR PROTECTION LAWS

3.0. Introduction

The Companies Act has since adopted creditor-protection mechanisms from its predecessor[390] to address the need to provide appropriate legal redress to investors and third parties (creditors).[391] It has adopted new mechanisms from common law and other jurisdictions with well-developed corporate law jurisprudence. The previous chapter discussed those mechanisms directly meant to address different circumstances related to insolvency or its possibilities. This chapter shall thus examine other mechanisms derived from company laws other than those intended to address insolvent circumstances. The chapter further discusses various enforcement platforms in the Companies Act to ensure creditors have access to justice systems at all times. It also infringes on other legislation besides company legislation and thus briefly examines credit law principles derived from there. Therefore, the effectiveness of such creditor protection mechanisms and principles of credit law shall be holistically reviewed to determine how these provisions or mechanisms advance the protection of creditors in company affairs. The following mechanisms and principles of credit law from provisions are thus canvassed:

- "Sanctioning of directors & prohibition of reckless trading"
- "The *Turquand* rule"
- "The piercing of the corporate veil"
- "Derivative action"
- "Credit systems"
- "Enforcement mechanisms"

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390 The Companies Act of 1973.
391 See preamble of the Companies Act.

3.1. Sanctioning of directors & reckless trading

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, particularly directors and their immediate subordinates such as managers and other important officials in the company (prescribed officials). 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 conduct. 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.

The Companies Act departs from the past in that, in line with the 1973 Companies Act, directors were to be held criminally liable for certain unlawful conducts/ contravening provisions of the 1973 Companies Act, and they would typically incur civil liability under the common law except for some instances where civil liability was statutory.[392] The Companies Act attempts to decriminalise directors` liability in most instances in favour of civil liability. One would suggest that imposing criminal and civil liability would completely deter directors from engaging in certain unlawful dealings at the expense of other stakeholders. Criminal sanctions are problematic because they threaten the director`s ability to perform his duties freely without fear of being 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 Companies 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 company's best interests, and with the degree of care, skill, and diligence expected from a reasonable director. Suppose one is to act in the best interests of the company. In that case, he is expected to uphold several stakeholders' interests. For the company's best interests to be achieved, the stakeholders must be satisfied, including creditors who are essential to the ongoing concern of the business

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

operations through their supplies and funding. In some circumstances, a director acting in the company's best interests will save himself and the company from inevitable civil suits or criminal liability. Section 77(1) - (10) of the Companies Act statutorily sets out the liability of directors and prescribed company officers in several different transactions. The provision also applies to members of the audit committee and a committee of the board, irrespective of whether the persons serving on the committee are directors of the company or alternate directors. Section 77(2) of the Companies 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, specifically regarding breach of directors' duties and any related delictual losses. The Companies Act has taken cognisance of common law. It 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.

3.1.1. 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 between the 1973 Companies Act and the importance of creditor protection thereof.

3.1.1.1 Acting on behalf of the company without authority

A director who acts for the company without necessary authority will be held personally liable for the loss the company may suffer.[393] This reconciles with the fact that the

[393] s 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

Companies Act, unlike the 1973 Companies Act, now has given credence to the *Turquand* rule *in place* of the 1973 Companies Act`s doctrine of constructive notice.[394] Under the Companies 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. Still, it shall have recourse against its directors who so acted. This development is essential as far as creditor protection is concerned.

3.1.1.2 Fraudulent, reckless, and insolvent trading

A director shall be held personally liable for losses, damages, and costs if he consents to carry on the company's business despite knowing that it is prohibited in section 22.[395] Section 22 of the Companies 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 mainly affects creditors who may keep supplying goods or investing in a company without knowing about it. Its directors are further called to apply their minds and act reasonably, ensuring they avert any reckless treading or fraudulent conduct. This is for the company's best interests and the best interests of several stakeholders and creditors, who are of the essence in this research.

Still on fraudulent trading, under section 77(3)(c) of the Companies Act, a director will be explicitly held 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 stakeholders, such as creditors, makes this sanctioning of the essence for this research. Creditors` interests are safeguarded, knowing the law covers any fraudulent conduct against them. Some directors falsify the company's financial statements to convince creditors they can afford the credit facility. Section 77(3) (d) of the Companies Act strictly holds directors liable for authorizing financial statements or company documents, such as the

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.

394 The *Turquand* rule is discussed in subsequent paragraphs.

395 s 77(3) (b) of the Companies Act.

prospectus, when they knew that third parties would be misled into believing a false picture.

Comparably, section 424 of the 1973 Companies Act governed fraudulent and reckless trading. Still, it was limited to judicial management and insolvent and solvent companies' winding up or liquidation.[396] The researcher believes that acting “recklessly” consists of failing to consider the consequences of one’s actions. It entails an attitude of reckless disregard for such consequences. In the context of s 424 of the 1973 Companies Act, the court should have regard, amongst other things, to the scope of operations of the company, the role, power, functions, and powers of the directors, the amount of the debts, the extent of the company’s financial difficulties and the prospects, if any, of recovery. Whether a company could not pay its debts when they were due, which is pertinent in assessing whether the company has conducted its business recklessly, was a question of fact decided as a matter of commercial reality. In *Raflatac SA (Pty) Ltd v Bell & Another,*[397] Plaintiff alleged that Defendant was trading recklessly and insolently. However, efforts that the Defendant had made to limit the prejudice on the plaintiff by keeping in abeyance the existing debt and making future purchases on a cash basis led the court not to find the defendant to have acted recklessly concerning insolvency.[398] It is then up to the Defendant to prove that they had not been operating under insolvency conditions depending on the facts of a particular case.

On the other hand, Section 22 of the Companies Act is broader as it is not constricted to winding up or liquidation time. That is, there is no need first to have the company undergo liquidation processes to discover whether it was trading under insolvent conditions. However, the discovery dates back to a period before liquidation, and directors would account for why they traded under such unlawful conditions. Section 22 of the Companies Act has also added another type of wrongful trading, "trading

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396 s 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…”

397 (3017A/2009) [2012] ZAECGHC 5 (2 February 2012).

398 ibid.

under insolvent conditions," which safeguards more of the interests of creditors. In *Ozinsky NO v Lloyd,*[399] 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.

Previously, the creditor had a *locus standi* or right to participate in or institute proceedings in court or any forum for a claim under s424 (1) of the 1973 Companies Act. It didn't matter that the other creditors, with more than one creditor, had not applied regarding s424 (1), but s424 (1) could cover the affected creditor. If it appeared that the company's business was being carried on recklessly, with gross negligence, or with intent to defraud any person or for any fraudulent purpose, the creditor could enforce the remedy against the company`s directors. In *Terblanche No & Others v Damji & Another*[400] Knoll J held that for this court to exercise discretion to visit the respondent with personal liability for the company's debts the relevant portions of s 424(1) required the applicants to establish that the business of the company, which may refer to any one of the transactions, was carried on (i) recklessly; or (ii) with intent to defraud creditors (aa) of the company; or of any other person; or (iii) with any fraudulent purpose; (iii) by any person who was knowingly a party to the carrying on of business in the manner aforesaid. In *Cooper & Others NNO v Mutual Life Assurance Society & Others,*[401] the court took the same view adopted in *Burley Appliances v Grobelaar No & Others*[402] when it held that section 64 of the Close Corporation Act 69 of 1984, which is applied the same as s424 (1), created statutory rights and corresponding liabilities when the business of the Close Corporation is carried out recklessly or with gross negligence or with the intent to defraud any person or for any fraudulent purpose. The section provides that '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

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399 1992 (3) SA 396 (C) at 414G.
400 2003 (5) SA 489 (C) pp 510.
401 2001 (1) SA 967 (SCA).
402 2004 (1) SA 602 (C).

Court may direct.' In *Bowman NO v Sacks & Others,*[403] the court held that persons regarded as possible applicants under section 424 (1) are those with a direct and substantial interest in the subject matter in question. It is thus trite law that he who has a substantial interest in a matter has *locus standi* in common law.

On the other hand, section 22 of the Companies Act, in addition to giving powers to the Companies Commission to investigate and ensure compliance with the Act in this regard, is also backed up by section 218(2) of the Companies Act, which gives *locus standi* to creditors to deal with unlawful conducts which affect their rights in company affairs. With section 218, creditors may approach court to claim for costs, losses, or damages perpetuated by an unlawful act of a director. Section 214(1) (c) of the Companies Act carries on with 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 Companies Act. Section 214 of the Companies Act only invites criminal sanctions to deter specific and limited crimes, contrary to the 1973 Companies Act, which had a broader application of criminal sanctions 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 that is of the essence in protecting 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 Companies Act or a limitation, restriction, or qualification contemplated in section 20 of the Companies Act unless there is ratification by shareholders.[404] Thus, when shareholders have recourse against directors who mismanage the company affairs, it entails a deterrence of abuse of creditor interests, among others. However, creditors may not have the same *locus standi* as shareholders.

Directors may incur personal liabilities because of their role in governing the company. The company is a separate legal entity with its liabilities. Still, proceedings may also be instituted against directors, and 'the most commonly encountered basis for liability

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403 1986 (4) SA 459 (W).
404 s 20(6) of the Companies Act.

is that a director or any other person took part in, allowed, or authorized specific conduct of the company.' In this instance, the directors are generally liable under the above general requirements. Section 22 of the Companies Act applies even if the company is still an ongoing business, irrespective of whether or not the company is wound up. Therefore, s22 is not confined to a winding up of the company.

3.1.1.3 Participation in a meeting that authorises unlawful transactions

Section 77(3)(e) of the Companies Act lists several transactions that will inevitably attract liability to 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 that are relevant to creditor protection as follows;

Financial assistance: Directors would, under the Companies Act, be held personally liable for damages, losses, and costs that the company may suffer as a result of participating in a meeting and failing to vote against a resolution for providing financial assistance for the acquisition of securities to any person despite knowing that the financial aid is in contravention of section 44 or the company's Memorandum of Incorporation.[405] Moreover, a director will be held liable for participating in a meeting and failing to vote against providing financial assistance to a director or prescribed officer under section 45 despite knowing that it contravenes the Act or the company's Memorandum of Incorporation.[406]

Section 38(3) and s 37(2) of the 1973 Companies Act imposed criminal liability on directors who engaged in financial assistance as it was then strictly prohibited. On the other hand, sections 44, 45, and 77(3) of the Companies 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 specific contexts, and the criminal liability provision should have been retained for sections such as this one.[407] A proper deterring sanction against directors who abuse the

405 s 77(3) (e) (iv) of the Companies Act.
406 s 77(e) (v) of the Companies Act.
407 Only s 214 of the Companies Act retains criminal liability on limited grounds.

current leeway to give financial assistance will help avert the abuse of creditor interests as propounded above.

Distributions, including the 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 under section 46 and also for supporting an acquisition by a company of any of its shares despite knowing that the said acquisition was contrary to sections 46 or 48.[408] 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 conclude that the company would satisfy the solvency and liquidity test after making a distribution.[409] 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;[410] and
- Requiring the company to indemnify any director who has been or may be held liable, including indemnification for costs of the proceedings.[411] 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 also benefit creditors protected by the solvency and liquidity test. Comparably, the 1973 Companies Act gave creditors *locus standi*, concerning the acquisition of shares, to approach the court against unlawful acquisition as provided by section 86(3), which reads as follows;

408 s 77(3) (e) (vi; vii) of the Companies Act.
409 s 77(4) (a) of the Companies Act.
410 s 77(5) (b) (ii) (bb) of the Companies Act.
411 s 77(5) (b) (ii) (bb) of the Companies Act.

> "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."

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

Falsifying accounting records and financial statements: When accounting records and financial statements are wrongly tempered, many stakeholders fall for the deceit. For instance, investors or potential creditors would need a true picture of accounting records and financial statements to assess whether or not their prospective debtor company qualifies for the extent of financial advance or credit supply envisaged. If a true picture is concealed, these third parties may wrongly invest in a debtor company that is perhaps insolvent, which is detrimental to the innocent third party. The Companies Act thus deters company controllers from failing to keep accurate and complete accounting records and from falsifying financial statements. Section 28(3) provides as follows:

> (3) It is an offence for—
> *(a)* a company—
> (i) with an intention to deceive or mislead any person—
> *(aa)* to fail to keep accurate or complete accounting records;
> *(bb)* to keep records other than in the prescribed manner and form, if any;
> or
> (ii) to falsify any of its accounting records, or permit any person to do so; or
> *(b)* any person to falsify a company's accounting records.

The preceding provision reveals that, in most cases, the intention is to deceive or mislead someone. It is a global dilemma that books are usually cooked to suit the

needs of the person who consents to such intentions for an intended goal. The law, however, boldly set itself to hold someone criminally liable for such defrauding intentions.[412] Where one also suffers civil damages after having acted on the strength of inaccurate and incomplete accounting records, the researcher understands that section 218 of the Companies Act would be applied to hold the person personally liable for such damages.[413]

On the other end, financial statements should be prepared according to approved accounting standards in a manner that fairly presents the company`s state of affairs, the financial position, the correct transactions, the company's assets, liabilities, and equity, as well as its income and expenditure, and any other prescribed information.[414] Section 29(6) insinuates criminal liability on those who act in a manner prohibited concerning the preparation and approval of financial statements; it reads as follows:

> (6) Subject to section 214(2), a person is guilty of an offence if the person is a party to the preparation, approval, dissemination, or publication of—
> *(a)* any financial statements, including any annual financial statements contemplated in section 30, knowing that those statements—
> (i) do not comply with the requirements of subsection (1); or
> (ii) are materially false or misleading, as contemplated in subsection (2); or
> *(b)* a summary of any financial statements, knowing that—
> (i) the statements that it summarises do not comply with the requirements of subsection (1), or are materially false or misleading, as contemplated in subsection (2); or
> (ii) the summary does not comply with the requirements of subsection (3), or is materially false or misleading.

Section 29 clearly outlines instances that may lead to criminal prosecution. It further acknowledges the ultimate operation of section 214 on such matters. Likewise, section 218 would be relevant to civil liability arising from the fraudulent presentation of incorrect financial statements. These provisions protect creditors since they are third parties and cannot readily ascertain the sufficiency of accounting records and financial statements presented before them as prerequisites to conclude certain transactions.

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412 s 28 & 214 of the Companies Act.

413 s 218(2) provides that any person who contravenes any provision of the Companies Act is Liable to any other person for any loss or damage suffered by that person as a result of that contravention.

414 s 29(1) of the Companies Act.

3.1.2. Summary of director liability

Conclusively, one would note that directors were much threatened by criminal sanctions under the 1973 Companies 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 advantage, one would apply to lift the corporate veil under the common law as this was not statutorily provided for. The Companies Act has far-reaching developments concerning the sanctioning of directors. The codification of the director`s fiduciary duties is essential for ascertaining the law concerning what a director is expected to do.[415] Section 77 codifies the common law position as far as a breach of fiduciary duty is concerned.[416] 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.[417]

In addition, section 77(3) lists examples of unlawful transactions in which directors may be held liable due to 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 to it should a particular set of facts not fall squarely within the ambit of the examples provided in section 77(3).[418] In most cases, the decriminalisation of director liability in favour of civil liability reflects the adoption of the common law principle of piercing the corporate veil, which shall be discussed in Chapter 4 regarding creditors' protection. The courts are to look beyond the veil of the company and attach liability upon a director who blindly commits prohibited acts/ omissions at the expense of the legal person.[419] With this, creditors remain with many remedies available regarding statutory corporate laws backed up with their usual common law remedies. Although the provisions are imperfect, one would want to acknowledge these legal developments on creditor protection as they

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415 s 75 & 76 of the Companies Act.

416 s 77(2) (a) of the Companies Act.

417 s 77(2) (b) of the Companies Act.

418 Grové AP, 'Company Directors: Fiduciary Duties and the Duty of Care and Skill' (LLM Thesis, UP 2012) 47.

419 s 20(9) of the Companies Act. The section gives any interested party the *locus standi* to use this remedy of last resort.

make the law certain and easily accessible. A comparison shall thus be made with counterpart provisions in select cognate jurisdictions in the subsequent chapters.

3.2. The *Turquand* rule and creditor protection

3.2.1. Introduction

The *Turquand* Rule or ‘the indoor management rule’ emanated from an English case, *Royal British Bank v Turquand.*[420] This common law principle was initially intended to mitigate the unbearable effects of the doctrine of constructive notice[421] by entitling *bona fide* third parties who contract with a company to assume that all of the company’s internal governance necessary to conclude a valid contract has been complied with.[422] In the genesis case, *Royal British case,* the company's articles of association authorized its board of directors to borrow money provided they obtained prior approval from shareholders. The board borrowed money from Plaintiff without shareholders` approval. The Bank or Plaintiff did not know 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 (the 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.[423] The *Turquand* rule was introduced and applied in South Africa in the case of *Mine Workers’ Union v Prinsloo,*[424] where it was held to form part of South Africa`s common law for the future development of common law. In *Tuckers Land and Development Corporation (Pty) Ltd v Perpellief,*[425] the court stated the following concerning this common law principle;

[420] (1856) 6 E & B327, 119 ER 886.

[421] ibid. “The *Turquarnd* 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.”

[422] Cassim, ‘Corporate Capacity, Agency and the *Turquand* Rule’ (n94) 181.

[423] *Gormerly `s* case (n202) para 15.

[424] 1948 (3) SA 831 (A).

[425] 1978 2 SA 11 (T) 15.

> [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, 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 preceding insight helps clear out certain misunderstandings regarding circumstances where 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 act. In addition, a third party who lacks knowledge of internal affairs but is nevertheless suspicious that an internal irregularity might have occurred cannot rely on the *Turquand* rule.[426] Thus, a third party will likely inquire into such suspected irregularities.[427]

Moreover, the Turquand rule does not protect a third party that acts on the strength of forged documents.[428] This possibly flows from a common law understanding that no legal remedy is allowed out of an unlawful cause.[429] To invoke the *Turquand* Rule, one

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[426] *Northside Developments (Pty) Ltd v Registrar General* (1990) 8 ACLC 611.
[427] ibid.
ibid. *Rueben v Great Fingall Consolidated* 1906 AC 439 (HL).
[429] Common law maxim: "*Ex Turpi Causa Non Oritur Actio".*

will have to rely on the doctrine of estoppel,[430] which debars the company from denying a creditor`s claim based on non-compliance with internal rules when the agreement was concluded, e.g., lack of authority by the 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, which will be dealt with in the succeeding paragraph.

3.2.2. The Companies 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 Companies 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.[431] 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 prudent when dealing with ring-fenced companies, for they will be presumed/ deemed to know the company`s memorandum of incorporation and its restrictive conditions, which may affect any third party who blindly deals with such companies.[432] 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.[433] The joint and several liability of directors of such companies is limited to debts and liabilities contracted during their periods of office.[434] It is the researcher`s view that creditors should thus take extra caution and ensure that fruitful arrangements are made for debt repayment, whether within or outside the responsible director`s term

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430 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 sanction is estopped. 'Estoppel' <https://en.m.wikipedia.org/wiki/Estoppel> accessed 29 October 2018.

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

432 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 Companies Act.

433 Cassim, 'Corporate Capacity, Agency and the *Turquand* Rule' (n94) 180-1.

434 *Fundstrust Pty Ltd (In Liquidation) v Van Deventer* 1997 (1) SA 710 (A).

of governance or that they claim all their debts before a responsible director`s term expires or before their demise or their unexpected unavailability as that would impair on a creditor`s recourse options.

The *Turquand* rule is thus, for the first time, introduced into South African legislation by section 20(7), read together with section 20 (8) of the Companies Act. The sections are 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.
> (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 with direct access to the company's information, such as directors, prescribed officers, and shareholders, to rely on the *Turquand* rule. 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 be protected is expressly excluded, and an institutional rather than a functional category is established.[435] It is unclear why only these categories are excluded, and the functional category is secluded.[436] There are thus similarities between the statutory and common law indoor management rules. The overlap between the two shows that section 20(7) goes much further than the common law *Turquand* rule in dealing with third parties whom the *Turquand* rule may not cover. 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. It excludes a third party who 'reasonably ought to have known.'[437] This widens the scope of third parties whom the *Turquand* rule may not protect, putting creditors at risk of failing 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

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435 Delport PA, 'Companies Act 71 of 2008 and the *Turquand* Rule' [2011] JCRDL 136.
436 ibid.
437 ibid 187.

confirmed in a 2015 case, *One Stop Financial Services (Pty) Ltd v Neffensaan Ontwikkelings (Pty) Ltd & Another*,[438] 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. Still, this time, with much freedom of its application as its primary reason for existence, the ramifications of the doctrine of constructive notice have now been repealed. Some commentators thus wonder as to why there is a need for the *Turquand* rule when the constructive notice doctrine has been repealed. In contrast, others believe dealing with the remnants of this doctrine in ring-fenced companies and personal liability companies is necessary.[439] 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 Companies Act overrides any memorandum of incorporation.[440] 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 or ostensible authority, unless such a company is a ring-fenced company.

3.2.3. Summary of 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 determining whether the company representative has the authority to act on behalf of the company. The concurrent application of the common law *Turquand* rule and the statutory one cannot be understated. That being said, it should be noted that the doctrine of constructive notice

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438 2015 (4) SA 623 (WCC).

439 Davis D, *et al, Companies and Other Business Structures in South Africa* (OUP, 2013) 42.

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

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.

3.3. The piercing of the corporate veil and creditor protection

3.3.1 Introduction

A company has a separate legal (juristic) personality from its members (the shareholders) and 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 its best interests while it is assumed to be owned by its shareholders.[441] The United Kingdom case of *Salomon v Salomon & Co Ltd*[442] is a seminal case for the existence of a company as a 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.[443]

According to *Rajak*, a specific challenge arises when the threat of civil personal liability influences directors' decisions: ' How to balance the interests of creditors and directors in terms of legislative provisions?'[444] 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 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 piercing the corporate veil to hold them personally liable.

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441 s 76 of the Companies Act.
442 [1897] AC 22 (HL).
443 See Sibanda *(n137)* 35, on the enlightened shareholder value approach.
444 Rajak HH, 'Director and Officer Liability in the Zone of Insolvency: Comparative analysis' [2008] PELJ 211.

The concept of piercing the corporate veil is sometimes referred to as the 'lifting of the corporate veil,' although these terms have different meanings.[445] This is beyond the scope of this discussion. However, it should be noted that courts would typically refer to 'piercing the veil' when they intend to treat company liabilities as those of shareholders or directors and disregard the company's separate legal personality.[446] In contrast, the courts would refer to 'lifting the veil' as that point when they merely consider who the company`s shareholders and directors are.[447] 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.[448] The concept is applied reservedly in situations of fraud, dishonest and improper conduct, as shown in the *Knoop NO*[449] case where the court held the following:

> 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 when the company is stripped of all its assets and creditors have nowhere else to look to recover their debts. They may approach the court to look beyond the veil and hold those 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.[450] Although it is accepted that the separate legal personality principle has to be sometimes disregarded, there have been inconsistencies in applying the piercing of the veil concept. So far, there were no clear

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[445] Sometimes termed as "*looking beyond the veil*".

[446] Cassim, 'Legal Concept of a Company' (n94) 46.

[447] ibid.

[448] 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.

[449] ibid, *Knoop* case.

[450] *Cape Pacific* (n448).

guidelines for when the courts would pierce the corporate veil.[451] The Appellate Division in the *Cape Pacific* Case[452] has endeavoured to lay specific 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.[453]

- Courts should know they do not have the general discretion to disregard the company as a separate legal personality whenever they consider it just to do so.[454]

- It is stressed that there is yet no formulation of general principles about when and when the corporate veil may be pierced. Thus, each case must be treated on its own merits.[455]

- It was stated that where there is fraud, dishonesty, or other improper conduct, the need to preserve the separate legal personality would, in such circumstances, have to be balanced against policy considerations that arise in favour of piercing the corporate veil.[456]

- 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.[457]

- 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.[458]

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451 ibid.
452 ibid.
453 ibid, 803.
454 ibid 803.
455 ibid 802.
456 ibid 803.
457 ibid 804.
458 ibid 805.

However, the above guiding principles are 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*,[459] it was held that the mere fact that a company has only one shareholder in complete control does not constitute a basis for disregarding its separate personality. In *The Shipping Cooperation of India Ltd v Evdoman Corporation and Another*,[460] Corbett CJ, after indicating that he did not find it necessary to attempt to define the circumstances in which the Court would pierce the corporate veil, held that those circumstances would include where there is, "fraud or other improper conduct in the establishment own use of the company or the conduct of its affairs''. It was noted by His Lordship also, Smalberger JA in the *Cape Pacific case* as follows:

> "The law is far from settled with regard to the circumstances in which it would be permissible to pierce the corporate veil. Each case involves a process of enquiring into the facts, which, once determined, may be of decisive importance...I do not deem it necessary or advisable in the present appeal to attempt to formulate any general principles with regard to when the corporate veil may be pierced."[461]

The preceding view was also accepted by the court in *ADT Security (Pty) Ltd v Botha and Others,*[462] where it was stated as follows:

> "Much will depend on a close analysis of the facts of each case, considerations of policy and judicial judgment. Nonetheless what, 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."

The preceding is also corroborated in *Botha v Van Niekerk*, [463]where it was held that the court will pierce the veil when the Plaintiff has suffered unconscionable injustice due to improper conduct on the defendant's part. Although this approach was refused in the *Cape Pacific* case,[464] it seems the Companies Act, as discussed below, portrays an almost similar wording, notwithstanding that it is directed at the offended person

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459 2007 (3) SA 34 (SCA) para 11.

460 1994 [1] SA 550 [A] at page 566 F-C.

461 *Cape Pacific* (n448)

462 [2010] ZAWCHC 563, at para 17.

463 1983 (3) SA 513 (W), 525.

464 *Cape Pacific*(n448), 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.

and not necessarily the company itself. It is thus of essence that the provisions of the Companies Act be examined below.

3.3.2. Piercing the veil under the Companies Act vis-à-vis creditor protection

Piercing the corporate veil is one of the corporate principles 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 Companies 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 deters directors or shareholders from unconscionably abusing the legal personality of a company. Courts have the discretion to deal with any such action that qualifies as an 'unconscionable abuse' should any affected or interested person approach the court on notice of motion supported by a substantial affidavit laying out the acts of 'unconscionable abuse.' According to the *Gore* case,[465] in 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. Using the word 'may' shows that courts have discretion on whether to pierce the corporate veil. 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.

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 wrongdoer's conduct to determine whether such

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

conduct constitutes 'unconscionable abuse.'[466] Suppose the conduct constitutes 'unconscionable abuse' of the juristic personality of a company as a separate legal entity. In that case, the court may exercise its discretion and pierce the corporate veil, holding the wrongdoer liable. What constitutes 'unconscionable abuse' may be derived from common law, such as fraud, dishonesty, or any conduct so considered; hence, the list cannot be a closed one in terms of section 20(9).[467] Comparably, regarding the Close Corporations Act of 1984, the test for piercing the corporate veil is 'gross abuse of the separate legal personality of a company.'[468] According to the court in *Ex Parte Gore*,[469] 'unconscionable abuse' is less extreme than 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 concerning the formation and use of companies diverse enough to cover all the descriptive terms like 'sham,' 'device,' and 'stratagem.'[470] Section 20(9) is a solution or a remedy for 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.[471] In a 2017 case, *City Capital SA Property Holdings*[472] Schippers AJA gave the following meaning to 'unconscionable abuse':

> 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 to pierce the veil under the Companies Act compared to the common law ambits. However, It is recommended that the common law meaning be used concurrently with the new provisions to enhance the interpretation of the meaning of 'unconscionable

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466 Mashiri PT, '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' (LLM thesis, UKZN, 2016) 33.

467 ibid.

468 s 65 of the Close Corporation Act 1965.

469 *Gore* case (n465) 34.

470 ibid.

471 ibid.

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

abuse.'[473] Before the Companies Act, Scott JA in *Hulse-Reutter and Others v Godde*[474] 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 to justify the application of section 20(9) of the Companies Act. Instead, it has to result in company controllers having an unfair advantage at the company`s expense, resulting in unconscionable abuse. 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.[475] It is trite that fraud is purposed at unduly enriching or benefiting the fraudster at the victim's expense. 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.[476]

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 that justify piercing the corporate veil are still far from being settled.[477] Courts will, however, look beyond the corporate veil where justice requires it, not only when there is no alternative remedy.[478] Unconscionable abuse of a juristic personality should not be an exhaustive list but should be determined according to the merits of each case. In a nutshell, the general approach to be adopted when dealing with an application to pierce the corporate veil has been summarised by Steenkamp J in

473 *Gore* (n465) 34.
474 *Hulse-Reutter and others v Godde* [2002] 2 All SA 211 Para 20.
475 *City Capital SA* (n472).
476 Nwafor AO, 'Piercing the Corporate Veil: An Incursion into the Judicial Conundrum' [2015] 11(3), CBRDCJ *148*.
477 ibid 146.
478 *Gore* (n465) para 28.

Zeman Quickelberge and Another,[479] where it's stated that the courts will commonly require an element of fraud or other improper conduct before they will pierce the corporate veil. It is further noted in *Zeman`s* case that the piercing of the corporate veil "means disregarding the dichotomy between the company and the natural person behind it and attributing liability to that person where he has misused or abused of corporate personality." In these circumstances, a court will be entitled to look into substance rather than form to arrive at the facts. The court does not require "unconscionable injustice" to determine whether the veil should be pierced as formulated in Botha`s case above, and it was found that it was perhaps too rigid of a test. The court opted for a more flexible approach, allowing the facts of each case to determine whether the piercing of the veil was the ultimate remedy. In principle, there is no basis for why piercing the corporate veil should necessarily be precluded if another remedy exists. As a general rule, if a person has more than one legal remedy at his disposal, he can select any of them, and he is not obliged to pursue one rather than the other. If the facts of a particular case otherwise justify piercing the veil, the existence of another remedy and the failure to pursue that available remedy should not, in principle, serve as an absolute bar to a court granting relief. The existence of another remedy or the failure to pursue it may be a relevant factor when policy considerations come into play, but they cannot be of overriding importance.

Having attempted to define the meaning of unconscionable abuse above, it is thus essential to consider the 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 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 noted 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

[479] (2011) 32 ILJ 453 (LC).

> remains a figment of law, liable to be curtailed or withdrawn when the objects of their creation are abused or thwarted.[480]

Thus, the court must weigh the balance scales between the need to promote the interest of justice where unconscionable abuse is also evidenced and the need to preserve the corporate principle of juristic personality existing separately from company owners and controllers. Suppose the scales of balance are in favour of the juristic personality`s separate existence principle. In that case, 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 the court to seek orders in terms of subsections (a) & (b). The meaning of an interested person is not given in the Act. However, an interested person must indeed be interested in the subject. The established principle is that to be considered an interested person; one needs to have a direct and sufficient/ or substantial interest or perhaps have their rights enshrined in the Bill of Rights infringed upon.[481] On the premises, a creditor whose rights or interests have been affected due to an unconscionable abuse of the juristic personality of a company will, by all means, qualify as an interested person, hence having the right to stand before the court. It follows that the researcher believes that the preceding understanding will unequivocally apply where a creditor`s interests are affected by the 'unconscionable abuse conduct' of those running the company's affairs.

3.3.3. Summary of Piercing of the corporate veil

Directors are obligated to act in the company's best interest, which may entail ensuring that all of the company`s stakeholder interests are reasonably balanced. A director who breaches his fiduciary duties may be held personally liable in section 20(9) of the Companies Act as long as an interested person can prove that the breach amounts to an unconscionable abuse of the company's legal personality. The same applies to shareholders who may want to manipulate directors to achieve goals by taking

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[480] *Gore (n465)* para 29.

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

advantage of the juristic person. Reckless and fraudulent trading in section 22 of the Companies Act accordingly forms part of unconscionable abuse of the juristic person; hence, one may concurrently claim against the company together or with its owners or controllers in terms of section 20(9) and section 218 of the Companies Act. Shareholders and directors are thus called to be careful in their actions as far as infringing the 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 lightly 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 that creditors will be advised to use other remedies that still hold directors liable without invoking section 20(9).[482]

The judgment in the *Gore* case is highly significant not only because it is the first case in which the statutory remedy of piercing the corporate veil was considered but also because of the valuable and thorough analysis of the authorities on piercing the corporate veil. The judgment sends a clear warning to directors, shareholders, and controllers of company groups that the corporate veil will be pierced where unconscionable abuse of the juristic personality of the company is found, including in company groups, and that the remedy will not be regarded as an exceptional one to be used only as a last resort. It appears that the statutory remedy of piercing the corporate veil would be applied by the courts with less reticence than the common law remedy of piercing the corporate veil. How the courts will further develop this statutory remedy remains to be seen. Conclusively, the legislation on the 'piercing of the corporate veil' concept thus makes available different avenues for creditors to deal with their affected rights in dealing with debtor companies, ensuring creditor protection's effectiveness through mandatory legislated company laws. The statutory piercing of the veil in the RSA should thus be evaluated compared to its implementation in select cognate jurisdictions.

482 s 22; s 214 & s 218 are important alternatives.

3.4. Derivative action

3.4.1 Introduction to derivative action

The derivative action, also known as the *derivative suit* (in the United States), is a global phenomenon.[483] It originated in the common law world and is regarded by some as one of the most exciting and ingenious accountability mechanisms for large formal organizations. When a wrong is done to a company, the action is brought by the company itself and not by its shareholders. On the contrary, a derivative action is an exception to this rule; it is brought by a shareholder, predominantly minority shareholders, on behalf of a company to protect its legal interests.[484] This is distinct from the situation where shareholders wish to enforce their shareholder rights, in which case they would have personal redress and would not have to rely on a derivative action.

The need for a minority shareholder to bring a derivative action on behalf of the company to redress a wrong done to the company generally arises when the company fails or refuses to institute legal action to redress that wrong.[485] Section 165 of the Companies Act has introduced a new statutory derivative action available to a much broader class of applicants than just minority shareholders.[486] Creditors may also use the derivative action avenue, with the leave of the court, to indirectly secure their legal rights, which may be prejudiced if the perpetrators undermine the company's interests.[487] Since it's not directly linked to creditor protection, this mechanism shall not be discussed at length in this thesis.

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483 Rotem Y, 'Pursuing Preservation of Pre-Bankruptcy Entitlements, Corporate Bankruptcy Self-Executing Mechanisms' [2008] BBLJ 79.

484 s 165(2) of the Companies Act. See also *Prudential Assurance Co Ltd v Newman Industries Ltd* (No 2) [1982] 1 All ER 354, 364.

485 s 165(5) *(a)* (i) of the Companies Act.

486 s 165(2) of the Companies Act.

487 s 165(2) *(d)* of the Companies Act provides that a person may serve a demand upon a company to commence or continue legal proceedings, or take related steps, to protect the legal interests of the company if the person — …. (d) has been granted leave of the court to do so, which may be granted only if the court is satisfied that it is necessary or expedient to do so to protect a legal right of that other person.

3.4.2. Derivative action and creditor protection under the Companies Act

In the Republic of South Africa, section 165 of the Companies Act statutorily adopted and developed the common law derivative action`s position of allowing a natural person or any stakeholder, other than a company, to bring or prosecute legal proceedings on behalf of that company. Section 165 of the Act provides for any director or prescribed officer, shareholder, registered trade union, or any other person with leave of court to serve a demand upon a company to commence or continue legal proceedings or take related steps to protect the company's legal interests. Importantly, and as discussed in the recent case of *Marib Holdings (Pty) Ltd v Parring and others*,[488] it was stated that the Companies Act sets out the basis on which a court may set aside such a demand by any person with *locus standi*. Section 165(3) of the Companies Act states that a company served with a demand may apply within 15 business days to a court to set aside the demand only because it is frivolous, vexatious, or without merit.

The derivative action is thus a mechanism that corporate law furnishes to tackle agent problems because the corporate insiders who should initiate such claims occasionally become caught in a conflict of interests. Each jurisdiction decides whether to employ a derivative action mechanism and on what terms.[489] However, corporate law regulation has become increasingly affected by surrounding regulatory environments in a globalized world that offers many attractive places where investors can incorporate their businesses. Conflict-of-laws rules usually manage the interaction between local and foreign regulatory rules.

Consequently, creditors may also employ the derivative action avenue, with the leave of the court, to secure their legal rights, which may be prejudiced if the perpetrators undermine the company's interests.[490] Under section 165, the court is entrusted with a pivotal function; the court serves as the gatekeeper to derivative actions and may disallow applications for derivative actions that are frivolous, vexatious, or without

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488 (22058/2019) [2020] ZAWCHC 74.

489 The launching of delinquency proceedings under the Companies Act 71 of 2008 by means of the derivative action–*Lewis Group Limited v Woollam* 2017 (2) SA 547 (WCC) 673-688.

490 s 165(2)(d) of the Companies Act provides that a person may serve a demand upon a company to commence or continue legal proceedings, or take related steps, to protect the legal interests of the company if the person (d) has been granted leave of the court to do so, which may be granted only if the court is satisfied that it is necessary or expedient to do so to protect a legal right of that other person.

merit.[491] The court is required to exercise its discretion regarding specific criteria for granting leave to institute a derivative action, as shown in Foss's case.[492] The common law derivative action has thus evolved to be more inclusive of protecting the rights of minority shareholders and creditors or other applicants subject to leave of the court being granted for same.[493]

The *Mouritzen* case[494] in South Africa was a litmus test to understand derivative actions under the 2008 Act.[495] In the *Mouritzen* case, Ndlovu J handed down the first judgment in South Africa concerning the new statutory derivative action. In this case, K Mouritzen and D Mouritzen were brothers and the only directors of Greystone Enterprises (Pty) Ltd ("Company"). The Mouritzen Family Trust (the beneficiaries of the families of both K and D Mouritzen) holds 98% shares in the capital of the Company, and D Mouritzen and his wife hold shares in each. K and D Mouritzen were paid equal monthly salaries by the Company and were issued credit cards in their names on the basis that transactions on those credit cards were debited to and paid by the Company. K Mouritzen alleged that D Mouritzen was abusing his credit card to the detriment of the Company and the shareholders. On 23 May 2011, K Mouritzen, through his attorneys, sent a letter that constituted a s 165(2) demand to the Company's postal address, the Company's attorneys by email, and to D Mouritzen by email, in terms of which he demanded that the Company institute legal action against D Mouritzen to compel him to produce records of his credit card transactions and necessary supporting documents to enable the Company to determine whether or not those expenses were adequately charged against the Company or were personal and liable to be paid by D Mourtzen.

In the *Mourtzen* case, the court had to derive guidelines from section 165 to consider when determining whether one may get a remedy through the provision. The guidelines were as follows;

491 s 165(3) of the Companies Act.
492 *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189.
493 s 165 of the 2008 Act.
494 *Mouritzen v Greystone Enterprises (Pty) Ltd & Another* (10442/2011) [2012] ZAKZDHC 34; 2012 (5) SA 74 (KZD) (8 June 2012).
495 Shandu S, 'Mouritzen and the New Era of Derivative Actions: Company Law, Without Prejudice' [2012] 12 (7) SAJ, 26-29.

a) **Whether the applicant acted in good faith:**[496] here, the court relied on the Australian case, *Swansson v Pratt,*[497] where the learned Judge stated as follows:

> "[I]n my opinion, there are at least two interrelated factors to which the Courts will always have regard to in determining whether the good faith requirement of s.237(2)(b) is satisfied. The first is whether the applicant honestly believes that a good cause of action exists and has a reasonable prospect of success. Clearly, whether the applicant honestly holds such a belief would not simply be a matter of bald assertion: the applicant may be disbelieved if no reasonable person in the circumstances could hold that belief. The second factor is whether the applicant is seeking to bring the derivative suit for such a collateral purpose as would amount to an abuse of process.

Thus, to pass the "good faith" test, they need to show good cause and reasonable prospects of success and that they don't seek to pursue other personal motives under the company`s shield, thus abusing the court process. In light of the preceding, the court in the *Mourtzen* case stated the following;

> "In my view, factual proof of any pre-existing personal animosity between the parties, such as in the present instance, does not *per se* serve as conclusive proof that any person referred to in section 165(2) of the Act is not acting in good faith in serving a demand under that subsection, or instituting an application under section 165(5). However, personal animosity between the opposed parties is an important factor which the Court will always take into account together with other relevant evidentiary material presented before the Court in a given situation, in determining whether or not an applicant has, on a balance of probabilities, satisfied the 'good faith' requirement".[498]

It is thus clear that courts would examine whether the presence of animosity between opposite ends is not the drive for legal action taken. The fact that there is hate does not mean it is the motive for the action. Thus, its presence should be considered, together with other relevant factors, to ensure that justice prevails in the company's best interests. Where one passes the "good faith test," the guidelines below would also suffice.

496 s *165(5) (b) (i) of the Companies Act.*

497 (2002) 42 ACSR 313.

498 *Mourtzen* (n494) para 58.

b) *Whether the proposed legal action is in the best interests of the company as envisaged in section 165(5) (b) (iii) of the Companies Act*

In as much as a person may also have genuine personal concerns on the matter, the ultimate goal should be to ensure that the suit prioritizes securing the company's best interests and individual interests that might be at stake.[499] The court in the *Mourtzen* case showed this requirement would, in most cases, overlap with the requirement of good faith.[500] An instance where a person does not act in good faith but is driven by an ulterior motive, such as a personal vendetta, will generally not be in the company's best interests.[501] Of course, as indicated above, this assertion is made in the context and understanding that personal animosity *per se* is not conclusive proof of lack of good faith towards a respondent in the 165(5) application.[502]

Thus, where the above guidelines are successfully fulfilled, the court will be inclined to grant leave for the applicant to seek relief in the company's name. In the leading *Mourtzen* case, it was finally held that the applicant be given leave, in terms of section 165(5) of the Companies Act 71 of 2008, to institute an action in the name of Greystones Enterprises (Pty) Limited against the second respondent, claiming to seek the relief that Digby Hall Mouritzen be ordered to render a complete account of his expenditure on his First National Bank Limited credit card number 4901368288665000 for three years before the date of this order, among other pertinent reliefs. Such orders help unveil hidden acts detrimental to the company's best interests and its stakeholders, such as creditors, employees, other directors, and other shareholders. Thus, when derivative action principles are employed appropriately, a company's best

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499 In the *Swansson* case above, the Australian court made the following observations; "At the outset, it is important to note that s 237(2) (c) requires the Court to be satisfied, not that the proposed derivative action *may be, appears to be,* or *is likely to be,* in the best interests of the company but, that it ***is*** in the best interests. In this respect, s.237(2) differs significantly from its counterpart in the Canadian legislation, which requires the Court to be satisfied that the proposed derivative action "appears to be" in the interests of the company, and from s.165(3) of the New Zealand Act which requires that the Court "have regard to … the interests of the company. These provisions seem to have led the Courts of those countries to the view that the best interests of a company need to be considered only in a *prima facie* way: see e.g. *Re Bellman and Western Approaches Ltd* (1981) 130 DLR (3d) 193,at 201; *Vrij v Boyle* (1995) 3 NZLR 763, at 765; *Techflow (NZ) Ltd v Techflow Pty Ltd* (1996) 7 NZCLC 261, 138."

500 *Mourtzen* (n494) para 63.

501 ibid para 63.

502 ibid para 41.

interests are ensured, and the interests of stakeholders who may be affected by a wrong against a company are also preserved.

3.4.3. Summary of the derivative action

A transition is noted from the common law provisions to the new statutory provisions that widely encompass and give locus standi to many stakeholders. Creditors are also not excluded in invoking the new statutory derivative action in section 165(2)(d) of the Companies Act. The advantages and disadvantages of this avenue for creditor protection are noted. It is thus the researcher`s conclusive view that the protection afforded to a creditor or any other third party or outsider under this statutory derivation is rather complex as it carries a lot of legal processes requiring creditors to obtain leave from the court to do certain acts. There is no automatic right given to creditors in this regard. It is suggested that amendments be proposed to remedy these deficiencies as far as creditor protection is concerned, or else creditors would resort to employing other creditor protective mechanisms that are less demanding in their application compared to the statutory derivative action. A comparative approach shall be undertaken to evaluate this mechanism regarding creditor protection according to internationally set standards as shall be portrayed in corporate laws of select cognate jurisdictions.

3.5. Credit systems

3.5.1. Introduction

Since the 1997-98 financial crisis in emerging markets, considerable progress has been made in identifying the global financial system's components and articulating and applying standards and assessment methodologies for core system elements.[503] Therefore, the principles and guidelines for Effective Insolvency and Creditor Rights Systems contribute to that effort as an important milestone in promoting international consensus on a uniform framework to assess the effectiveness of insolvency and creditor rights systems, offering guidance to policymakers on the policy choices

503 Arner DW, *et al*, ‘Property Rights, collateral, Creditor rights, and Insolvency in East Asia’ [2006] 42 JCLEA 515.

needed to strengthen them. Below are some credit system principles that should be taken cognisance of in this research;

a) Compatible enforcement systems for both secured and non-secured debts

A modern credit-based economy requires predictable, transparent, and affordable enforcement of unsecured and secured credit claims through efficient mechanisms outside of insolvency and a sound insolvency system. These systems must be designed to work in harmony. Enforcement systems should provide efficient, inexpensive, transparent, and predictable methods for enforcing a security interest in property. Enforcement procedures should provide for the recovery of asset values based on market values. Both non-judicial and judicial enforcement methods should be considered. A regularized credit system should be supported by mechanisms that provide efficient, transparent, reliable, and predictable procedures for recovering debt, including the seizure and sale of immovable and movable assets and the sale or collection of intangible assets such as debts owed to the debtor by third parties. The legal framework should provide for the creation, recognition, and enforcement of security interests in movable and immovable property arising by agreement on operation of law.[504]

b) Security Interest Legislation

Legislation should ensure that security interests related to any or all of a debtor`s obligations to a creditor, present a method of notice that will sufficiently publicize the existence of security interest to clear rules of priority governing competing claims or interests in the same assets, eliminating or reducing priorities over security interests as much as possible.

c) Recording and Registration of Secured Rights

There should be an efficient and cost-effective means of publicizing secured interests in movable and immovable assets, with registration being the principal and strongly preferred method to the access registry, which should be inexpensive and open to all

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504 See a discussion on enforcement mechanisms in para 3.6 below.

for both recording and search. Enforcement systems should provide efficient, inexpensive, transparent, and predictable methods for enforcing a security interest in property.

d) Director and Officer Liability

Director and officer liability for decisions detrimental to creditors made when an enterprise is insolvent should promote responsible corporate behaviour while fostering reasonable risk-taking. At a minimum, standards should address conduct based on knowledge of or reckless disregard for the adverse consequences to creditors.

3.5.2. Role of Insolvency and Creditor Rights Systems

There are two dimensions to the global financial system. On the one hand, national financial systems operate autonomously and respond to domestic needs. On the other hand, national systems are tied to and interact daily with the systems of their trading partners. Insolvency and creditor rights systems lie at the juncture of this duality. The first is the country dimension, where national systems depend on various structural, institutional, social, and human foundations to make a modern market economy work. There are as many combinations of these variables as there are countries, though regional similarities have created common customs and legal traditions.[505]

Effective systems respond to national needs and problems, so these systems must be well-rooted. Transparency, accountability, and predictability are fundamental to sound credit relationships in the country's broader cultural, economic, legal, and social context. Legal and institutional mechanisms must align incentives and disincentives abroad; thus, the second dimension is the international dimension. New commerce, communication, and technology methods constantly reshape national markets and redefine notions of property rights. Businesses routinely transcend national boundaries and have access to new types of credit. Credit and investment risks are measured by complex formulas, and capital moves from one market to the next at the tap of a computer key. Public perceptions and investor confidence in local markets

[505] Tomasic R, 'Creditor Participation in Insolvency Proceedings' in Tomasic R et all (eds), *Asian Insolvency Systems: Closing the Implementation Gap* (OECD Publishing, 2007) *214.*

drive capital flows. Effective insolvency and creditor rights systems play an essential role in creating and maintaining the trust of both domestic and foreign investors.

The credit system and guidelines principles emphasize contextual, integrated solutions and the policy choices involved in developing those solutions. The principles distill international best practices in the design of insolvency and creditor rights systems. However, adapting international best practices to the realities of developing countries requires an understanding of the market environments in which these systems operate.[506] The challenges include weak or unclear social protection mechanisms, weak financial institutions and capital markets, ineffective corporate governance and uncompetitive businesses, and ineffective laws and institutions. These obstacles pose enormous challenges to adopting systems that address developing countries' needs while keeping pace with global trends and international best practices. Applying the principles in this research at the country level will be influenced by domestic policy choices, laws, and institutions' comparative strengths (or weaknesses). A modern, credit-based economy requires predictable, transparent, and affordable enforcement of unsecured and secured credit claims through efficient mechanisms outside of insolvency and a sound insolvency system.

These systems must be designed to work in harmony, and commerce is a system of commercial relationships predicated on express or implied contractual agreements between an enterprise and a wide range of creditors and constituencies. Although commercial transactions have become increasingly complex as more sophisticated techniques are developed for pricing and managing risks, the fundamental rights governing these relationships and the procedures for enforcing these rights have not changed much. These rights enable parties to rely on contractual agreements, fostering confidence that fuels investment, lending, and commerce. Conversely, uncertainty about the enforceability of contractual rights increases the cost of credit to compensate for the increased risk of non-performance or breach. This results in credit tightening, which affects economic growth since credit providers are reluctant to avail themselves of their credit services.

[506] Hamadziripi F, 'Judicial Construction of the Requirements of good faith in section 165 (5) (b) of the Companies Act 71 of 2008: *Mbethe v United Manganese of Kalahari*' [2018] 4 (2) JCCLP 74-87.

3.5.2.1 Legal framework for corporate insolvency

Though approaches vary, effective insolvency systems should aim to integrate with a country's broader legal and commercial systems. Maximize the value of a firm's assets by providing an option to reorganize. Strike a careful balance between liquidation and reorganization. Provide equitable treatment of similarly situated creditors; provide timely, efficient, and impartial resolution of insolvencies. Prevent the premature dismemberment of the debtor's assets by individual creditors. Provide a transparent procedure that contains incentives for gathering and dispensing information. Recognize existing creditor rights and respect the priority of claims with a predictable and domestic creditor-established process. Establish a framework for cross-border insolvencies, with recognition of foreign proceedings.

3.5.2.2. The Insolvency Act of 1936 and creditor protection

The insolvency law in the Republic of South Africa is regulated mainly by the Insolvency Act,[507] which remains the primary source of South African credit regulation regarding insolvency matters. Where a debtor becomes insolvent, the law should be used to help determine whether one is insolvent or not, in addition to outlining guidelines for helping creditors recoup their debt asset from an insolvent creditor without suffering much prejudice and also without arbitrarily affecting the rights of the insolvent person. The Insolvency Act defines an insolvent natural person as a debtor whose estate is under sequestration and includes such a debtor before the sequestration of his estate, according to the context. Unlike natural persons, a company doesn't undergo sequestration but a liquidation process when it is insolvent. Where one needs to wind up and liquidate a factually solvent company, that is, whose assets exceed its liabilities and which is commercially insolvent, what criteria are used to establish commercial insolvency? Would one apply the Companies Act and the 1973 Companies Act, or would they apply a portion of both? In the ordinary course of events, creditors, being outsiders, have limited knowledge of the assets and liabilities of a company that owes them money. It is not prudent to expect them to continually confirm whether their debtor is factually solvent before they can consider the business rescue or liquidation process. Section 8 of the Insolvency Act stands as a guideline. It

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[507] Insolvency Act 24 of 1936.

thus lists several acts of insolvency on which grounds the creditor may apply for the sequestration of the debtor when the debtor fails to satisfy all claims. These apply to natural persons, although they may serve as guidelines, especially when dealing with personal liability companies, as they are jointly responsible for debts with their directors who are natural persons. When it comes to companies, section 345 of the 1973 Companies Act provides that a company is deemed to be unable to pay its debts if:

- 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 (commercial insolvency).

It is thus worth noting that failure by a company to pay debts reflects not on actual insolvency but on commercial insolvency. The factual solvency of a company is not a determinant of whether a company should be placed in liquidation; accordingly, it is not a bar to an application to wind up a company in terms of the 1973 Companies Act because it is commercially insolvent. It will, however, always be a factor in deciding whether a company cannot pay its debts. Thus, a commercially solvent company (whether factually solvent or insolvent) may be wound up in terms of the Companies Act only; a solvent company cannot be wound up in terms of the 1973 Companies Act. Creditors should thus ultimately benefit from any envisaged process that follows an invoking of an act of insolvency. Acts of insolvency also extend to instances where parties are negotiating settlements on a *bona fide* note. As a general rule that has to be done without prejudice, yet in *ABSA Bank Limited v Hammerle Group (Pty*) Ltd,[508] the Supreme Court of Appeal asserted an exception to this general rule as follows;

> "It was true that as a general rule, negotiations between parties which are undertaken with a view to a settlement of their disputes are privileged from disclosure regardless of whether or not the negotiations have been stipulated to be without prejudice. However, there are exceptions to this rule. One of these exceptions is that an offer made, even on a 'without prejudice' basis, is admissible in evidence as an act of insolvency. Where a party therefore concedes insolvency . . . public policy dictates that such admissions of insolvency should not be precluded from sequestration or winding-up proceedings, even if made on a privileged occasion. The reason for the exception is that liquidation or insolvency

508 2015 (5) SA 215 (SCA) at para 13.

proceedings are a matter which by its very nature involves the public interest. A *concursus creditorum* is created and the trading public is protected from the risk of further dealing with a person or company trading in insolvent circumstances. It follows that any admission of such insolvency, whether made in confidence or otherwise, cannot be considered privileged".

Debtor companies or persons must thus be careful in making offers for settlement purposes, regardless of whether they are without prejudice. Any appearance or portrayal of the commitment of an act of insolvency would trigger the winding up and sequestration of the incumbent person, whether juristic or natural. Principles of insolvency concerning credit systems are thus imperative to ensure effective protection of creditors as far as insolvency is concerned.

3.5.3. National Credit Act 34 of 2005 and creditor's protection

The South African National Credit Act[509] is an essential piece of legislation that regulates the credit system in South Africa. Before the National Credit Act, the Credit Agreements Act[510] and the Usury Act[511] governed the consumer credit industry. The only debt relief remedies available to the over-burdened consumer were sequestration and administration.[512] The National Credit Act (NCA) provides for the over-indebted consumer and provisions deterring reckless lending/ or credit facilities. The NCA is thus set to protect both the consumer (debtor) and the credit provider (creditor).[513] Section 3 of the NCA amplifies the need to promote a healthy environment that promotes equal opportunities in access to credit facilities that are also not harmful to the consumer while protecting the interests of those who provide such facilities. It is clear from the purpose of the NCA that consumers are the ones who are more vulnerable in these agreements. As such, they must be educated to ensure they engage in responsible borrowing and avert over-indebtedness.[514] At the same time, credit providers are expected to explain the *pros* and *cons*, test affordability on the

509 National Credit Act 34 of 2005.
510 The Credit Agreements Act 75 of 1980.
511 Usury Act 73 of 1968.
512 Renke, Roestoff & Haupt <http://www.journals.co.za/ej/ejour_obiter.html > accessed 07 December 2021.
513 s 3(d) of the Act provides that the purpose of the Act among others is to ensure the promotion of equity in the credit market by balancing the respective rights and responsibilities of credit providers and consumers.
514 See also PART D of the NCA provisions (section 79) in addition to s 3(b) (i) of the NCA.

consumer, and ensure that they avoid reckless lending.[515] In the case of *First Rand Bank v Olivier,*[516] Judge Erasmus held that one of the purposes of the Act is to "provide for the debt reorganisation of a person who is over-indebted," which was implemented by the debt review provisions. Thus, at the very least, one can conclude that the NCA is there to assist the over-indebted consumer and that all requirements, especially those dealing with over-indebtedness, should be interpreted to effect this purpose. In helping an over-indebted consumer, a disappointed creditor has a chance in some circumstances to recoup his investment in cases where the rehabilitation processes succeed in restoring the consumer to a stable state where they can pay their debts either with a reduced or reviewed instalment or restructured credit facility that protect interests of both parties.

Section 4 of the NCA outlines the application of the Act. This section shows that companies or juristic persons considered small to medium size, specifically, with an annual turnover of less than a million rand are thus covered by the NCA.[517] In other words, a company with an annual turnover that equals or exceeds one million has no cover afforded to it in the NCA. It is the researcher`s view that the intention of the legislature in putting these bars based on a company`s capacity was based on the understanding that bigger companies would usually know what needs to be done in terms of ensuring a fair credit system, in addition to them, having sufficient income and financial asset to assail any credit facility they find themselves in hence not considered as victims of the past disadvantages in terms of the NCA thereof. This is not the same with small or medium-sized companies falling under the ambit of the NCA, as they need protection from creditors who recklessly lend to them while at the same time requiring relief through debt review or restructuring where necessary.[518] Corporate creditors, when dealing with a debtor company covered by the NCA, are covered as follows:

- They are charged with a mandate to examine these debtor companies as to their affordability capacity; hence, somewhere, somehow, they are likely going to lend

515 See also PART D of the NCA provisions (s 80) in addition to s 3(b) (ii) of the NCA.
516 (2008) JOL 22139 (SE).
517 See also s 7 for the one million threshold on annual turnover.
518 See part D of the NCA on provisions relating to debt review; restructuring; suspension of credit obligations and also debt counsellors` task under the NCA for rehabilitation of an overburdened debtor.

funds or advance goods and services on a credit facility to a debtor company that is financially capable of repaying them which then avoids disappointments;

- They are not allowed to load debts on a debtor company that is already ailing with some debts (over-indebted); hence, a closer check is needed on the creditor company, which in turn protects its investment;[519]

- Debtor companies are also allowed to restructure their debt commitment or to undergo debt review, including debt counselling, which, if appropriately managed, may still help the creditor company to recoup its investment in the long run;[520]

- The education of consumers before embarking on credit facilities also helps as debtors can make an informed decision and may not use ignorance as an excuse when legal proceedings are inevitable; this thus places corporate creditors in safety.

Having outlined the *pros* of these NCA provisions to a corporate creditor, it is imperative to note that a thin line lies between the *pros* and *cons* of the NCA provisions to a creditor. A creditor may either benefit or lose under these provisions. For instance, a corporate creditor that acquiesces itself with acts prohibited in the NCA provisions, such as reckless lending, may fall into the defence of reckless lending. If reckless lending is proven, the court may;

i) set aside all or part of the consumer's rights and obligations under the agreement as the court determines and reasonable in the circumstances,[521] or

ii) suspend the force and effect of that credit agreement under subsection (3)(b)(i), which provides that if a court declares that a credit agreement is reckless in terms of section 80(1)(b)(ii), the court must further consider whether the

519 s 79 of the NCA.

520 s 85 of the NCA provides as follows; "Despite any provision of law or agreement to the contrary, in any court proceedings in which a credit agreement is being considered, if it is alleged that the consumer under a credit agreement is over-indebted, the court may-
(a) refer the matter directly to a debt counsellor with a request that the debt counsellor evaluate the consumer's circumstances and make a recommendation to the court in terms of s 86(7); or-
(b) Declare that the consumer is over-indebted, as determined in accordance with this Part, and make any order contemplated in s 87 to relieve the consumer's over-indebtedness."

521 s 83(2) (a) of the NCA.

consumer is over-indebted at the time of those court proceedings; and if the court concludes that the debtor is over-indebted it may either suspend the force and effect of the agreement until a date it determines or it may direct the restructuring of a debtor`s obligations in terms of the agreement.[522]

Given the preceding, it is apparent that one of the disadvantages of a corporate creditor engaging with a debtor corporation that falls under the ambit of the NCA will be the verdict that suspends the force and effect of a credit agreement as that delays creditor relief. In worst circumstances, the court may set aside all or part of the debtor`s obligations and, thus, result in a loss to the creditor. The defence of reckless lending should, however, not be abused by debtors who are culprits who intentionally withhold relevant information that creditors may use to have a fair assessment or evaluation of their affordability capacity, in addition to many other acts of lack of good faith in arms-length deals. In the case of *Standard Bank v Panayiotts,*[523] Judge Masipa held that the requirements of Rule 32 could not be disregarded and that a defendant that raises section 85 defence needs to satisfy the Court that it is done in good faith and not merely as a delaying tactic. In *Standard Bank v Hales and Another,*[524] Gorven J held that the mere admittance of the consumer's over-indebtedness is insufficient for the Court to use its discretion in favour of the consumer. It is thus trite law that the courts are always inclined to punish any abuse of process or any engagement in a frivolous and vexatious process. In the case of *First National Bank v Myburgh,*[525] Moosa J held that the Court's discretion should not be exercised based on speculation but based on the facts before the Court. Thus, the Court cannot base its decision on speculated circumstances or outcomes but instead on the evidence placed before it. In such cases, the Courts will make a section 85(a) referral to allow the debt counsellor to place detailed facts before them for a well-informed, just, and equitable decision. This is necessary for certainty to avert unnecessary withholding of the enforcement of rights by an affected creditor. Corporate creditors are, therefore, implored to do all statutory diligence necessary when dealing with debtor companies that fall within the NCA`s to

522 s 83(2) (b) of the NCA.
523 (2009) 6 (SA) 63 (KZD).
524 (3) SA 315 (D).
525 2002 (4) SA 176 (C).

avert either delay or loss that emanates from the shielding given by the NCA to consumers.

3.5.4. Consumer Protection Act 68 of 2008 and creditor protection

The Consumer Protection Act, 2008 (No 68 of 2008) (CPA) sets out the minimum requirements to ensure adequate consumer protection in South Africa. The CPA thus constitutes an overarching framework for consumer protection, and all other laws that provide for consumer protection, usually in a specific sector, will need to be read together with the CPA to ensure a joint protection standard. It is thus apparent that the CPA is primarily set to protect the interests of an ordinary consumer.[526] Consumers include natural persons and juristic persons with a turnover value that is less than the R2 000 000.00 threshold set by the Minister from time to time.[527] All suppliers of goods and services must note the measures inscribed in the CPA and ensure they comply to avoid disgruntlement when disputes arise.

To help alleviate dispute resolution under the CPA, the Consumer Goods and Services Ombud (CGSO) was accredited as the official dispute resolution scheme for the Consumer Goods and Services industry.[528] The Ombud deals with complaints relating to all transactions under the CPA, other than transactions with the automotive sector, organs of state, financial institutions, or entities regulated elsewhere. The CGSO operates in terms of the Consumer Goods and Services Industry Code, which requires all businesses within the industry to register with CGSO or face consequences under the CPA, including the imposition of administrative fines by the Tribunal.

Although the CPA is primarily set to protect consumers in general, creditors with consumers, especially juristic persons under the CPA for research purposes, are also indirectly protected by the CPA as follows;

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526 s 3 of CPA.

527 The Minister of Trade and Industry has by notice in the Government Gazette No 34181, dated 1 April 2011 determined the monetary threshold to the size of the juristic person at R2 million.

528 The CGSO was accredited as the industry Ombud from 30 April 2015 and the Consumer Goods And Services Industry Code is effective from 30 April 2015. See <www.cgso.org.za > accessed 07 December 2021.

- The CPA encourages the education of consumers so they can make informed decisions which then would not allow them to use ignorance as an excuse in the future;
- The CPA also requires that consumers be informed of all essential terms and conditions in an agreement and that such endeavours be recorded for future and quality purposes.
- The CPA prohibits unfair trade or fraudulent trading activities.
- The CPA also provides for a consistent, accessible, and efficient system of consensual resolution of disputes arising from consumer transactions;

When the preceding purposes are achieved, creditors are indirectly thus protected as they would have to deal with consumers in a fair market world where general principles of trade are observed for the benefit of both consumers and creditors. Also, consumers educated to handle their consumption of goods and services appropriately are less likely to be victims of failure to pay for goods and services that they consume, which ultimately is an advantage to creditors who deal with them.

3.5.5. Summary of Credit Systems

As said earlier on, effective credit systems are the ones that respond to national needs and problems. As such, credit systems must reflect on critical principles of transparency, accountability, and predictability to ensure sound and solid credit relationships. Protecting secured and non-secured debts through solid credit principles and reliable enforcement measures also plays a fundamental role in instilling confidence in investors, which in turn triggers economic growth and development. The Insolvency Act provides guidelines on how to determine that one is insolvent, which in turn help creditors pursue set remedies to ensure the ultimate goal of recouping their investment is achieved in addition to the primary need to provide for efficient management of insolvent circumstances for the best interest of all parties. The NCA plays a pivotal role in regulating all credit agreements or transactions and ultimately ensures the rights and interests of all parties concerned, whether natural or juristic persons are secured as long as they fall within the cover of the NCA.

On the other hand, the CPA is primarily set to protect consumers, although it also indirectly protects creditors. The effectiveness of these credit systems, as inscribed in both common law and the statutes mentioned above, cannot be overemphasized. A Comparative examination shall thus be undertaken in subsequent chapters to evaluate the effectiveness of these credit systems in line with international standards set in well-developed jurisdictions.

3.6. Enforcement mechanisms open to creditors

3.6.1. Introduction

As said earlier, a modern credit-based economy requires predictable, transparent, and affordable enforcement of unsecured and secured debt claims through efficient mechanisms in appropriate forums, tribunals, courts, etc. The Companies Act has established additional enforcement channels within which creditors, other stakeholders, or affected or interested persons may enforce their rights. Firstly, in section 156 of the Companies Act, there are now four avenues/ channels/ forums within which creditors or any affected or interested person may utilise to address matters that the Companies Act regulates. These are:

- High court
- The Companies Commission (CIPC) or the takeover regulation panel;
- The Companies Tribunal or
- Alternative Dispute Resolution.

A brief discussion of the platforms and enforcement shall be given separately below.

3.6.2. High court/ or courts

The High Court remains the primary forum for dispute resolution, interpretation, and enforcement of the Companies Act.[529] Including the other three channels or

[529] Memorandum on the Objects of the Companies Bill, 2008, para 3. Also see s 157 of the Companies Act.

alternatives for addressing complaints and enforcing rights under the Companies Act helps reduce the burden on the Courts and save costs, time, or resources where possible.[530] Since the Companies Act's promulgation, several cases have been resolved in courts, mainly as most people favour the court process, which is anciently proven and guaranteed with ultimate authority over these matters. In the preceding sections, we outlined how courts would help creditors by upholding the principles of several creditor protective mechanisms. The court would ensure that directors are liable for resolutions passed approving prohibited transactions without compliance with the solvency and liquidity tests.[531] The court would sanction derelict directors and those who trade recklessly, fraudulently, and under solvent conditions, with either criminal or civil liability to protect creditor interests.[532] The courts would ensure creditor interests are protected during the liquidation or winding up process, whether on solvent or insolvent condition, it being open to entertain any legal suit related to unfair conduct in this regard.[533] The courts will be ready to assist creditors and debtors by endorsing compromises and arrangements between parties and ensuring that these arrangements achieve the best interests of affected parties.[534]

Moreso, the courts would endorse business rescue proceedings where it is equitable to do so to ensure the resuscitation of a financially ailing company so that it would be solvent again or, when it fails to go back to its solvent state, so that creditors may recoup better returns at liquidation.[535] The courts are inclined to protect creditors and third parties who deal with the company`s agents in good faith, not knowing that they are acting mala fide or have omitted to act in the company's best interests when, in reasonable exercise, they should so act.[536] Courts would pierce the veil and hold liable directors who perpetuate unconscionable abuse on the person of the legal entity to harm an innocent third party.[537] Courts would give leave to creditors to sue in the company's name, where their rights and those of the debtor company are affected by the contact of those in control.[538] Courts would ensure they uphold all relevant

[530] Cassim, 'Enforcement & Regulatory Agencies' (n94) 826.
[531] ibid. see para 2.1 above.
[532] ibid. see para 2.2 above.
[533] ibid. see para 2.3 above.
[534] ibid. see para 2.4 above.
[535] ibid. see para 3.1 above.
[536] ibid. See T*urquand* rule on para 3.2.
[537] ibid. see para 3.3.
[538] ibid. See derivative action in para 3.4.

principles of the credit systems to provide a sanitized credit environment.[539] Thus, The High Court has inherent jurisdiction to uphold the laws, including the Companies Act, for justice to those affected by disregarding legal positions. To date hereof, it is the researcher`s view that creditors still favour approaching court compared to all these alternative forums provided for in the Companies Act.[540] Thus, courts remain the final destination for creditors and all stakeholders whose interests and rights are affected during their business with the company.

3.6.3. The Companies Tribunal & The Takeover Regulation Panel

Section 157 gives *locus standi* to different stakeholders or groups of people or any person who may be affected by a contravention of a provision in the Companies Act so that they may enforce their rights in either court, the companies' commission, the companies' tribunal, and the Panel. Section 157 reads as follows:

> 157. (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.

It is apparent from the preceding provision that any person may approach the Companies Tribunal if they have rights that are affected under the Companies Act and as long as they are acting in a representative capacity either for an individual or as a member of a group or acting in the public interest. However, the leave of the court may be needed in this case. It must, however, be known that the Tribunal may not have jurisdiction to entertain all matters under the Companies Act. In a Companies Tribunal case, in *re ex parte*: *Minu (Pty) Ltd,*[541] it was held that "section 30 of the Companies

539 ibid. See para 3.5 on credit systems.

540 See the Companies Tribunal website <https://www.companiestribunal.org.za/decisions-orders/> accessed 09 December 2021. The researcher had an opportunity to peruse through all cases that are brought to the Companies Tribunal as reflected on the foregoing website yet most cases recorded therein are for director disputes, reviews of the CIPC decisions, exemptions and change of company names (Trademark issues). The researcher could not come across any case relating to creditor rights infringement on the website of the Companies Tribunal except for the latter.

541 In *re ex parte*: *Minu (Pty) Ltd* CT031MAY2016 (Companies Tribunal Case).

Act is peremptory and it does not give the Tribunal the jurisdiction to grant extensions to the required time to file annual financial statements." It was further held that the Tribunal is a creature of statute and can only grant relief contemplated in the Companies Act."[542] Following the constitutional principle of legality, the Companies Tribunal has to act within the powers conferred upon it by the enabling or founding piece of legislation.[543] The Companies Tribunal can, therefore, only grant relief on matters outlined explicitly in the Companies Act; it does not have inherent jurisdiction to consider all matters before it, such as the High Court.[544]

On the other hand, the Companies Tribunal is seemingly cost-effective as it allows individuals to open their matter and lodge their claims directly through its website without legal representatives.[545] It seems that amongst a company`s stakeholders, primarily directors, the Companies Tribunal platform has been utilised as an alternative to the direct court approach.[546] In one of the matters, it was held that "the onus to provide facts which would justify a finding that there is neglect or dereliction of duty rests on the applicant. A conclusion on whether there is neglect or dereliction of duties can only be drawn from the evidence presented to the Tribunal. A mere recital of the non-compliances that provides no factual particulars of how neglect and dereliction was committed is not sufficient..."[547] In addition to the preceding, some of the matters that the Companies Tribunal has dealt with so far relate to reviewing decisions by the Companies Commission and the Panel.[548] The Companies Tribunal thus serves a crucial function in handling matters presented before it; the researcher still awaits to see cases brought explicitly by creditors to the Companies Tribunal as the doors of

542 ibid at para 10 & 11. See also para 6 of *ex parte In re Computershare Investor Services (Pty) Ltd* CT032MAY2016.

543 See *Senwes v Competition Commission* (118/2010) [2011] ZASCA 99 and *Fedsure Life Assurance Ltd v Greater Johannesburg Transitional Metropolitan Council 1999 (1) SA 374 CC (at 56-59).*

544 See also *Majestic Silver Trading 389 Proprietary Limited v The Companies and Intellectual Property Commission* CT004Dec2013 where it was held that it is clear that the Companies Tribunal do not have jurisdiction to order the CIPC to re-instate a deregistered company in terms of s 83 of the Companies Act as it is not a "court". Para 13 & 14.

545 Companies Tribunal website <https://www.companiestribunal.org.za/decisions-orders/> accessed 09 December 2021.

546 See *Gerrit Marthinus Van Zyl v Nuco Chrome Bophuthatswana (Pty) Ltd & others* CT01 FEB/2016, a Companies Tribunal matter.

547 ibid para 63.

548 See *CAL CONSULTING CC v CIPC* CT028MAY2016, where the Tribunal upheld CIPC (Companies Commission)`s decision by refusing applicant`s application to change its financial Year in a manner unjustified.

the Tribunal remain open for creditors to bring matters within its jurisdictional capacity.[549]

The counterpart of the Companies Tribunal when it comes to affected transactions is the Takeover Regulation Panel.[550] Most of these affected transactions may result in the jeopardy of creditor interests if not regulated, hence the need for a Panel such as this, which even goes to the extent of applying to the 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.[551] Creditors would also utilise the Takeover Regulation Panel, where there are hostile takeovers and impending majors that may affect the interests of creditors negatively. Moreover, the Companies Tribunal and the Panel serve to adjudicate on matters referred to them just like a court of law and make orders as guided by the Companies Act. They may facilitate alternative dispute resolution processes between parties.[552] Creditors with disputes may prefer these forums as they may be cost-effective while at the same time promoting less formal means of resolving disputes. The Tribunal or Panel may approach the court to file their orders or any resolution between parties, amicably settling to certify the same as an order of the court regarding their rules.[553] This will help enforce compliance with their orders or parties' resolutions regarding the court`s rules.

3.6.4. Companies Commission

Another interesting avenue creditors may use instead of outrightly approaching the court, which may be more costly, could be complaining to the companies' commission for an investigation on how the company is being run that affects the creditor`s rights and those of others.[554] Upon investigation, the company's commissioner may issue compliance notices, which may result in positive results that favour the interests of the

549 See the Companies Tribunal website <https://www.companiestribunal.org.za/decisions-orders/> accessed 09 December 2021.

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

551 s 201 of the Companies Act. See also Cassim & Yeats, Fundamental transactions, Takeovers & offers' (n94) 747.

552 s 195 of the Companies Act.

553 s 195(8) of the Companies Act.

554 Cassim, 'Enforcement & Regulatory Agencies' (n94) 835.

creditors and other stakeholders. Section 22 of the Companies Act allows the commission to deal with any suspicions of 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 issue a compliance notice that, when not taken seriously, may result in serious penalties that may even end in forced liquidation. Section 157(2) gives the Commission powers to intervene or assist any person in legal proceedings to the extent of suing in the names of and on behalf of the affected persons to whom its compliance notices are not given heed. The powers endowed upon the commission assist creditors who are financially handicapped in enforcing their rights without cost through the arm of the commission. Section 157(2) 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 preceding provision shows that the commission may as well intervene in any proceedings on matters that it has *locus standi* over or where it has a substantial interest, it being an enforcement device or tool with a mandate to ensure compliance with the Companies Act and enhance fair trade practices under the Companies Act. It becomes cost-effective to the affected person when the commission takes it upon itself to investigate the matter and possibly sue the offending party in the affected party's name or intervene in any such matter as amicus curia to canvass submission that favors the affected party. All in all, creditors in this research are encouraged to utilize the services of the commission when they see irregularities that may ultimately affect their investment in the debtor companies.[555]

3.6.5. Alternative Dispute Resolution

According to *Cassim*, “one of the alternative procedures provided by the Companies Act for resolving complaints or securing rights is the Alternative Dispute Resolution

555 The avenue of the commission`s intervention is more preferable than the court`s derivative action discussed in para 2.8 above.

(ADR)."[556] ADR, or Voluntary Resolution of Disputes (VRD), is provided for in Part C of Chapter 7 of the Companies Act and thus purposefully refers to conciliation, mediation, and arbitration processes.[557] An affected person may refer a matter for ADR processes at the Companies Tribunal instead of adjudication processes at the Tribunal or court.[558] Section 166 (1) of the Companies Act provides as follows;

> 166. (1) As an alternative to applying for relief to a court, or filing a complaint with the Commission in terms of Part D, a person who would be entitled to apply for relief, or file a complaint in terms of this Act, may refer a matter that could be the subject of such an application or complaint to—
> *(a)* the Companies Tribunal; or
> *(b)* an accredited entity, as defined in subsection (3), for resolution by mediation, conciliation or arbitration.

From the preceding provision, the creditor and affected person also have a choice of whether to employ the ADR process in the Tribunal or through an accredited entity. Of course, an accredited entity that specialises in handling ADR processes will not do these matters for free but would require the referring party to pay its fees or, whereby, agree that both parties boot the bill for the accredited entity. ADR processes referred to the Tribunal would not require the referring party to pay fees relating to legal tariffs save for the ordinary fees necessary for administration purposes, if any. ADR procedures require that both parties submit themselves to such engagements in good faith to ensure reasonable dispute resolution probabilities.[559] If the resolution fails to be resolved, the tribunal or the accredited entity will issue a certificate of such failure. In contrast, if the matter is successfully resolved, such settlements would be declared a consent order by recording such order as an order or may direct parties to approach the court to declare the resolution/ settlement agreement an order of the court for enforcement purposes.[560] Creditors are thus encouraged to employ these mechanisms where the other party is inclined to amicable resolution of disputes compared to the acrimonious legal or adjudication procedures.

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556 Cassim 'Enforcement & Regulatory Agencies' (n94) 851.
557 s 166 of the Companies Act.
558 s 156(a) read with section 166 of the Companies Act.
559 Cassim, 'Enforcement & Regulatory Agencies' (n94*)* 851.
560 ibid.

3.6.6. Summary of enforcement mechanisms

Widening the scope of avenues through which rights may be enforced under the Companies Act helps creditors affected by any conduct to have many options to explore in enforcing their rights. Even when they are not affected but feel the conduct is not favourable for the company, they still have grounds to report to the relevant bodies, just as whistle-blowers. One of the salient provisions in the Companies Act ensures that whistle-blowers[561] are protected, as provided for in the Protected Disclosures Act 26 of 2000.[562] Creditors are thus given *locus standi,* amongst other stakeholders, to approach courts, the commission, and the tribunal for adjudication or ADR processes according to their choice. It is worth noting that some platforms are less costly than others. Also, some are convenient to utilise in certain circumstances due to issues of approachability, affordability, effective processes that are time-saving, etc. Thus, creditors have a wide choice and thus have effective protection under the Companies Act with an increased opportunity to approach any appropriate forum to enforce their rights under the Companies Act. The effectiveness of these enforcement mechanisms shall thus be assessed in subsequent chapters compared with their counterpart forums in select cognate jurisdictions.

3.7. Conclusion

This chapter explored mechanisms and specific provisions entrenched in the Companies Act that are not linked to insolvency. It also briefly explored some relevant provisions from various pieces of legislation that are not part of company laws but are an aid to creditor protection. It further outlined certain credit principles and systems derived from common law. The scope of director liability has been developed to be more civil than criminal liability. The researcher agrees with other scholars who applaud the legislature for enhancing civil liability; however, the legislature could drastically consolidate and utilize both avenues to deter directors from acting against the interests of creditors and other stakeholders by abusing their position of authority. In 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

561 Those who disclose irregularities or contraventions of the Companies Act.
562 s 159 of the Companies Act.

companies and personal liability companies, by ensuring that creditors are not expected to know of non-compliances with internal procedures & formalities in debtor companies. Thus, a debtor company will be bound by a creditor`s claim regardless of whether its internal procedures were complied with 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. Moreso, the new statutory derivate action, although it has a lot of requirements for a creditor to utilise it, it at least gives creditors *locus standi* to interfere and act in their names and on behalf of the company where irregularities or crimes committed against the company`s best interests would ultimately affect the rights of other stakeholders such as creditors. Although these statutorily adopted mechanisms may not be ideally placed in some instances, their weight cannot be understated as they contribute to achieving adequate creditor protection through mandatory company laws. The relevant common law credit systems or principles and provisions entrenched in the Insolvency Act, the NCA & the CPA are essential in ensuring healthy relations between corporate creditors and debtor companies. Moreover, access to justice has been made easier as the Companies Act has added other cost-effective forums to resolve corporate-related disputes, such as the Companies Commission, the Panel, and the Companies Tribunal

Moreover, the Companies Act decisively extends *locus standi* to various stakeholders to approach all forums provided. In addition, the Companies Commission may even act on behalf of an affected person or intervene in legal proceedings where one may not obtain appropriate redress without its intervention. In conclusion, the researcher applauds the legislature for developing the existing mechanisms before the current Companies Act and for adopting new mechanisms into company legislation, thus ensuring adequate creditor protection. In subsequent chapters, a comparative assessment of South African Creditor protection laws' effectiveness shall be conducted against counterpart laws employed in the UK, USA & Australia.

CHAPTER 4: THE LEGAL FRAMEWORK FOR CREDITOR PROTECTION IN THE UNITED KINGDOM

4.1. Introduction

The previous chapters have articulated how the credit system is a fundamental sphere where consumers of debt can borrow money, incur debt, and defer payments in generally flexible and convenient ways. In as much as a good and functional credit system is essential, the overall functionality and effectiveness of any credit and debt consumer system are based on the background of governing laws and policies. Some of the commonly used mechanisms in ensuring the effectiveness of the credit system, as explored in the previous chapter, include mere assessment and building of a credit record, which gives an insight to creditors on the consumer's credit/debit history before lending out any more money, with the likelihood that a person with a bad credit record may not be granted credit. In this regard, creditors are essential to the sustainability of the credit/debit consumer cycle. In as much as credit may not be limited to liquid money only, the interests and rights of creditors are important in this regard and must be fully protected and promoted. However, due to several uncertainties and inconsistencies, as well as changing risks in the credit system, the position of the creditor seems to be generally a risky one, which necessitates this and forthcoming chapters, focussing on how different countries have attempted or successfully enclosed the credit system from adverse risks or falling apart.

This chapter will explore creditor protection laws in the UK. A critical comparison with South African creditor protection laws shall be made, much of the emphasis being on measuring the effectiveness of South African creditor protective mechanisms against those implemented in the UK to draw useful conclusions for developing South African laws.

4.2. Brief background

As indicated earlier, this study seeks to scrutinise creditor protection mechanisms entrenched in South African Corporate law and purposively determine their effectiveness in advancing creditor interests in company affairs. That enquiry is triggered by the need for corporate laws to adapt to and align with the pace of global economic changes in open and democratic societies. The 2004 DTI Policy document

on South African Corporate Law Reform (SACLR) proposed a shift from the traditional shareholder-centric view, which espouses shareholder importance in corporate governance, to a model that retains the supremacy of shareholder interests while simultaneously catering to the interests of other stakeholders (the enlightened shareholder value approach). In light of the DTI policy proposal, the parliament, in enacting the South African Companies Act 71 of 2008 (the Companies Act), reflected on the need to appropriately redress investors and third parties ('creditors') rights in the preamble to the Companies Act. It is based on the forgoing expositions that this research work sought to establish whether the South African Corporate law had been adequately modelled to protect creditors and to look beyond the traditional company's goal of profit maximisation for the shareholder at the expense of other stakeholders, such as the creditors, who equally have stakes in the success and continuation of the company.

Thus, a comparative doctrinal and critical analysis of creditor protection laws from selected cognate jurisdictions is undertaken to determine the efficacy of the protection mechanisms accorded to creditors under the South African corporate jurisprudence. The first jurisdiction that will be analysed in this regard is the United Kingdom.

The United Kingdom (UK) will be utilised in this study for comparative studies as one of the countries with advanced "first world economies" characterised by highly developed corporate laws and regulatory frameworks. The UK is a sovereign European country comprising England, Wales, Scotland, and Northern Ireland. An analysis of different literature in previous chapters of this study reveals that the English common law system is more market-friendly in that it provides higher levels of shareholder and creditor protection, and this legal support has led to increased financial development.[563] It is further indicated that various legal systems, including the legal systems of the USA, Australia, and South Africa, have adopted significant aspects of the English common law concept. This ensures some similarities in Corporate Law applications in the respective countries. In addition to more advanced corporate practices in those other countries, that disposition vantagely positions the

563 La Porta R, *et al,* 'A The Economic Consequences of Legal Origins' [2008] 46 JEL 286.

corporate jurisprudence in those countries for a comparative study with that of South Africa.

Like South African corporate law, English corporate law also envisages adopting the enlightened shareholder value approach as a theory for corporate governance, which justifies creditor protection in both jurisdictions.[564] In pursuit of creditor protection, one would learn that English courts developed the concepts of the lien, set-off, trust, and mortgage to provide for multiple and overlapping security interests over a company`s assets from an early stage of the UK`s industrial development.[565] Notwithstanding these developments, it is recorded that since the 1980s, there have been numerous legislative changes, some triggered by concern over the effects on creditors of director misconduct, others driven by a perception that rules designed primarily for closely-held firms were not working well in the context of the liquidation of big firms.[566] Thus, legislation from the mid-1980s created new rescue-driven procedures. In the early 2000s, creditors' rights and expectations were revised, culminating in the trampling of the right of secured lenders to initiate liquidation, making rescue-orientated administration a preferred procedure.[567]

4.2.1. Creditors and the Company

Protecting creditors' interests regarding corporate laws is a significant discussion among scholars and policymakers. According to Hazarika, creditors are not regarded as part of a company or as members. However, they play a vital role in maintaining a company.[568] The primary role of creditors is in the form of a functionary as they provide crucial credit necessary for running a company's business. Without finances or financial standing, most companies are in no position to carry on the business for which the company was incorporated or came into existence. In this set-up or relationship of companies and creditors, companies virtually become debtors to the creditors, which is a relationship that comes with obligations. The critical obligation in

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564 s 172 of UK`s Companies Act 2006; DTI Police Document (n1) 23.

565 Dennis V & Fox A, *The New Law of Insolvency: Insolvency Act 1986 to Enterprise Act 2002* (GB Publishers, London 2003)10.

566 Ratford W & Smith R, *A Guide to the Insolvency Act 1985* (LFT Publications, 1985) 56.

567 See Dennis (n565), Rescue-oriented proceedings became preferable than outright liquidation; only when a rescue had failed that's when liquidation could be considered.

568 Hazarika D, 'Protection of Creditors' [2013] <https://ssrn.com/abstract=2353238> accessed 20 February 2023.

this regard, related to the purposes of this study, entails the obligation created for a company to take proper care of the interests of creditors. In contemporary times, where laws have been developed and enacted to protect legal relationships of this nature and the interests and obligations thereof, it is still imperative to look at whether everything is being done to ensure that the interests of creditors are protected in corporate dealings.

In *MacMaster's Trustees v Executor of Kruger,*[569] it was noted that a creditor is anyone to whom a company has a financial obligation. In this regard, the term has been applied to refer to suppliers of goods, services, bondholders, banks, and other lending institutions that provide long-term and short-term financing, taxation authorities, and employees to the extent to which their remuneration is not paid.[570] This standard has been applied to justify further that a creditor in corporate relations would be anyone with a financial interest in the company to the extent to which the company is obliged to fulfil such an obligation *qua* creditors.[571] Further elaboration indicates that once a company has creditors, such creditors will have a continued interest in the company's financial health as an active participant in an economy.[572] The same applies to other kinds of creditors, such as suppliers of services who will be interested in the company's continued existence and settling of invoices as per the arrangements made, which entails the viability of a company to such a form of creditor also ensures the viability of such a creditor as the company would be a reliable consumer. On another note, if the creditor is of a bondholder, bank, or other financing/lending institution that is interested in the viability of a company for purposes of settling debts and its continuity for purposes of borrowing in the future, this ensures the viability of the creditors' working capital and sustainability. This demonstrates that in their diverse forms and shapes, creditors find a commonality in their shared interest in the continued financial health and well-being of a company as an active participant in an economy, something beyond the satisfaction of financial dues.

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569 4 Searle 210.
570 ibid.
571 ibid.
572 ibid.

4.2.2 From a UK court's perspective, do directors owe a duty to company creditors?

While the commonwealth courts, particularly in the United Kingdom, have had a lengthy and voracious number of cases dealing with the duty of company directors to act in the interests of creditors, some inconsistencies are notable. The rationale behind directors' duty to creditors has stemmed from the notion of a company being insolvent. However, differing judgments note that directors' duty towards creditors arises before a company is insolvent, with no court fully defining insolvency in this context.[573] The Company Law Review Steering Group in the UK opted to include directors' duty towards creditors in the general codification of directors' duties that were being undertaken. However, the state denied this notion because it would merely influence directors not to fully adopt the company rescue culture that the state was advancing, facilitating, and attempting to foster.[574] This resulted in adopting section 172(3) of the Companies Act of 2006, which has been heavily criticised as vague as it merely provides that common law should be left to develop without further statutory guidance.[575]

While the duty of directors to creditors has remained predominant in common law, which South Africa also shares, this has been interpreted as further stemming from the director's duty to act in the company's best interests.[576] While issues of what matters most to creditors in respect of companies are essential to answer, the rationale is that the economic viability of a company than its capital structure and capital accounts is of concern to creditors such that the question of how best to protect this economic viability, while maintaining a balance between interests of shareholders and creditors, must be answered. This would require an extensive discussion of recent case laws to complement the justification for creditor protection in chapter 1.[577]

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573 McKenzie-Skene DW, 'Directors' duty to creditors of a financially distressed company: a perspective from across the pond' (2006-2007) 1 *JBTL* 499, 509.

574 Keay A, 'Directors taking into account creditors' interests' (2003) 24 Company Lawyer 300, 301.

575 ibid, Keay in critiquing s 172(3) of the Companies Act 2006 UK.

576 Pretorius JT et al, 'Hahlo's South African Company Law through the Cases' (6th edn, Juta Cape Town, 1999) 286 -87.

577 See chapter 1, para 1.6 above.

In *BTI 2014 LLC v Sequana SA and others*[578] *(the Sequana SA case),* a recent case, the UK Supreme Court had an opportunity to deal with an essential aspect of corporate law germane to this study. It had to dissect through legal provisions to elucidate whether the directors owe a duty to creditors or whether "company interests" include those of creditors. For a better analysis, a brief outline of the facts of the *Sequana SA* case suffices hereunder. In May 2009, AWA's directors, who are the second and third respondents, caused it to distribute a dividend of €135m ("the May dividend") to its only shareholder, the first respondent Sequana SA, which extinguished by way of set-off almost the whole of a slightly larger debt which Sequana owed to AWA. It is common ground in this court that the May dividend was lawful in that it complied with the statutory scheme regulating the payment of dividends in Part 23 of the UK Companies Act of 2006 and with the common law rules about the maintenance of capital.

Furthermore, the May dividend was distributed when AWA was solvent on both a balance sheet and a commercial (or cash flow) basis. Its assets exceeded its liabilities, and could pay its debts as they fell due and became payable. But it had long-term pollution-related contingent liabilities of a very uncertain amount, which, together with an uncertainty as to the value of one class of its assets (an insurance portfolio), gave rise to a real risk. However, there is no probability that AWA might become insolvent at an uncertain but not imminent date. In the event, AWA went into insolvent administration almost ten years later, in October 2018. The Appellant BTI 2014 LLC sought, as an assignee of AWA's claims, to recover an amount equivalent to the May dividend from AWA's directors because their decision that AWA should distribute the May dividend was a breach of the creditor duty.

Meanwhile, AWA's main creditor applied to set the May dividend aside as a transaction at an undervalue intended to prejudice creditors under section 423 of the UK`s Insolvency Act of 1986.[579] The two claims were heard together in the High Court before Rose J. The May dividend was held to have fallen foul of section 423, although Sequana then went into insolvent liquidation, and no part of it was repaid. However,

578 [2022] UKSC 25.

579 s 423 of UK`s Insolvency Act of 1986 gives *locus standi* to a victim of a transaction mala fide or prejudicial to apply to court for an order avoiding such transaction or protecting interests of victims of such transaction(s).

the Appellant failed against the directors before the judge and in the Court of Appeal. This was because, although they had not considered the interests of AWA's creditors, other than for the non-qualifying purpose of deliberately causing prejudice to them, the creditor duty had not become engaged by May 2009. AWA had not then been insolvent, nor was a future insolvency either imminent or probable, in the sense of being more likely than not, even though there was a real risk of it. In attempting to give the rationale for the judgment, Lord Briggs made the following comments:

> In the judgment of the Court of Appeal, the creditor duty did not arise until a company was either actually insolvent, on the brink of insolvency or probably headed for insolvency. A risk of insolvency in the future, however real, was insufficient unless it amounted to a probability. Although the dividend was lawful, this did not of itself prevent its payment amounting to a breach of the creditor duty, had it arisen by May 2009.[580]

Lord's preceding comments depict that the creditor's duty and the duty owed by directors to creditors only arise when the company is insolvent or is right on the brink of insolvency or when the future risk culminates into a notable probability of it occurring. This understanding emanates from section 172 of the UK`s Companies Act of 2006, which requires a director of a company to act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to the need to foster the company's business relationships with suppliers, customers, and others.[581] Thus, the primary duty imposed on directors by section 172(1) is expressed in promoting "the success of the company for the benefit of its members as a whole." Accordingly, the duty is no longer described by reference to the interests of the company, and the previous problem of identifying the interests of an artificial person is side-stepped.[582] Since the duty under section 172(1) is focused on promoting the company's success "for the benefit of its members as a whole," it is clear that, although the duty is owed to the company, the shareholders are the intended beneficiaries of that duty.[583] To that extent, the common law approach of shareholder primacy is carried forward into the 2006 Act. It is then a settled matter in corporate law that the primary duty of directors in pursuit of the company's best interests is for the profitable benefit of its members.

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580 Lord Briggs in the *Sequana SA case* (n578), para 116.
581 s 172 (1)(c) of the Companies Act of 2006.
582 Lord Reed in the *Sequana sa* case (n578), para 65.
583 ibid.

In carrying out their primary duty under section 172(1), the directors are also under a secondary obligation to have regard “amongst other matters” to the considerations listed in paragraphs (a) to (f). In analysing section 172(1), Lord Reeds gave an insight concerning the secondary duty of directors towards creditors and other stakeholders as follows:

> This reflects a recognition that the promotion of the company’s success requires that consideration be given to such matters as the interests of its employees and the need to foster its business relationships with suppliers and customers. The considerations listed in paragraphs (a) to (f) are capable of including the treatment of certain creditors of the company. Creditors are liable to include employees, suppliers, customers and others with whom the company has business relationships; and their treatment may well affect the company’s reputation and its creditworthiness, and have consequences for it in the long term. However, the primary duty imposed by section 172(1) remains focused on promoting the success of the company for the benefit of its members.[584]

In the premises, the directors' primary duty should be juxtaposed with their secondary duty to promote healthy business operations of the company and, thus, “the company`s best interest.” Therefore, a company`s best interests cannot be ascertained if the director`s secondary duties are disregarded. It is thus proposed that the South African Companies Act be reformulated in this clear fashion as its UK counterpart, which clearly explains the company's best interests.[585] The UK Companies Act further requires directly or explicitly implores directors, <u>in certain circumstances</u>, to act in the best interests of creditors.[586] UK courts have seemingly decided that these circumstances relate to the company`s insolvency status. When a company is insolvent or is on the brink of insolvency, or has a probability of being insolvent in the near future, directors' duties are expected to shift from those of benefiting members` interests to those of creditors` interests, whose interests would be at stake.[587] Lord Toulson and Lord Hodge in *Bilta (UK) Ltd v Nazir (No 2)*,[588] in remarks concerning the shift of director duties in insolvency circumstances, stated the following:

> It is well established that the fiduciary duties of a director of a company which is insolvent or bordering on insolvency differ from the duties of a company which is able to meet its liabilities, because in the case of the former the director’s duty towards the company

584 ibid, para 66.
585 See s 76(3)(b) of the SA Companies Act which doesn’t explain or give further detail to its meaning of “the best interests of the company”.
586 s 172(3) of the Companies Act of 2006.
587 *Bilta (UK) Ltd v Nazir* (No 2), [2015] UKSC 23.
588 ibid, para 123.

> requires him to have proper regard for the interest of its creditors and prospective creditors…

Insolvency is thus one of the main circumstances that propels company directors` duty to shift from the primary duty. This is why, in most cases, creditors may come through to make arrangements once a company is bordering on the lines of insolvency; they may apply for liquidation, business rescue, or restructuring. These processes affect directors` duties and powers as, in most cases, a neutral person is brought in to ensure that creditor interests are secured the most and, at most, salvage the company. Thus, in the absence of insolvency possibilities, creditor interests, although considered, would remain subjective to the main interests of the company and its members. In *Brady v Brady,*[589] Nourse LJ stated that creditor interests are significant only when a company is ailing financially and thus insignificant when a company`s assets are enormous and the debts minimal. Lord Reed, although agreeing that the company's interests include those of creditors, vehemently denies that there is a "creditor duty" distinct from the directors' fiduciary duty to act in the company's best interests. He asserts the following in *obiter dictum*;

> In summary, I reject the contention, raised in some of the authorities, that there is a "creditor duty" distinct from the directors' fiduciary duty to act in the interests of the company; but I have come to the conclusion that there are circumstances in which the interests of the company, for the purposes of the latter duty, should be understood as including the interests of its creditors as a whole. As it seems to me, there is a risk of confusion if this is described as a creditor duty, as the parties described it, as there is not a duty owed to creditors, or any duty separate from the directors' fiduciary duty to the company. Rather, there is a rule which modifies the ordinary rule whereby, for the purposes of the director's fiduciary duty to act in good faith in the interests of the company, the company's interests are taken to be equivalent to the interests of its members as a whole. I understand all the members of the court to be in agreement on that point. Where the modifying rule applies – a rule which I shall describe as the rule in *West Mercia*, after the leading case of *West Mercia Safetywear Ltd (in liq) v Dodd*[590]- the company's interests are taken to include the interests of its creditors as a whole. The duty remains the director's duty to act in good faith in the interests of the company. The effect of the rule is to require the directors to consider the interests of creditors along with those of members. The weight to be given to their interests, insofar as they may conflict with those of the members, will increase as the company's financial problems become increasingly serious. Where insolvent liquidation or administration is inevitable, the interests of the members cease to bear any weight, and the rule consequently requires the company's interests to be treated as equivalent to the interests of its creditors as a whole...[591]

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589 [1988] BCLC 20, 40.

590 [1988] BCLC 250. The *West Mercia* case is seemingly considered as the leading case concerning the inclusion of creditor interests as a whole in company interests, along with interests of members (the modifying rule giving credence to the enlightened shareholder value approach) and thus a diversion from the ordinary rule which ensured shareholder primacy (shareholder centric approach).

591 *Sequana SA case* (n578), para 11.

The rationale of Lord Reed could probably be that the company employs directors to work for the good of the company as the company`s brains/ soul and thus manage its day-to-day operations. The company, a distinct personality separate from its owners (members), has directors to oversee it and stand as gatekeepers to safeguard its interests even from potential abuse by its owners, members, or any other stakeholder. In safeguarding company interests, the ultimate goal is to benefit its members primarily and its other stakeholders in what Lord Reed terms the modifying rule to the ordinary rule. Directors are thus seized with securing company interests and benefiting its members, although such duty is to the company itself. The effect of the modifying rule is, therefore, to require the directors to consider the interests of creditors and members when pursuing their duty towards the company, not members or creditors.

In pursuing company interests, the extent of consideration of either shareholder or creditor interests is thus determined by the company's financial position. Where insolvent liquidation or administration is inevitable, the members' interests cease to bear any weight, and the rule consequently requires the company's interests to be treated as equivalent to the interests of its creditors as a whole. This similarly applies to situations where a company is financially distressed and has to undergo either creditor compromises, restructuring, or rescue proceedings; in all these circumstances, creditor interests become of essence to the company`s interests in *place* of shareholder interests. The researcher thus concludes that creditor interests and those of members should be considered by directors, in their course of exercising their duty to the company, and not to creditors or members, and thus to ensure the best interests of the company subject to the interests of the *duo* being given interchangeable preferences or precedence depending on the company's financial position. Having canvassed creditor interests in this section, it is essential to now ventilate much on mechanisms developed over time in securing the interests of creditors in companies. One would then note that UK insolvency laws are vast in ensuring creditor protection when insolvency arises.

4.3. Creditor protection mechanisms through law

The following are the broad creditor protection mechanisms by law, and the discussions will explore how the UK addresses each of these categories.

4.3.1. Debtor control mechanisms

This is one of the critical variables to creditor protection mechanisms in the form of restrictions placed on company activities to reduce the risk of default.[592] This mechanism focuses on the daily transactions and operational activities of shareholders and directors, which may expose the company to financial failure and vulnerabilities or potentially deprive creditors of their interests that may be secured in the company's assets.[593] In essence, the mechanisms prescribe minimum remedies for creditors as contained in the coding provisions concerning minimum capital required for incorporation of a company, subsequent restrictions placed on the payment of dividends as per the company's capital, rights of courts to pierce the corporate veil to protect creditors, directors duties to consider and protect interests of creditors, which are measures that are effective in particularly to the protection of unsecured creditors as well as public enforcement of directors in instances of insolvency through among others, disqualification of directors for wrongful trading.[594] A last sub-group of this broad creditor protection mechanism includes legal provisions that address the entire process of liquidation proceedings to ensure equal treatment of equally posited creditors and to minimise the costs of insolvency proceedings in any other case.[595] On this note, the discussion will look at particular developments in the UK made along the debtor model type of creditor protection mechanisms.

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592 Armour J & Bennett H, 'Vulnerable Transactions in Corporate Insolvency' (Oxford, Hart Publishing, 2003) 155.

593 ibid.

594 Mevorach I, 'Transaction Avoidance in Bankruptcy of Corporate Groups' [2011] 8 ECFLR 235–258.

595 ibid.

4.3.1.1. UK Provisions on fraudulent trading and wrongful trading

The interests of creditors under restrictive debtor mechanisms are statutorily provided under section 993 of the Companies Act 2006. That provision makes it a criminal offense for directors to trade to defraud creditors.[596] Further to this, section 213 of the Insolvency Act of 1986 provides that directors of a company undergoing liquidation will be liable to contribute towards the company's assets upon the order of a court, particularly where creditors have been intentionally defrauded.[597] On the other hand, the Report of the Review Committee on Insolvency and Law Practice UK notes that future creditors are also affected in this spectrum, considering that common law extends creditor protection beyond the present creditors.[598] It can be argued that these are some fundamental provisions in the context of creditor protection mechanisms. They do not only deter companies from ignoring the creditor interests but force companies to exercise caution in their daily operations and transactions, particularly with creditors, by ensuring that in the creditor-debtors relations in this context, the company, through its functionaries (directors) does not come off as defrauding creditors or intending to do so as this would attract criminal and civil remedies for the creditors.

On another note are the wrongful trading restrictions regulations for protecting creditors' interests. The Cork Committee has noted these mechanisms as a highly recommended set of rules for inclusion under the wrongful trading prohibition provisions in the Insolvency Act. These provisions are set out in section 214 of the UK Insolvency Act.[599] The rationale behind these provisions is elaborated by noting that functionaries of a company in the UK are obliged to run company business in good faith in the interests of the company's present and future shareholders and the interests of other constituencies being considered to the extent which they enhance shareholder value. In this regard, when insolvency is imminent, functionaries of companies may act out in opportunistic behaviour to reallocate the risk of the business to creditors. Such risk is generally transmissible to creditors through acts such as

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596 s 993 of the UK Companies Act of 2006.

597 s 213 of the Insolvency Act 1986.

598 Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558, London, 1982).

599 s 214 of the Insolvency Act.

where liquidation may be in the interests of creditors, yet directors opt to continue trading.

In contrast, incurred losses will continue to harm the position of and affect the interests of creditors and not shareholders beyond invested amounts.[600] This is the primary trend in small businesses or small private companies where the shareholders and managers are generally the same. It follows that section 214 of the Insolvency Act imposes a form of debtor control mechanisms whereby a duty is imposed on directors to carefully take every necessary step that potentially minimises the likelihood of loss to the company's creditors, especially where it was prima facie evident there was no reasonable prospect of avoiding liquidation that would have benefited creditors.[601] Section 213 provides that in this kind of instance, the court imposes a sanction against a director to pay an amount that the court deems fit.[602]

The standard of debtor behaviour expected and imposed through section 214 has often been criticised as being uncertain and vague with chilling effects for directors, which has been countered as merely a standard imposed to foster the growth of company/business rescue culture, which would at least benefit creditors, within the topic of creditor protection mechanisms.[603] The standard in this regard is argued to be one where, regardless of grey areas that may be imminent, the moment directors perceive the lower prospects of saving a company, they are to immediately redirect their focus to the position and interests of creditors rather than shareholders. This ensures that the company, as a debtor, in their daily operations and transactions, immediately self-restrains and limits its operations to the extent which such operations will further restrict and affect the realisation of interests of creditors and instead opt for liquidation to benefit such creditors. Machado argues further that this approach by the UK is an effective form of ex-post mechanism which, by restring debtor fraudulent and wrongful trading, it is equally creditor protection than a blind non-protective ex-ante approach such as initial minimum capital since internalisation of business risk is best achieved.[604] In this regard, mechanisms such as minimum capital rules are perceived

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600 Machado FS 'Effective Creditor Protection in Private Companies: Mandatory Minimum Capital Rules or Ex Post Mechanisms?' *[2010]* 3 (4) *RDSLJ* 681-718, 701.

601 s 214 of the Insolvency Act UK.

602 s 213 of the Insolvency Act.

603 Gower P & Worthington S, 'Gower & Davies: Principles of Modern Company Law' (9th ed, Sweet and Maxwell Publishers, 2012) 372.

604 Machado (n600) 702.

and contrasted as not offering an equally potent and effective measure of creditor protection. It is further noted that the efficiency of wrongful trading and fraudulent trading rules have been upheld and recommended for adoption at the European Union level.[605]

4.3.1.2. UK Disqualification of directors to protect creditor interests

Machado notes that the company operates through its functionaries within a company's operations and transactional business. To protect the interests of creditors, rules, and laws addressing the disqualification of directors serve as a critical creditor protection mechanism in the UK.[606] Sections 1 and 2 of the Company Directors Disqualification Act of 1996 (CDDA) provide that directors may be disqualified to the extent of prohibition from being a director of a company, from acting as a functionary of a company that receives company property, or from partaking in the promotion, formation, and management of the company directly or indirectly.[607] This means since the inclusion of this provision, disqualification of directors may not only wait on a court order but through an out-of-court disqualification arrangement in as much as grounds can be established in terms of section 6 of CDDA that the director(s) in question are 'unfit,' thus imposing mandatory disqualification.[608] However, the critical question regarding this development is how and where it connects with protecting the interests of creditors. The provision, which seems concerned with addressing serious breaches of commercial morality, recklessness, or gross negligence, had a deeper connection to protecting the interests and position of creditors in the UK.

The courts in the UK have paid attention to the context of undercapitalisation issues and how directors may conduct business to set up an undercapitalised company in a manner that leads it towards insolvency, intentionally or negligently harm creditors, then leave the company to form another and repeat the same procedure.[609] This kind of conduct breeds commercial immorality. Hence, the mechanism of disqualifying directors found to be acting in such a manner where directors attempt to trade at the

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605 Report of the High-Level Group of Company Law Experts on A Modern Regulatory Framework for Company Law in Europe (2002) 68.

606 Machado (n600) 702.

607 ibid.

608 ibid.

609 The Cork Committee described such scheme as the 'Phoenix syndrome'. Vide Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558, London, 1982).

expense of creditors, and this attracts a two-year minimum to 15 years maximum director disqualification, with the possibility of criminal and civil liability for debts incurred by the company they ran in instances where such disqualified directors fail to comply with the disqualification order.[610]

This mechanism has been criticised as almost restricting the flexibility of directors in terms of the minimum capital needed to establish a business or rather to borrow from creditors in pursuance of business without risking the creation of the image of attempting to trade at the expense of creditors. As a more defined statutory mechanism, it has been further argued that if the legislature is not better positioned than shareholders to assess what would be adequate finance for a business over related business risk, then the courts are likely to be in the same position and encounter the same capitalisation over risk phenomenon.[611]

Machado pinpoints and makes a clear contrast that this argumentation is not well founded because even if it may be difficult for courts to assess what is an adequate amount to finance a business that still provides a cushion for creditors, courts are, however, placed in a more flexible position where it is possible to take into account the size of the business plan, type of business or venture and other relevant factors.[612] It is further argued that this mechanism works because it provides an assessment phase where the court's focus is placed on the directors' intention or gross negligence, which could prejudice creditors by under capitalising the company in question, which is a stark contrast to courts merely scrutinising the adequacy of capital financing of a business.[613] The creditor protection mechanism is further argued to be more effective in protecting the interests of creditors because the director disqualification rules are broader in scope than the mechanism of wrongful trading. The main reason is that disqualification rules apply to the entire conduct of directors and not merely conduct exhibited after the point at which there was no reasonable prospect that liquidation would be avoidable.[614]

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610 *Keypak Homecare Ltd, Re* [1990] B.C.L.C. 440.
611 Machado (n600) 703.
612 ibid.
613 Ibid.
614 Gower (n603) 372.

4.3.1.3. Piercing the corporate veil to protect creditors

English law is very cardinal regarding the doctrine of piercing the corporate veil and developed and entrenched under common law. Bruck notes that the doctrine of piercing the corporate veil originates in common law, particularly English law.[615] In its origins, the doctrine is perceived to have been a mere reaction to the inflexible position held by the House of Lords on a decision made to the effect that entities have distinct personalities separate from the directors overseeing the entity. In the case of *Salomon v Salomon*,[616] the House of Lords decided that an entity should be separated from its shareholders and directors by applying the law. The entity was held to be different and separate from the natural persons subscribing to its memorandum of incorporation, subsequently attracting a separation in liability. This decision separates entities from the natural persons overseeing the entity. Still, most importantly, this decision also came with the exception of piercing the corporate veil.

What has been a matter of contention under this mechanism, as much as the protection of creditors is concerned has been the issue relating to the standard, criterion, and basis on which a company's corporate veil may be pierced. The first testing standard entails that there must be some unified interest and ownership between the entity and its owners, so separating their personalities has to cease existing.[617] This entails that the interests of both entities and owners should be separated so that their personalities can hardly be separated. This would infer that a separation of personality between the entity and its owner would be a fallacy in such a case. The successful application of this test would entail that a common law court has passed the first test standard. The second testing standard entails adhering to the principle of separate personality between the entity and its owners, which should only lead to inequitable situations where injustice results.[618] In this case, the inequitable situation is deemed to be cause for applying piercing the veil where taking all acts and inferring that they are acts of the entity only and not the owners of the entity leads to

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615 Bruck k, 'Lifting the Corporate Veil in Corporate Groups under the Commercial Code of Ethiopia' (LLD thesis, Adis Ababa University, 2003) 60.

616 [1896] UKHL 1, [1897] AC 22.

617 Backer LC, 'Comparative Corporate Law: United States, European Union, China and Japan, Cases and Materials, (Carolina Academic Press, Durham, 2002) 987.

618 ibid.

an unfair situation towards third parties, which in this case could be creditors who may be disadvantaged or harmed thus justifying the piercing of the veil.

In direct application to the position of creditors, piercing the corporate veil protects creditors mostly from the opportunistic behaviour of directors. In illustration, directors may attempt to reallocate risk to creditors due to liability limitation that comes automatically from incorporation and separation of the entity and its directors. It follows that courts are inclined to allow creditors to gain access to shareholders' assets to disregard the general but essential limited liability of shareholders.[619] This would entail piercing the corporate veil at work and yielding positive results for creditors who may have suffered losses. Machado further elaborates that, in theory, applying the piercing of the veil doctrine to protect creditors under UK laws means that where a company is set up with an inadequate capital structure or incurs debts, then the doctrine allows for those debts or undercapitalisation to be satisfied by realising the personal assets of the functionaries of the company.[620] This means whether the debts were incurred out of gross negligence or intention to harm creditors and whether that is the same for the undercapitalisation of the company, the position of creditors would be protected as the limited liability of company functionaries would be set aside, the veil pierced and the affairs of the company fully assessed for purposes of protecting the interests of creditors.

Mulbert notes that the English courts have less reserve to disregard the corporate personality in undercapitalisation matters more than other common law jurisdictions.[621] The UK court's approach is considered conservative even when dealing with parent-subsidiary structures where business may be pursued under thinly capitalised subsidiaries as customary practice in the sectors.[622] For instance, in the case of *Adams v Cape Industries Plc*,[623] the court noted that there was an entitlement to lift the corporate veil where a company that was a member of a corporate group used the corporate structure as a means to pass legal liability to another member of the group rather than the relevant corporate group.[624] Furthermore, UK courts favour

619 *Salomon case* (n616).
620 Machado (n600) 703.
621 Mülbert PO, 'A synthetic view of different concepts of creditor protection – or: A high-level framework for corporate creditor protection' [2006] 7 (1) EBOLR 357-408, 392.
622 *Atlas Maritime Co SA v Avalon Maritime Ltd, The Coral Rose* [1991] 4 All E.R. 769.
623 [1990] Ch. 433.
624 ibid.

piercing the corporate veil under the creditor protection context in cases of torts, small private companies than public companies, because of the potential of risk allocation to creditors based on how the decision-making constituency is generally vested in a shareholder who will be one functionary serving the company.[625]

Concerns about using this mechanism to protect creditors have been vague regarding the best point for creditors to rely on this mechanism. Another observation is that in the UK, courts do not just apply the mechanism in undercapitalisation cases, which restricts the mechanism's essentiality. Regardless of these shortcomings, this remains one of the most effective creditor mechanisms one can use in the UK, and it presents itself as a cheaper administrative route.

4.3.2. Credit contracts mechanisms

Goode has referred to this model of creditor protection mechanism as the self-help mechanism adopted and utilised by creditors to protect their interests.[626] This would entail a collection of carefully developed and adopted legal provisions to ensure their ability to assume various forms of security and collateral that protect the interests of creditors dealing with companies. For instance, these cover variables such as mortgages, floating charges, financial collateral, retention of title clauses, enforcement of interests through seizures and sale of assets, the appointment of receivers without a court order, and insolvency set-off clauses that capture and guarantee the protection of secured creditors' interests.[627] In these mechanisms, the law plays a fundamental role in setting the tone and precedent for recognition of ranks and claims by individual different creditors.

On this note, it is essential to explore further which of the UK creditor protection mechanisms are aligned with this broad category of creditor protection mechanisms under credit contracts.

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625 Mülbert '(n621).

626 Goode R & van Zwieten K, 'Principles of Corporate Insolvency Law' (4th edn, Sweet & Maxwell, London, 2011) 79.

627 ibid.

4. 3.2.1. Liens, set-offs, security interests contracts, Debentures, and retention of title

UK laws allow creditors to conclude contracts with companies when granting credits to secure interests in the company's liquidity or insolvency. This generally refers to getting security over a loan given to a company by having a security contract, also known as proprietary right acquisition over a specific company property. As will be further shown in the following insolvency procedure discussions, creditors who hold such contracts or security will, at a time of winding up the company, be allowed by the Insolvency Act of1986 to take away such an asset from the company or any other creditor to satisfy the debt, for as long as the credit security agreement made specific reference to the particular property.[628] This mechanism is held to be an efficient creditor protection approach in the UK as it allows the creditor to elevate creditor position amongst other creditors without the need to compete with other claims from different creditors secondly, is the ability of the creditor to trace usage, value of the property and whether or not such property has been wrongfully dispossessed or not and lastly is the easiness for getting independent out-of-court settlement or enforcement for debt repayment based on holding proprietary rights over a specific asset of the company.[629]

A second provision under the UK Insolvency procedure deals with the need for liens to be drawn in the form of floating charge holders wherein non-constant assets that change quantity and value are involved as a means to secure a loan by a company.[630] These kinds of agreements need not refer to a specific piece of property of the company as a form of security for the loan, as this can even cover the whole business and the non-constant assets traded by the company in question or other assets that the company will acquire in the future. This creditor contract mechanism is part of UK statutes. It is regarded as an effective creditor protection mechanism to ensure that secured creditors do not get all the assets to the detriment of other creditors.[631]

Another key creditor contract mechanism available for the protection of creditors in the UK is the notion of debentures. The term debenture arises from commercial practice,

628 Insolvency Act of 1986.
629 Jackson TH, 'Bankruptcy, no bankruptcy and the creditors' bargain' [1982] 91, YLJ 857, 868.
630 Insolvency Act of 1986.
631 Finch V, 'Corporate Insolvency Law: Perspectives and Principles' (Cambridge University Press 2009) 55.

which means documented evidence that a debt is secured. The reason why debentures are not direct secure debt forms is depicted in the case of *British India Steam Navigation Co v IRC*,[632] where under Lindley J, a debenture can apply to unsecured debt in the sense that through a simple acknowledgment of indebtedness, given to a creditor (unsecured or secured), becomes a debenture which also comes with an undertaking by directors to pay certain fixed instalments. Debentures are, therefore, a vital creditor protection mechanism as they further allow debenture holders access to company accounts and directors' reports. Such debenture holders will also have to be noted on the company register, where other debenture holders can also inspect.[633] In addition to debentures being a general creditor protection mechanism, the Companies Act further makes a mandatory requirement that debentures secured by a charge must be registered with the Companies House together with the charge either land, negotiable instrument, uncalled shares, book debts, or floating charges among others.[634] The sole purpose of this additional requirement can be argued to be a further measure to ensure complete protection of current and prospective creditors since these registered debentures will publicly appear on a company profile, which enables prospective creditors to assess the risk of making credit-granting decisions. In *National Provincial Bank v Charnley,*[635] it was noted that by registering a charge on a debenture, creditors are also sorted on a priority list, and the failure to register the debenture is that the charge becomes void and unenforceable. However, this does not extinguish the debt itself.

The UK laws also provide for other fundamental creditor interests security mechanisms in contractual forms, such as the retention of title. Retention of title is another vital creditor protection mechanism wherein the creditor includes a title retention clause in the credit agreement. This clause would be to the effect that even if goods or a service has been rendered to the company, the ownership and proprietary rights to the goods will remain with the creditor until the price of sale is fully paid. In this case, the company will only acquire possession of the related goods acquired on credit due to the effect of the retention clause included in the related agreement between the parties. In the case of *Aluminium Industrie Vaassen BV v Romalpa*

632 (1881) 7 QBD 165.
633 s 744-748 of the Companies Act of 2006 UK.
634 s 860 of the Companies Act of 2006 UK.
635 [1924] 1 KB 431.

Aluminium Ltd,[636] the creditor (Aluminium Industrie) included a retention of title clause over goods given on credit. When the debtor company (Romalpa) became insolvent, another creditor claimed to be a holder of a floating charge over such goods given on retention of the title clause by Aluminium Industrie. The court noted that the goods provided on credit by Aluminium Industrie had never been entirely part of Romalpa's estate and could not be part of a floating charge for another creditor.[637] The court further noted that in this case, such a retention clause was valid even if it was not registered, on the basis that only assets belonging to the company and then charged to a creditor would need to be registered.[638]

Lastly, in the case of *Foster v Wilson,*[639] the court had to deliberate on how creditors' interest can be protected in a case where there are agreements between the company and creditor alluding to the fact that the creditor will loan money or service to the company and in return the creditor gets some service from the same company on credit. The court held that in this instance if the company were to become insolvent, such a creditor would not have to pay what it owes the company and then wait with other unsecured creditors for payment of what the company owes them but, instead, a set-off of the applicable debt difference must be executed followed by payment of the difference. This also depends on the creditors' ability to settle the set-off difference.[640]

4.3.3. Insolvency procedure mechanisms as creditor protection mechanisms in the UK

Insolvency procedures are generally translated as mechanisms governing corporate reorganization and liquidation. Insolvency procedures are typically provided for in laws of general applications as rules relating to the execution of insolvency (corporate bankruptcy) proceedings by shareholders and directors, with other exclusive provisions on whether a collection of creditors can file for insolvency based on the balance sheet of the company or a single creditor's ability to commence liquidation proceedings, priority given across different creditor groups in liquidation proceedings, and whether directors can retain control during such proceedings or whether creditors

636 [1976] 1 WLR 676.
637 ibid.
638 ibid.
639 (1843) 152 ER 1165.
640 ibid.

alone (secured or unsecured) shareholders or courts have the final authority in the appointment of a business rescue practitioner (bankruptcy trustee, or administrator as may be applicable).

In this context, a state of insolvency is one where a company cannot pay its debts to the creditors. Insolvency in the case of companies is made possible by the creation of debtor-creditor relations wherein companies borrow or consume services on credit, thus incurring debt. In this regard, the need to protect creditors arises when a company must be wound up. Unlike many procedures, the winding-up process considers the interests of creditors with high priority. One critical issue in the insolvency procedures is whether creditors are secured. Companies in their operations will generally obtain credit by either borrowing or offering security to the creditor, which would, in turn, make the creditor a secure creditor. Companies can also seek and acquire loans without offering security; thus, the creditor risks being an unsecured creditor and, in other cases, obtaining loans on a third-party guarantee who, in most cases, maybe the director of the debtor company. Notwithstanding which criterion a creditor falls under, the interests of creditors must be protected to deter and prevent company functionaries from engaging in opportunistic behaviour, especially if they know that under all various mechanisms, including insolvency procedures, some creditors may not be protected.

As the UK is part of the European Union (EU), the EU has been developing corporate law-making procedures to harmonise member states' corporate law. In the EU Second Company Law Directive of 1976,[641] public companies were required to maintain their legal capital. This leaves room for member states to draw and develop their legislative approach on issues such as the solvency and liquidity of private companies. The UK designed and reformed its corporate laws through the Companies Act of 2006, which prescribes regulations on minimum legal capital for public companies and how capital reduction can be permitted through creditor(s) and court consent.[642] On the other hand, private companies have a different approach to creditor protection, which is heavily characterised by insolvency and liquidity prescripts.

641 EU Second Company Law Directive of 1976.
642 Companies Act of 2006.

Section 122(1) (f) of the Insolvency Act of 1986 provides that a court can grant a petition for winding up a company in the UK where such a company cannot pay its debts.[643] In the stages pre-wounding up, the courts generally do a cash flow test and an assets over liabilities test to determine whether the company in question has a cash flow issue and whether the liabilities exceed the assets, including contingent and prospective liabilities, to make an order relating to winding up, administration or voidable transaction, which also automatically imposes liability on directors as a response to creditors interests being secured.

According to the Bankruptcy Act of 1941 UK, it has always been statutorily followed that under the insolvency procedures aimed at protecting creditors, losses are to be shared among the creditors proportionally.[644] The procedures also pay attention to secured creditors who hold a security agreement over specific property of the company, and such a creditor will be allowed to have their debt satisfied by taking away such an asset during these insolvency procedures without much administrative deliberations. Section 176A of the Insolvency Act provides that an issue arises in the case of unsecured creditors' interests and that a certain amount of money must be set aside as a ring-fenced fund for catering to all unsecured creditors.[645] The amount is set at 600 000 euros or 20% of the residue value or, in other cases, 50% of the value of anything under 10 000 euros.[646]

There are four critical procedures by which UK insolvency laws and procedures are executed to bring finality to the affairs of a company experiencing financial woes. These four procedures are voluntary company arrangement, administration, administrative receivership, and the winding up procedure. The proceeding discussion will go through these four procedures, given how they best serve and cater to creditors' interests.

4.3.3.1. Voluntary Company arrangement to protect creditor interests

The procedure of voluntary company arrangement entails that the directors of a company may propose to creditors to accept a certain amount of the debt owed, for

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643 s 122(1) (f) of the Insolvency Act of 1986 UK.
644 Bankruptcy Act of 1914 UK.
645 s 176A of the Insolvency Act of 1986 UK.
646 ibid.

instance, 70%, and spread the repayment of that amount over a certain period on grounds the company also commits to a new business restructure scheme.[647] The procedure is voluntary under UK laws, except for small companies. The procedure may be initiated by the director(s), administrator, or liquidator if appointed.[648] Secured and preferred creditors' interests may not be reduced without their consent, and the entire procedure unfolds under the supervision of an insolvency practitioner who oversees and scrutinises company reports, finances, and proposals for debt reduction. From its inception to contemporary times, voluntary company arrangements were not widely used. It, however, is an available mechanism by which the company *mero motu* proposes to settle the debts, with the consent of the creditors, in a manner that will be comfortable and allow the company to survive. In an objective sense, the mechanism serves to protect the interests of creditors when evoked, thus very relevant to this study. It is noted that the creditors must vote on the proposal, and at least 75 percent of the consensus would approve the proposal, making it binding on all creditors.[649]

4.3.3.2. Administration as a creditor protection mechanism

The administration is the second procedure, noted to be borne after the Cork Report of 1982 that advocated for fostering the 'business rescue culture' and the need for the process to unfold in a transparent, accountable, and collective manner.[650] Under Schedule B1 para3 of the Enterprises Act of 2002, which updates provisions of the Insolvency Act, the administrator, once appointed, has the primary duty of rescuing the company as a going concern and, where not possible, then realising the available assets to distribute to all creditors.[651] The significant effect of invoking an administration process is the statutory moratorium placed on claims, bringing enforcement procedure to recover debts by creditors, and a bar on secured creditors taking or selling assets subject to security unless a court order is sought for and

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647 Insolvency Act, s 1-7 UK.
648 s 4 Insolvency Act of 1986 UK.
649 Insolvency Rules 1986 Rule 1.19.
650 *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd* [2003] BCC 885, on the "rescue culture".
651 Schedule B1 para 67 of the Enterprise Act of 2002 UK.

granted.[652] The moratorium ensures that the administrator who replaces the directors has breathing space to restructure and manage the company's affairs.

It is important to note that at this juncture, it is theoretically founded that the duties of the appointed administrator, in this case, are solely to be performed in the interests of creditors. The administrator must draft a restructure plan and proposal, which must be tendered to the registrar and unsecured creditors within ten weeks from the appointment, followed by a creditors' meeting to vote and approve the proposed plan(s).[653] However, before drafting the plans and presenting them to the creditors for approval, it was noted in *Re Transbus International Ltd*[654] that as per Schedule B1 para 59, an administrator might do whatever is necessary or expedient in the management of affairs of the company and its property since the process of administration as a whole is meant to be a flexible, cheaper, comparatively informal alternative to liquidation. Thus, no more applications must be lodged in court for administration purposes. This can, for instance, entail that, as per the administrator's assessment and balance of probabilities, they can sell all available assets to realise the creditors' claims and end the subsequent process. It has followed that due to the flexibility of administration, it has become common practice for UK companies to negotiate with banks and get an administrator appointed under an agreement that the business will be sold immediately (often company directors are the buyers), which positively keeps the business running, keeps employees in their jobs and most importantly secures interests of creditors all over again.[655] These have become known as pre-packaged administrations, and in the case of *Re Kayley Vending Ltd,*[656] it was noted that in these kinds of administrations, the applicant debtor company must furnish enough information to the effect that the arrangement is not being used to the detriment and disadvantage of unsecured creditors. In *Revenue and Customs Commissioners case,* the court affirmed Re Kayley's decision. Further, it noted that in all out-of-court administrator appointment arrangements, the administrator's conduct

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652 Schedule B1 para 40-44 of the Insolvency Act of 1986.
653 Schedule B1 paras 60-69 of the Insolvency Act of 1986.
654 [2004] EWCH 932 [9].
655 Frisby S, 'A Preliminary Analysis of Pre-packaged Administrations: Report to R3- the Association of Business Recovery Professionals' (London: R3, 2007) 50.
656 [2009] EWCH 904 (Ch), [2009] BCC 578.

would be highly scrutinised, with particular attention paid to how they treat unsecured creditors.[657]

Lastly, the administrator has broad discretion in making the most subjectively and objectively appropriate decision. This would either be to save the company, sell the business, or wind up the company, which all must be done in a manner that does not harm the creditors. In *Re Charnley Davies Ltd (No 2)*[658], it was alleged that the administrator had harmed the creditors by deciding to sell the business at an undervalued price; however, creditors cannot sue the administrator in his capacity as the duties performed are owed to the company.

4.3.3.3. Receivership

Receivership is one of the procedures once fully recognised and followed under the insolvency procedures in the UK. The method has become partially abolished in contemporary times.[659] Under this mechanism, a secured creditor or holder of a floating charge or proprietary rights would be empowered to appoint an administrative receiver whose sole duty would be to realise the value of the floating charge or secured item for the holder once it became exercisable, regardless of other preferential debt being in existence and needing to be paid.[660] The chances of debt recovery for unsecured creditors would be meagre under these circumstances. The holder of such a proprietary right owed no duty to any other creditor regarding the time of appointing a receiver, even if such an appointment would negatively affect the refinancing or restructuring of the business.[661] It is submitted that one of the reasons for its partial abolition is that the process would leave little value for the company, and other creditors, there would be minimal incentive or balance to cater and balance all their interests.[662] Receivership is, however, still available and permissible for floating charges created before 2003 as well as in other eight types of corporate insolvency, namely, capital market investments, public-private partnerships with step-in rights, utility projects, urban regeneration projects, extensive project finance with step-in

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657 *Revenue and Customs Commissioners v Maxwell* 2010] EWCA Civ 1379.
658 [2003] EWCA Civ 1506, [2004] BCC 111.
659 Insolvency Act of 1986 UK.
660 *Shamji v Johnson Matthey Bankers Ltd* [1986] BCLC 278
661 ibid.
662 ibid.

rights, financial market, system and collateral security charges, registered social landlords and rail and water companies.[663] It can be argued that regardless of trying to protect the interests of creditors, this method remains restricted and cannot fully protect all affected creditors with the same standard of care and concern for their different secure or unsecured interests.

4.3.3.4. The liquidation mechanism for creditor protection

Liquidation is generally the last mechanism and measures applied in addressing the affairs of a financially burdened company. The major effect of liquidation is that it brings the operation and incorporation of a company to an end. In the UK, the process can be invoked by both the shareholders and directors in the form of voluntary liquidation or by the creditor(s) in the form of compulsory liquidation, and provisional liquidation can also be granted in cases of urgent threats to the company assets, mechanisms also common to South Africa. The aftermath includes selling assets and liquidating other goods to pay creditors first and then shareholders if any value remains. In the liquidation process, a liquidator is appointed for the sole purpose of realising the value of the company, distribution of assets in order of statutory priority, releasing the claims of fixed security interest holders, paying preferential creditors (the liquidator's expenses, employees and pensions, and the ring-fenced fund for unsecured creditors), the floating charge holder, unsecured creditors, deferred debts, and finally shareholders.[664]

In essence, the liquidator has a broad discretion similar to an administrator who may subjectively and objectively decide how to address the insolvency, realisation of company value, and distribution of assets, with the interests of creditors paramount. This is, therefore, a valid and available creditor protection mechanism in the UK that can effectively bring back partial or whole interests invested in the debtor company for all creditors concerned, depending on the circumstances of each case.

The UK has also recently amended some of its Insolvency laws in 2017 purposively to modernise the laws in England and Wales to acknowledge electronic communications usage for creditors, removal of mandatory physical creditors

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663 *Feetum v Levy* [2006] Ch 585.
664 s 74(2) (f) of the Insolvency Act 1986 UK.

meetings, creditors' options for further correspondences, and payment of small dividends by office holders without needing creditors to lodge a formal claim.[665]

4.4. Conclusion

In essence, the UK is a developed economy wherein debtor-creditor relations can be assumed to have reached a certain point of development through regulation and developments made through applicable laws. The courts in the UK have explored the extent to which creditor interests should be considered in pursuing company interests.[666] Also, the discussions of this chapter show the conservative yet effective mechanisms employed by the UK in protecting the interests of creditors when dealing with businesses or companies. To ensure a coherent rationale for creditor protection, the UK provides, in theory, law, and judicial practice, clear directives and guidelines for how creditors are protected in dealing with companies. As per the three broad categories explored herein, the UK caters to creditors' interests and needs through debtor control mechanisms as per provisions of law, which can be common law or statutory in this case, also through creditor contracts that restrict and protect the interests of the creditors from the point of granting the credit and also when all fails, the insolvency procedures which are more administrative and judicial but objectively designed to protect and realise interests of creditors.

On this note, it is essential to proceed to a different jurisdiction while reserving the key distinguishing features of the UK jurisdiction for further comparison with South Africa's current position and other jurisdictions, as discussed in the ensuing chapters.

665 Modernised insolvency rules commence in April 2017 "The Insolvency Service" 25 October 2016.
666 See paragraph 4.2.2 above and, also the *Sequana SA case* (n578).

CHAPTER 5: CREDITOR PROTECTION IN THE USA

5.1. Introduction

The previous chapter looked at creditor protection mechanisms in the UK. The findings indicate that the UK is a developed economy from which debtor-creditor relations can be assumed to have reached a certain point of development through regulation and developments made through applicable laws. The discussions of this chapter show the conservative yet effective mechanisms employed by the UK in protecting the interests of creditors when dealing with businesses or companies. To ensure a coherent rationale for creditor protection, the UK provides, in theory, law, and judicial practice, clear directives and guidelines for how creditors are protected in dealing with companies. The UK caters to creditors' interests and needs through debtor control mechanisms as per provisions of law, which can be common law or statutory, and also through creditor contracts that restrict and protect the interests of the creditors from the point of granting the credit and only when all fails, the insolvency procedures which are more administrative and judicial but objectively designed to protect and realise interests of creditors.

This chapter will explore creditor protection laws in the USA. A critical comparison with South African creditor protection laws shall be undertaken; the objective is to measure the effectiveness of South African creditor protective mechanisms against those implemented in the USA to draw useful conclusions for developing South African laws.

5.2. An overview of the development of debtor-creditor law landscape in respect of creditor protection in the USA

According to Warren, corporate creditors are entitled to satisfy their debts and get some benefit from all or part of a corporation's resources.[667] Such creditors are also further entitled to access and recover debts from other third parties due to the corporation that owes them or to recover debt from individual members to the extent of paying off the creditors.[668] Warren also notes that regardless of this becoming standard practice in modern-day America, it was not the position when American laws

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667 Warren EH 'Safeguarding the Creditors of Corporations' [1923] XXXVI (5), HLR 509.
668 ibid.

were versed in the British laws.[669] No creditor protection mechanisms were available to analyse charters, parliamentary Acts, and judicial decisions. Safeguards for creditors could be found only as a matter of exceptional circumstances through express provision by charter or statute creating clauses which are also noted to have been rare.[670] In this regard, in all American states where British law reigned, the general rule was that no safeguards were available for creditor protection in dealing with corporations until the American Revolution.[671]

Warren traces the period of the first incorporation of companies in the USA until 1830, where he notes that the period before 1830 is marked with corporate law, which did not protect corporations' creditors. Warren notes that the first incorporation case of the Beverly Cotton Manufactory was the precedential indication that the legislature did not protect corporate creditors.[672] Such creditors are reported to have only had some form of protection under common law principles and equal protection of all creditors, those of individuals and those of corporations.[673] Warren reports that around 1809, the legislature adopted an extreme position to safeguard creditors of corporations by requiring that members of a corporation be liable for corporate debts as claimed by creditors.[674] However, in 1830, the policy to require corporate members to pay creditors was repealed. The legislature redressed this position by adopting a policy requiring corporations to set aside a defined capital share amount, which would pay toward creditors' safety.[675]

Furthermore, the policy required that shares had to have a par value and that shares should not be issued unless a value was received in the form of cash or the equivalent of money to the extent it matched the par value of the shares.[676] In furtherance of this position in 1903, it was required that shares with par value be reflected with a dollar sign in the significance of monetary value. However, in 1920, these developments were reversed to the initial position in the Beverly Cotton Manufacturing factory. While

669 ibid, 521.
670 ibid.
671 ibid.
672 ibid 531.
673 ibid 532.
674 ibid.
675 ibid.
ibid.

it is clear that the legislature recognised the importance of and attempted to place a protection mechanism for corporate creditors, Warren notes that statutes began to shape out and meet the needs of changing times to add to the creditor protection mechanism of payment of defined capital.

According to the General Laws:[677]

> (a) Annual reports of condition must be filed which are open to public inspection; and the officers signing a report are jointly and severally liable for all the debts and contracts of the corporation contracted or entered into while they are officers, if the report is false in any material representation and they know, or on reasonable examination could have known, that it was false.
> (b) Stockholders are liable, within limits, in case of un- authorized reductions of capital stock (see below);
> (c) Stockholders are liable, within limits, for debts to operatives;
> (d) Directors are jointly and severally liable for the debts and contracts of the corporation in the following cases: "First, for declaring or assenting to a dividend if the corporation is, or thereby is rendered, bankrupt or insolvent, to the extent of such dividend." Second, for debts contracted between the time of making or assenting to a loan to a stockholder or director and the time of its repayment, to the extent of such loan. "Directors who vote against declaring said dividend or who vote against making said loan shall not be liable as aforesaid."

This shows how the American legislature began shaping laws and introducing certain safeguards and protection mechanisms for corporate creditors. Key to this law was the prohibition of the reduction of capital stock, which would render the corporation bankrupt or insolvent. Warren notes that understanding how this is significantly aimed at protecting the interests of creditors would be done through understanding the term 'capital' as used in capital stock.[678] A company obtains assets through three main mechanisms: receiving from stockholders, receiving from creditors, and through earnings and profits. Upon receiving or earning, a company does not separate or place its capital or assets in different compartments but places them in one unit or mass. In this regard, a corporate body would find itself restricted from capital stock reduction in a manner that could lead to bankruptcy or insolvency, which would subsequently affect the interests of creditors.

Before exploring how the USA currently deals with creditor protection mechanisms under debtor-creditor relations in the corporate sector, examining and defining the debtor-creditor relationship and the circumstances that give rise to such a relationship

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677 s 47, s 48, s 36, s 35, s 38, s 40 & s 37 of the US General Laws.

678 Warren (n667) 534.

in US corporate settings is essential. The laws regulating and defining debtor-creditor relations in the USA are split between state legislation, case law, and federal statutes. For instance, Federal related laws include the US Federal Tax Lien Act 16 of 1954,[679] which regulates tax-related liabilities and penalties and bestows the State with a lien over the property or property rights, whether real or personal rights that belong to the affected person, in this case, who would be reckoned a debtor and the State a creditor.

The Fair Debt Collection Practices Act[680] is another federal law in the US used to regulate and restrict the conduct of third-party debt collectors when employing debt collection mechanisms on behalf of a creditor. This is an important piece of law in this study as it defines areas around creditors using third parties to collect debts on their behalf. The law essentially regulates when and how debt collection can be carried out and the scope of people whom such debt collectors may contact to execute the mandate of a creditor. The law also prescribes liability and damages if a debtor's rights are violated during the case, and the debtor can sue both the creditor and the debt collector. This law is relevant because it defines another critical area of collecting proceeds that a creditor is owed, in a sense, defining a mechanism for creditor protection against debtors.[681]

The Consumer Credit Protection Act[682] of 1601 is another Federal law of lesser significance to the study as it primarily seeks to protect consumer rights when dealing with creditors. The core idea behind the law is to ensure that credit consumers are not subjected to abuse in lending or getting credit from creditors. Federal law, however, indicates that the US recognises the importance of the debtor-creditor relationship in economic fluidity. The Federal institutions are equipped with agency regulatory frameworks to regulate Banks and Banking and Commercial Practices. The United States Supreme Court and the US Circuit Courts of Appeals also enforce federal laws. One of the cases from the Federal courts, *Till et ux. v. SCS Credit Corp*,[683] indicates the interpretation and application of creditor protection mechanisms under Federal laws. This mechanism will be discussed in full in succeeding discussions. Still, the court explored the 'cram down option' permitted under the Bankruptcy Code to protect

679 Federal Tax Lien Act 16 of 1954.
680 Fair Debt Collection Practices Act 15 of 1692 first adopted 1601.
681 ibid.
682 Consumer Credit Protection Act 15 of 1601.
683 541 US 465 (2004).

secured creditors through liens or undertaking of future property disbursements with a significant value not less than the debt claim amount.[684]

On the other hand, the state also has several statutory frameworks to regulate and define the creditor-debtor relationship. For instance, the Uniform Fraudulent Transfer Act (renamed the Uniform Voidable Transactions Act 2014)[685] is an essential legal tool in protecting creditors' rights and providing commercial litigation. The Act is generally applied in instances that allow a creditor to seize personal property or real estate of various family members, assistants, or associates of the debtor/perpetrator, depending on the circumstances. This applies in cases where the debtor tries to divest themselves of assets while they have pending claims that creditors await for settlement.[686] In this Act, a creditor is defined as "a person holding a claim, matured or immature, liquidated or unliquidated. The victim of a fraud scheme or embezzlement is a creditor."[687] A debtor is defined as a person who has the obligation to return a sum of money or property to its rightful owner.[688] The application of the Act must be limited to instances where the debtor divests assets to hinder, delay, or defraud a creditor or creditors. This practical and effective legal tool can be operationalized in the debtor-creditor relationship to protect the creditor's interests.

The New York Debtor and Creditor Law,[689] almost similar to the Uniform Fraudulent Transfer Act, regulates instances in which the debtor divests their assets where a creditor's claim is due, intending to hinder, delay, or defraud the creditor. The creditor is provided with the burden of proving the claim based on a preponderance of the evidence.[690] Like the Federal position, the State has courts that interpret and apply these debtor-creditor-related laws.

684 ibid.
685 Uniform Fraudulent Transfer Act as amended 2014.
686 ibid.
687 ibid.
688 ibid.
689 New York Debtor and Creditor Law. (Consolidated laws of New York) 1-291.
690 ibid chp 580 section 2.

5.2.1. Preliminary approach to creditor protection in the USA

The state is declared bankrupt when a company struggles financially in the USA. Bankruptcy is defined in the Federal Bankruptcy Law in Title 11 of the US Code (Bankruptcy Code), which complies with the US Constitution. Article 1 of the US Constitution provides that no State is permitted to pass regulations on bankruptcy. Still, States may pass laws that define and regulate other elements of the debtor-creditor relationship.[691] Debtor-creditor law is further defined as the law regulating instances where one party, known as the debtor, becomes incapable of discharging and paying debts to another, known as the creditor and the law centres on bankruptcy proceedings.[692]

Creditors are defined in this regard based on three broad categories. First is the category of creditors with a lien against a particular piece of property belonging to the debtor. If the debtor experiences bankruptcy, this kind of creditor must benefit from the proceeds or the sale of such a property as a mechanism to satisfy the debt. A lien may, therefore, arise in terms of statute (a statutory lien does not depend on common law or specific contractual clause), contractual agreement between parties (where through undertaking and agreement, one party offers collateral for a loan or credit that has been extended) and or judicial proceedings. Under this first category, regardless of how the lien comes to be, the common element is that the creditor is to be secure or have some form of security undertaking in exchange for a loan or credit given to the debtor.

The second category of creditors is one where the creditors own 'priority interest.' This aspect of priority arises as a result of statutory law. For instance, the Federal Tax Lien Act prescribes in its provisions that priority is given to creditors on debts owed to the Federal government arising from the Act.[693] This means a creditor in this regard, which would be the State, will enjoy priority on all debtors' obligations to creditors where the Federal government is owed to it in respect of the Act mentioned above.

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[691] US Constitution 1789 Article I.
[692] Bankruptcy Code 1978.
[693] Federal Tax Lien Act 1966

The third category of creditors includes creditors who do not have a lien against the debtor or a priority interest as per statute. These creditors are the ones who get paid and are only considered after the first two categories have satisfied their interests and debts. This means that the last category of creditors can be inferred as being at greater risk when dealing with a bankrupt debtor who may not have good enough assets to satisfy all creditors' interests.

Most US debtor-creditor law revolves around the pivot of bankruptcy proceedings, driving toward how creditors can obtain repayment from non-insolvent debtors. In this regard, creditors are provided with either the judicial approach or private sector debt collection mechanisms as regulated by the Fair Debt Collection Practices Act.[694]

5.3. Creditor protection mechanisms in the USA

The above discussions map out and define the landscape of debtor-creditor relations and further point to the availability of mechanisms that can be adopted to enforce debt or protect creditors. However, this is not in-depth, nor does it contrast across some of the mechanisms. The following discussions will conduct an in-depth analysis of these mechanisms one after the other. Pistor argues that the laws and mechanisms that regulate a country’s creditor rights accurately reflect the distinct pathway to economic development and the influence of political values and legal culture that influence development styles and possibly frame judicial and statutory responses to evolving the business environment.[695]

5.3.1. Judicial protection-based mechanisms

Judicial mechanisms are heralded as the primary mechanisms for debt enforcement and creditor protection, as demonstrated below.

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694 Fair Debt Collection Practices Act 1977.

695 K Pistor *‘Legal Ground Rules in Coordinated and Liberal Market Economies’* in Hopt KJ *et al* (eds), ‘Corporate Governance in Context: Corporations, Markets & States in Europe, Japan & the US’ (Oxford University Press, 2006) 264.

5.3.1.1. Attachment

Attachment mechanisms are employed through a court order in two instances: first as a pre-trial provisional remedy and second as a mechanism to enforce a final judgment or judgment debt. The first instance of using attachment in the pre-trial situation is aimed at protecting the interests of a creditor in a case where there is a possibility of the debtor who now becomes a defendant attempting to liquidate the property or transfer assets outside the jurisdiction of US courts. In such a case, the debtor would have become judgment-proof and avoid being taken to court to repay creditors. It is clear that this mechanism is essential and protects creditors significantly by allowing creditors to attach the debtor's property before obtaining a final judgment concerning the claim. This may also apply to the attachment of part of a bank account to ensure a debtor does not transfer money to an offshore account where the US courts have no jurisdiction. This mechanism is, however, carried out with an approach aimed at balancing both debtor and creditors' rights and interests, mainly where attachment is done as a provisional remedy before the final judgment debt. The plaintiff, the creditor, will be required to pay the court a form of cash bond, which serves as security that the debtor's property will be returned after the final judgment, which is not in favour of the creditor. These procedural safeguards are a balancing approach to ensure that in protecting the interests and rights of a creditor, those of a debtor are not infringed upon. When the property or liquid assets are attached, the US courts will generally directly transfer the property to the creditors or sell and give creditors the proceeds in any other case, depending on each case.

In the case of *In re Aquarius Disk Services Inc*,[696] the court considered whether or not it was appropriate to grant a creditor relief through attachment within 90 days after the debtor had filed for bankruptcy. Considering that a general moratorium could protect a debtor from any creditor action, the court relied on public policy favouring the protection of the creditor's interests by ordering attachment to proceed with a judgment debt to perfect the claim. In reaching the decision, the court also noted how it would pay attention to the need to secure the interests of unsecured creditors who may not have the same ability to claim for attachment within 90 days of the debtor filing for bankruptcy. This case shows that while the courts have broader discretion, they are

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[696] 254 BR 253 (9th Circuit 2000).

primarily guided by whether an attachment order would impact the interests of unsecured creditors. Furthermore, a writ of attachment is obtainable because it does not worsen the debtor's position or affect unsecured creditors.

5.3.1.2. Garnishment

Garnishment is another important mechanism by which creditors' interests may be protected in a debtor-creditor relationship. This mechanism is employed through the courts. An order for garnishment entails that the creditor, who will be the plaintiff in the matter, may collect or be paid by the debtor, who will be the defendant. The order for garnishment further instructs and mandates third parties who owe the principal debtor to pay a portion or all of the money to the creditor of the debtor whom they owe. However, in general practice, garnishment orders significantly impact the debtor's wages as the court may order that the garnishment order applies to the debtor's wages. However, the Federal Consumer Credit Protection Act of 1671 limits wage garnishment to create a balance.[697] The Act provides that where a garnishment order is directed towards a debtor's wages, it may not apply on more than 25% of the take-home wages or be 30 times proportional to the federal minimum wage, whichever would be less. The title provides as follows:

> (a)Maximum allowable garnishment
> Except as provided in subsection (b) and section 1675 of this title, the maximum part of the aggregate disposable earnings of an individual for any workweek which is is subjected to garnishment may not exceed
> (1)25 per centum of his disposable earnings for that week, or
> (2)the amount by which his disposable earnings for that week exceed thirty times the Federal minimum hourly wage prescribed by section 206(a)(1) of title 29 in effect at the time the earnings are payable,
> Whichever is less. In the case of earnings for any pay period other than a week, the Secretary of Labour shall, by regulation, prescribe a multiple of the Federal minimum hourly wage equivalent in effect to that set forth in paragraph (2).
> (b)Exceptions
> (1)The restrictions of subsection (a) do not apply in the case of
> (A)any order for the support of any person issued by a court of competent jurisdiction or in accordance with an administrative procedure, which is established by State law, which affords substantial due process, and which is subject to judicial review.
> (B) any order of any court of the United States having jurisdiction over cases under chapter 13 of title 11.
> (C) any debt due for any State or Federal tax.
> (2)The maximum part of the aggregate disposable earnings of an individual for any workweek which is subject to garnishment to enforce any order for the support of any person shall not exceed—

[697] Consumer Credit Protection Act 15 of 1671.

(A)where such individual is supporting his spouse or dependent child (other than a spouse or child with respect to whose support such order is used), 50 per centum of such individual's disposable earnings for that week; and
(B)where such individual is not supporting such a spouse or dependent child described in clause (A), 60 per centum of such individual's disposable earnings for that week;
except that, with respect to the disposable earnings of any individual for any workweek, the 50 per centum specified in clause (A) shall be deemed to be 55 per centum and the 60 per centum specified in clause (B) shall be deemed to be 65 per centum, if and to the extent that such earnings are subject to garnishment to enforce a support order with respect to a period which is prior to the twelve-week period which ends with the beginning of such workweek.
(c)Execution or enforcement of garnishment order or process prohibited
No court of the United States or any State, and no State (or officer or agency thereof), may make, execute, or enforce any order or process in violation of this section.

The restrictions on applying It is argued that in the scope of more than one remedy being available for creditor protection, most creditors opt for other mechanisms, such as attachment. It can be inferred from this study that wage garnishment is an example of a long-term debt repayment plan that will provide a repayment method in small or small portions over a longer period, which may not be economically practical. In this case, it would be understandable and reasonable for a creditor to prefer a mechanism such as attachment, especially in huge or significant debt values, that would significantly impact creditor operations if not repaid.

The case of *Sniadach. v Family Finance Corp*[698] indicates tensions regarding the applicability of garnishment in protecting the interests of creditors. The majority judgment hammered on the fact that garnishment orders made on a defendant's wages were equal to driving the defendant into poverty, considering the defendant would also be forced to pay attorney collection fees, among others.[699] The majority judgment argued on the constitutionality and compliance with due process (entailing one was entitled to hear the matter and make an opposition or defense before his property is taken or administered) of garnishment orders on wages, especially in cases where it can be determined that such wages are for supporting a family's welfare. In this first variance, there was no regard or mention of creditor protection or interests as a key or overriding cause of deciding for garnishment in all or a limited and defined number of cases. In this first variance, it was noted that garnishment on wages was not possible for a higher percentage of the wages in at least ten states in the US. At the same time, California, Pennsylvania, South Carolina, and Texas have laws that

698 337 89 S Ct 1820 (1969).
699 ibid.

protect wages from garnishment. One would have to serve a garnishment order on the defendant's employer in a different State with relaxed laws if the employer has offices in a different State. On the other hand, the dissenting judgment argued that as long as the employer and creditor comply with the maximum legal amount of garnishment of wages, even where there are multiple creditors, this would stand.[700] In other words, the dissenting judgment noted that the garnishment order for wages should be looked at in consideration of all amounts of money, inclusive of child support, if any, which the defendant is paying as a result of an order made against their payroll, and should satisfy the elements of legality in terms of law. The case of Snaidach is vital in this study because it is a big step in the US creditor protection summary remedies, as it came with the introduction of procedural safeguards aimed at balancing and protecting the interests of both creditors and debtors by ensuring that while a sound claim by a creditor is not the be ignored, this should not leave the debtor in a destitute position while remedying the position of the creditor.

5.3.1.3. Replevin

This creditor protection mechanism applies in cases of secured creditors, particularly in cases of a creditor who holds a lien or other security interest in a particular property of the debtor. In its original form, the mechanism means to employ measures to retain personal property wrongfully taken or held by another. In the debtor-creditor relation, the mechanism entails an action by which creditors recover collateral when a debtor defaults concerning secure loans. For instance, where a bank has financed some property and the debtor happens to be in default at a particular point or has missed several significant payments, such a bank/creditor would be entitled to file a replevin action against the debtor and repossess the property to recover the debt. A replevin may, therefore, be granted either as a provisional remedy or as a final judgment followed by a writ of authorisation of repossession of property, which secured the debt or property in which a creditor has secured interests based on credit given to the debtor. This method can be regarded as an effective creditor protection tool as it ensures that where a creditor issues out a loan on condition of being secured in some form and where the debtor defaults significantly, the creditor is entitled to seek a court

[700] ibid.

order to execute the property to recover the debt in this regard. This mechanism also simultaneously ensures that the debtor is prevented from divesting the asset or transferring the property in a manner where it becomes out of reach of the court's jurisdiction, which would prejudice the creditors.

Similar to the garnishment issue, the remedy of replevin has also been scrutinized in American case law, particularly regarding the violation of the 14th Amendment due process requirement. The due process requirement entails that one is entitled to a hearing where all sides are heard before the state can take away the liberty or property of the person affected. The courts have reasoned with an inclination of reasoning made in *Snaidance v Finance Family Corp,* where it was argued that summary remedies for relief of creditors and other stakeholders such as replevin have become embedded in the legal structure; however, are at loggerheads with the concept of due process.[701] In the case of *Fuentes v. Shevin,*[702] the court dealt with a case where the plaintiffs had obtained household goods on conditional sales contracts and defaulted on payments, resulting in the seller obtaining a writ of replevin through state procedures, allowing him to repossess the goods.[703] In this regard, the remedy of replevin for creditor became an issue, particularly with questions regarding its fairness considering the requirements for due process wherein the seizure of the property, regardless of being a summary remedy, was done before a hearing. Like the garnishment issue, the court had to weigh the rights of debtors and those of creditors in the case of a replevin. The majority judgment disagreed with all four arguments the defendants and the sellers presented. The defendants argued that the plaintiffs (debtors) had waived their rights to due process when they signed the conditional sales agreement. However, the majority judgment refused to accept this argument because there was no sufficient evidence to show the plaintiff was made fully aware of the effect of the waiver provisions.[704] Secondly, the defendants argued that the plaintiffs held no property rights under the conditional sales agreement after they defaulted in payment. However, the majority judgment noted that any interest in property was protected under the Constitution, and the plaintiffs had such interest.[705]

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701 ibid.
702 407 US. 337 (1972).
703 ibid.
704 ibid.
705 ibid.

Thirdly, the defendants also argued that safeguards were only necessary when the related goods were essential to sustaining life. Thus, unlike in Snaidach, the issue of safeguards was inapplicable. However, the majority judgment noted that no prior case made such a similar distinction.[706] In their fourth argument, the defendants pointed out that a seizure such as a replevin was a summary remedy allowed by courts as an extraordinary measure in particular circumstances. However, the majority judgment disagreed. The majority judgment noted that in all cases where such seizures had been upheld, at least three key things would be present, namely, the seizure would be to enforce State or public interest, if there were a need for prompt action, and the seizure would be conducted and controlled by the State.[707] The majority indicated that these three elements were not found in this case, and the seizure was made to enforce private interest, and it was without the control of the State.

Three out of the seven justices gave a dissenting judgment, stating that the practical aspects of procedures had not been considered to the extent of weighing the chances of abuse of replevin through bad faith, as this was not the case. The dissenting judgment noted that the majority had failed to protect creditors' rights adequately. This case highlights that courts still consider several factors and weigh the position of creditors and debtors. Yet, under corporate laws, it seems essential to assess and protect the rights of creditors, particularly where there is evidence that creditors are not abusing a procedure or remedy, just as is the reasoning of the dissenting judgment in this case.

5.3.2. Debtor control law-based mechanisms

These mechanisms refer to those which a creditor imposes on the activities and conduct of the debtor company for the period they exist as going concerns. The overall objective is to reduce the risk of default by the debtor. These mechanisms look at other shareholders' and directors' transactions and activities that may lead the company to fall into a vulnerable state that may be prejudicial to creditors. Such prejudice must be that creditors are deprived of access to all or part of the company's assets for recovery

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[706] ibid.
[707] ibid.

purposes.[708] In essence, the US corporate laws provide for mechanisms such as piercing the corporate veil, directors' duty to consider the interests of creditors, payment of dividends defined in relation to a company's capital, protection of unsecured creditors, and public enforcement of directors' duties.[709] This also relates to liabilities in the event of insolvency through, among other things, the disqualification of directors for wrongful trading. Finally, this sub-category includes provisions to protect the collective nature of liquidation proceedings, the goal of which is to equal treatment of similarly situated creditors and limit the cost of insolvency proceedings.[710]

5.3.3. Credit contracts

Creditors in all areas face an atypical problem if they are not secured and cannot necessarily rely on a common breach of contract remedies to protect their interests. In this regard, the variables range across forms of security and collateral such as mortgages, floating charges, financial collateral, retention of title clause, enforcement of such interests through seizure and sale of assets, the appointment of receivers without a court order, and insolvency set-off clauses, which all entrench the notion of a secured creditor. [711]

5.3.4. Rescue and Insolvency procedures

When consensual and negotiated restructuring or repayment of creditors fail, as well as the above statutory, judicial, or self-control mechanisms fail, insolvency procedures are invoked. Under American bankruptcy law, insolvency procedures are provided as a fundamental last resort tool for protecting creditors' interests. The bankruptcy procedures have a significant effect in that they prevent all other proceedings and claims from being considered, including the processes discussed above. The two critical mechanisms under bankruptcy are Chapter 11 reorganisation and Chapter 7 liquidation.

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708 Armmour J & Bennet H, 'Vulnerable Transactions in Corporate Insolvency' (Oxford, Hart publishing 2003) 66.

709 McCormack G, 'Swelling Corporate Assets: Changing What Is on the Menu' [2006] 6 JCLS 39–69.

710 Mevrach I, 'Transaction Avoidance in Bankruptcy of Corporate Groups' [2011] *8* ECFLR*,* 235–258.

711 Goode (n626).

5.3.4.1. Chapter 11 reorganisations

Chapter 11 of the US Code regulates the reorganisation of business entities other than banks, insurance companies, stockbrokers, and commodity brokers.[712] Once initiated, this process will have two significant effects. The first is the automatic stay effect, which allows a debtor to be free from meeting claims (pending, ongoing, or others) while being allowed to preserve and carry on business operations.[713] As this happens, the debtor is allowed to propose a corporate reorganisation plan. The second and most important effect and objective of the Chapter 11 mechanism are to maximise the probability of recovery of debtor's creditors.[714] In essence, chapter 11 reorganisation allows the preservation of business as a going concern, allowing judicial-based adjustments of debts and reduction of amounts owed or extending of repayment terms, as well as implementing an effective operational structure to maximise profits. At the core of this process is the need to satisfy and protect the interests of creditors.

The Chapter 11 process also allows for partial or wholesale of the entity or its liquidation. However, the difference between Chapter 7 liquidation and Chapter 11 liquidation or sale is that the entity remains under the control of the same management in most cases.[715] A Chapter 11 liquidation can be invoked voluntarily by the debtor or involuntarily by the creditors filing for relief under a US Bankruptcy Court. Section 109(a) of the US Code provides that a creditor is eligible for voluntary bankruptcy under Chapter 11 where domiciled or operates business or has property in the US.[716] The property requirement is a low threshold requirement since even a small amount of money in a US bank account or a retainer agreement with a US law firm sufficiently constitutes property for these purposes. When the process is initiated, any other party that institutes an action against the debtor or attempts in some way to gain access to control the debtor is subjected to a penalty due to the automatic stay effect.

In the case of an involuntary filing for bankruptcy, at least three creditors must jointly petition for the involuntary bankruptcy case. In this case, the debtor is also allowed to challenge the petition. The critical issue in this regard is how the law around Chapter

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712 US Code Chapter 11 s 109.
713 s 362 US Code chapter 11.
714 ibid.
715 Chapter 11 US Code.
716 s 109(a) US Code Chapter 11.

11 makes it clear that for as long as a company is solvent, the directors of such a company owe fiduciary duties to the company and ultimate beneficiaries, who are shareholders. However, when a company becomes insolvent, the creditors are deemed to automatically replace the position and priority enjoyed by shareholders as residual shareholders. The directors also begin to owe fiduciary duties to creditors.[717]

In this case, the mechanism is not subject to stricter requirements for eligibility purposes as a company does not necessarily need to be insolvent with liabilities exceeding assets or be unable to pay debts.[718] Many other solvent companies would instead implement these mechanisms voluntarily to restructure their business without much interference from third parties. The petition of this mechanism voluntarily by a debtor can be dismissed or refused where it is brought in bad faith or where there is sufficient evidence that the debtor is managing to pay debts as they become due. According to section 1112(4), bankruptcy courts look at whether or not granting such an order or dismissing it would be in the best interests of creditors.[719] This indicates that creditors' interests are at the centre of this mechanism; hence it finds significant relevance in this study as a vital creditor safeguard or protection mechanism.

Key to the process is the mechanisms by which the debtor's conduct is monitored while undergoing chapter 11 reorganisation to ensure the company's state of affairs as a going concern is not further worsened. For instance, the debtor will have to obtain consent and approval of the court *instead* of creditors' and shareholders' position before engaging in conduct that results in incurring secured debt, usage of liquid assets or cash as collateral, paying pre-petition claims, transacting business outside ordinary course of business or paying employees for pre-petition services.[720] In the same scope, a debtor granted a Chapter 11 mechanism will be allowed 120 days to develop and propose a Chapter 11 plan for reorganising the corporation.[721] Where these 120 days are running, no other party may submit or propose their plan. However, suppose the bankruptcy court does not extend the period upon application by the debtor with sufficient cause shown. In that case, other interested parties may either apply for termination of the debtor's exclusivity to propose a plan and have their own

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717 US Code chapter 11 involuntary bankruptcy.
718 s 1112 US Code Chapter 11.
719 ibid.
720 ibid.
721 s 1121 US Code Chapter 11.

approved instead.[722] Key to the plan and of significance to protecting creditors' interests is that the plan should broadly divide and define eligible claimants or parties with interests into different classes.[723] Each class must have similar claims or interests, for instance, a class of impaired claims or interests that are not paid in full or altered in some way. The plan can only be voted for and approved or rejected by a resolution of creditors with impaired interests or claims who are to receive and benefit from distribution in respect of the plan. A class of interested parties with unimpaired interests is regarded as accepting the plan impliedly, and classes without entitlement to receive and recover are regarded as rejecting the proposed plan. For overall approval of the plan, creditors with at least two-thirds in amount and more than one-half in a number of allowed claims in such a class must have voted for the plan. For the plan to also be crammed down on the rejecting class of interested parties, at least one impaired class of creditors must have approved the plan, and the plan must inherently meet section 1129 of Bankruptcy Code requirements, not subject parties to unfair discrimination and be fair and equitable.[724]

5.3.4.2. Chapter 7 liquidation

Chapter 7 of the Bankruptcy Code provides the ultimate mechanism to protect US creditors under liquidation.[725] Under this mechanism, a financially struggling company's non-exempt and non-secured assets will be liquidated to pay creditors. In this regard, a Chapter 7 trustee is appointed to oversee, manage, or realise all available assets of the entity and sell them off for the most reasonable value to distribute the proceeds among creditors. The trustee must follow the priority in preference of whom to pay first as set out by the Bankruptcy code. In this regard, secured creditors must lodge their claims first regarding property with a security interest, followed by the state or Federal government in pursuance of tax or other debts, and then unsecured creditors.[726] Sometimes, the Chapter 7 liquidation process is commenced due to a Chapter 11 reorganisation being converted to liquidation. The appointed trustee under Chapter 7 must investigate the company's affairs and pursue

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722 s 1121(d) US Code Chapter 11.
723 s 1126 US Code Chapter 11.
724 s 1129(b) US Code Chapter 11.
725 Chapter 7 of the US Code.
726 US Code Chapter 7 liquidation.

all available avenues or causes of action to significantly help maximize the recoveries that can be channelled to creditors.

Like Chapter 11 proceedings, a Chapter 7 proceeding can be commenced by filing a voluntary or involuntary petition. Furthermore, at least three creditors must jointly apply for the order of commencement of the involuntary Chapter 7 liquidation process, with the debtor company also being allowed to challenge the application.[727] According to section 707 of the US Code, a company may get into chapter 7 proceedings notwithstanding whether or not it is insolvent.[728] The substantive means test in this regard entails that for one to qualify for Chapter 7, liquidation ensures that only well-deserving parties are entitled to utilise the mechanism. For instance, parties with higher income-to-debt ratios who do not meet the Chapter 7 means tests can file for legal tools under Chapter 11 or 13, which generally leads to a higher distribution ratio for creditors.

Similar to Chapter 11, the Chapter 7 liquidation process is carried out under the supervision of the court. The only essential difference with the Chapter 11 process is that in Chapter 7, the trustee oversees the collection of non-exempt assets, liquidates them, and distributes them to the creditors.[729] The overall objective of the process is to ensure the company's affairs and business is divested as opposed to rehabilitation or reorganisation of the company as in the Chapter 11 reorganisation process. Section 365(e) of the US Code provides an automatic moratorium on stay or proceedings to allow the trustee to fully divest the debtor's affairs and business to distribute proceeds to creditors.[730] The provision also prohibits the automatic repudiation of contracts by parties to the debtor-creditor relationship based on the bankruptcy.

The procedure is expected to take at least a few months, considering that the objective is simply one of realising assets and distributing proceeds, unlike Chapter 11 reorganisation processes which may need and take more time. A Chapter 7 liquidation process may only take longer than a year when complex assets or litigation issues are imminent. However, upon completing the process, the trustee must draft and file a report on all his activities covering the investigations made, assets realised, and

727 ibid.
728 s 707 of the US Code Chapter 7.
729 US Code Chapter 7.
730 s 365(e) of the US Code Chapter 7.

distribution of proceeds. The report must also be accompanied by a certification that the debtor's estate has been entirely administered. Any party intending to object to the report would generally have at least 30 days to do so from the day the report is issued, and where there are no objections, it will be presumed that the estate has indeed been entirely administered; the trustee is therefore discharged from office.

5.3.4.3. Protecting foreign creditors

The US bankruptcy laws express that the foreign creditors of US debtor companies enjoy the same status as US creditors, and no distinct or formal requirements must be satisfied before being entitled to the exact protection mechanisms as those applicable to US creditors. This will also apply to the foreign creditor without alteration in instances with an automatic moratorium. However, the applicability of this position depends on whether the foreign creditor has priory submitted to US jurisdiction expressly or impliedly by carrying on business or acquiring assets located in the US. The foreign creditor must also be seeking recovery in a US bankruptcy matter.

In the case of *In Re JPA No. 111 Co., Ltd. and JPA No. 48 Co. Ltd,*[731] two Japanese single-purpose entities (debtors) owned aircraft leased to an airline. However, their business was affected by the Covid-19 pandemic and became financially distressed. FitzWalter Capital, a financial trading company, acquired a substantial portion of the secured debt of the foreign entities in 2021 and appointed itself as the security agent. FitzWalter then commenced foreclosure procedures in England regarding the leased aircraft. When the debtors became aware of the foreclosures being carried out by FitzWalter, they lodged a Chapter 11 procedure in the Bankruptcy Court in New York. The reason for Chapter 11 was to get the court's approval for differential bid procedures for the aircraft in a manner that would maximise returns and provide better equity, which they argued the English foreclosure would be incapable of doing. FitzWalter challenged this and applied for dismissal of the Chapter 11 application on the basis that the applicants lacked jurisdiction, alleging the application had been made in bad faith to frustrate the efforts of FitzWalter and that the court had to abstain in terms of section 305(a) (1) of the Bankruptcy Code on the basis that among other

[731] 21-12075 (DSJ).

factors, a means was available for the distribution of the debtor's assets.[732] The court refused to dismiss the matter after considering several factors, including the prospect of recovering a high value from the sale, which would bring more than the foreclosure. The case highlighted the need for foreign parties to be cautious of several issues when getting a Chapter 11 under the US courts, noting that Chapter 11 brings several burdens. Sometimes, the foreign parties may be in the best position by seeking other remedies or halting certain proceedings in the foreign jurisdiction than in the US. However, the case also consolidated that foreign parties have a voice and can be protected in the US courts, but they need to be aware of the imminent burdens of the bankruptcy process.

5.4. Conclusion

The USA provides a more detailed rescue-oriented approach to creditor protection than it does for liquidation, which the US Code clearly provides straightforwardly. The approach towards liquidation has some fundamental similarities to South Africa, the UK, and Australia, as shown in the next chapter. However, the most unique of its mechanisms is the Chapter 11 reorganisation, which is a rescue-oriented mechanism by which the incumbent managing members of the company are not discharged or suspended, and no moratorium will be effective in this regard. The US also expressly affords foreign creditors equal status and rights with US creditors without the need for any formal distinction being met.

[732] ibid.

CHAPTER 6: CREDITOR PROTECTION IN AUSTRALIA

6.0. Introduction

This chapter explores creditor protection laws in Australia. A critical comparison with South African creditor protection laws shall be made, aiming to measure the effectiveness of the South African creditor protective mechanisms against those implemented in Australia to draw useful conclusions for developing South African laws.

6.1. Background to Australia creditor protection

The Australian creditor and debtor law is, just as in South Africa, governed by both common law and statutory regulation. The Australian regulation of creditor protection is widely covered by insolvency procedures, just as in other countries such as the UK, the US, and South Africa. The Corporations Act 2001 provides a detailed approach to creditor protection through insolvency procedures; however, these are not the only recognised and applicable mechanisms. According to Anderson et al., the study of four decades of evolution of shareholder and creditor protection in Australian corporate law indicates that Australia has developed its position in such a manner that it is a worthy comparator and study of jurisprudence.[733] This makes Australia a more viable study for South Africa's lessons regarding effective creditor protection mechanisms. The study carried out by Anderson is a leximetric research study that looks into the protective strength of Australian corporate law for both shareholder and creditor rights and interests in the corporate world. The method adopted in this regard has also been used in various other international investigations of debates regarding the development of legal rules and the effect of multiple regulation styles on diverse economic outcomes.[734] In the preliminary background, the inquiry into Australian creditor protection shows that Australian corporate law bears more protection for shareholders than creditor protection. However, the standard of creditor protection in Australia is also argued to be very effective and broader when compared to other common law and civil law-based states such as the UK, the US, Germany, and Canada.[735] This still justifies the importance of incorporating Australia as a worthy

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[733] Anderson H *et al*, 'The Evolution of Shareholder and Creditor Protection in Australia: An International Comparison' [2012] 16 ICLQ 171.

[734] ibid.

[735] ibid 128.

comparator and survey for South Africa's lessons in effective creditor protection mechanisms.

The key challenge identified in the Australian development of creditor protection mechanisms is through the index that separates secured and unsecured creditors based on the argument that both have differing needs and interests. It is argued that Australian creditor protection mechanisms are developed with the consideration that in protecting the rights and interests of one class, the rights and interests of another class may likely be diminished and try to counteract this in this regard.[736] In a sense, Australian creditor protection mechanisms attempt to cover the diverse nature of creditor needs to offer maximum protection in all diverse circumstances. It is understood that creditor rights become an issue at the time of insolvency of the debtor company that faces liquidation or reorganisation. In these instances, a change can be noted in how secured or unsecured creditors get treated.

In this regard, the creditor protection index in Australian jurisprudence accommodates diversity for the strength of one protection mechanism to compensate for the weakness of another mechanism.[737] An example is where civil law-based mechanisms are generally compensated by the mechanism of legal reserve, which is used to trigger automatic liquidation for the benefit of unsecured creditors. On the same note, a more robust and effective insolvency system acts as the overall overbearing substitute for weaknesses of other mechanisms such as contract or debtor restraining mechanisms. In this regard, it is trite to proceed to discuss and explore creditor protection mechanisms as provided under Australian corporate law.

6.2. Creditor protection mechanisms

6.2.1. Protection through debtor-activity restriction

The use of mechanisms that restrict the conduct and activity of an entity when dealing with creditors is not exclusive to Australia; as shown in previous chapters, both the US and the UK also have mechanisms to regulate debtor activities as a safeguard for creditor interests. In Australia, specific rules are set in place to restrict and regulate

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736 ibid.

737 ibid, 182.

the conduct or activity of debtor companies, with some of them almost similar to those of the other countries discussed. For instance, the debtor restraining mechanisms in this regard fall under a 15-item index, which includes tools such as minimum share capital requirements for incorporation to proceed, dividend restrictions, equitable subordination, piercing the corporate veil, transaction avoidance, directors' liability, and public enforcement.[738] While some of these are common across all discussed states, some differences and additional lessons for South Africa are worth noting.

For instance, while the standard of minimum share capital is cherished and highly utilised in the UK and the US, the same is not required in Australia, considering that private and public companies generally attract separate and dissimilar rules. The Australian corporate law believes that the Department of Trade and Industry White Paper report noted that capital maintenance was largely irrelevant for private companies and their creditors. In the UK, the rule was mostly cherished.[739] As a mechanism regarded to be a debtor restraining mechanism, Australia seems to rely on other mechanisms, such as director liability under section 588V of the Corporations Act for insolvent trading.[740] The Act provides that where directors trade while reasonably expected to foresee insolvency or lead the company into insolvency, they will be held liable to a certain extent regarding the rights of creditors. This mechanism will be discussed in a broader scope under insolvency procedures. However, this differs from the UK 1992 refusal to apportion liability to a holding company's directors to protect creditors. According to the Cork Report, the UK declined to take this approach based on fear of discouraging entrepreneurship and risk unwarranted apportionment of liability.

Australia also prohibits the debtor company from paying dividends unless its assets exceed its liabilities. According to section 254T of the Corporations Act, public or proprietary companies cannot pay a dividend unless their assets exceed their liabilities immediately before the dividend is declared and paid, and the excess must be sufficient for corporate operations.[741] This is a considerable deviation and difference from the English position on payment and definition of dividends. Australia further

738 ibid, 193.
739 UK Department of Trade and Industry white Paper (Company Law Reform).
740 s 588V of the Corporations Act of 2001 Cth.
741 s 254T of the Corporations Act 2001.

requires that the payment of a dividend in that regard, if not leading to a disadvantage for creditors, must also be fair and reasonable towards the company's shareholders and not just materially prejudice the company's capacity to pay creditors.[742] This wording is objectively set to ensure that the creditor protection test is not subjective while considering an additional aspect, which in this case is the position of shareholders. Before adopting this position, Australia required dividends from profits under statutory guidelines resembling the common law creditor protection test. Concerning public companies, this is applicable, as well as additional requirements such as ensuring that the net assets of the company and a variety of calculations have been made beforehand and before paying dividends, considering the uncalled capital and undistributable reserves.[743] The reserves are, however, of little significance considering that unlike in the US, Australia made redundant the concept of share premium account through the abolition of the par value, a valued concept in the US.

In addition to this, Australia also provides a mechanism for equitable subordination, whereby the payment of debts owed by the debtor company to shareholders is withheld and deferred to the payment of outside/external creditors. In other countries, such as the US, this mechanism has been codified and is argued to have originated in the US through leading cases of *Taylor v Standard Gas Electric*[744] and *Pepper v Litton*.[745] In essence, the mechanism allows for the subordination of shareholders' debt to prioritise and pay company creditors first. Despite the mechanism being borrowed from the US, the substance of supporting laws differs in Australia. In contrast, this mechanism was advocated for in the UK in a limited scope but was not implemented.[746]

In essence, the debtor restraining mechanism provided for in Australia, as shown here, indicates that the set objective with regards to the position of creditors is that pre or post-remedial tools must be available to ensure the company's business is not traded

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742 ibid.
743 ibid.
744 306 US 307 (1939).
745 308 US 295 (1939).
746 Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558, 1982) (Cork Report) was chaired by Kenneth Cork. The Cork Report was followed by a White Paper in 1984, A Revised Framework for Insolvency Law (Cmnd 9175, 1984), and these led to the Insolvency Act 1986 (UK).

in a manner which can leave the creditors at risk of loss of their invested interests in the debtor company.

6.2.2. Protection through creditor contract rights

A second mechanism for creditor protection in Australia is creditor contract rules. This aspect includes set-off, enforcement of contracts, availability of security interests, and retention of title. These are also referred to as self-help or self-protection mechanisms outside the scope of insolvency law and proceedings. These can be set and implemented based on either law or through creditor contracts with the debtor company. In this instance, creditors are allowed to be proactive in adopting self-protection when dealing with consumers of debt in the corporate sphere. These adoptions also entail that they can be in the form of various non-possessory security interests.

With regards to set off, the Australian High Court ruled in 2023 in the case of *Metal Manufactures Pty Ltd v Morton*[747] it was held that a creditor is not entitled to deduct any outstanding claims against a debtor company from its liability to repay the company's liquidator unfair preference. This judgment is heralded for clarifying the murk area surrounding set-off wherein unfair preferences would occur in the name of a set-off, and the liquidator would have no means of recovery to accommodate all creditors, particularly unsecured creditors. This decision limits the application of set-offs as mechanisms for creditors while enhancing the probability that all creditors, particularly unsecured creditors, will eventually get something from the debtor.

In this instance, Australia is shown as well-developed regarding the utility of retaining title clauses as a contractual right available for creditors. While this mechanism is available in the UK and the US, it has been further codified and provided for in elaborate terms under Australia's 2009 Personal Property and Securities Act.[748] While in the UK, retention of title clause does not have to be registered, the 2009 Australian law makes it mandatory to register retention of title as a critical step towards consolidating a creditor claim and ability to recover from the debtor. In this case, the Australian creditor protection mechanisms in this regard are more advanced in that it

747 [2023] HCA 1.
748 Personal Property Securities Act 2009.

ensures that if this type of creditor contract right is utilised, it must have enough legal authority such that the debtor cannot even dispose of an asset to that they do not have a title. In such a case, the creditor would become aware.

6.2.3. Protection through insolvency law and procedures

The Australian insolvency law and procedures are also carefully drafted and developed to allow various mechanisms to protect creditors' interests and rights before the company is liquidated. The laws further ensure that even in the course of liquidation, creditors are fully protected. The following discussion will break down the various forms of insolvency procedures that are available and designed further to protect the interests and rights of creditors in Australia. In essence, Australia's insolvency mechanisms are aimed at displacing management based on new developments and the addition of voluntary administration. This is a deviation and different approach to how the US approaches insolvency under the Chapter 11 procedure discussed in the last chapter. The Australian insolvency law and procedure are Commonwealth and not state-based. It is regulated by various legislative instruments, primarily the Corporations Act of 2001 and its additional regulations, such as the Insolvency Practice Schedule, a schedule to the Corporations Act, and the Insolvency Practice Rules of 2016.

6.2.3.1. Voluntary administration

The Corporations Act provides for voluntary administration, a procedure added to the Act in 1993 as a development to creditor protection and company debt management mechanism.[749] Before its introduction, the only formal mechanism available before liquidations was compromise provisions under the scheme of the arrangement, which has always been considered expensive, time-consuming, and cumbersome.[750] The main objective of a voluntary administration is to ensure and provide for the business, its property, and its affairs to be administered once the company is deemed insolvent. The reasoning behind this is that there will be a need to maximise and heighten the chances of a company or its business continuing to exist and operate profitably.

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749 Corporations Act 2001 Cth.

750 McKenzie B, 'Overview of Australian Corporate Insolvency regimes: Restructuring & Insolvency' (2018) <http://www.bakermckenzie.com/australia> accessed 28 November 2022.

Secondly, further reasoning is that it will be impossible for the company or business to continue as a going concern capable of bringing better returns for creditors and members/stakeholders if the company is immediately wound up.[751]

In this regard, voluntary administration is a process that allows the company room to breathe and renew for the period applicable, where a moratorium on the proceedings and claims against the company will be effective.[752] This enables the company to continue to operate business and trade and assess and consider other rehabilitation mechanisms that may help the company or otherwise maximise the returns that can be channelled to creditors instead of immediately winding up. This means that the Australian insolvency procedure tries by all means to save the company and the business or at least to maximise potential return for creditors without opting for winding up the company as the key and only mechanism by which creditors' interests and rights may be protected.

A proposal on how to administer the company is placed before the creditors by the administrator for approval;[753] after that, approval of the administration is then implemented through a deed of company arrangement (DOCA). This DOCA is binding on all key stakeholders, including the company, its shareholders, and its creditors, except for secured creditors who need not vote for the DOCA as their interests and rights would be secured somehow. Therefore, it can be argued that this mechanism essentially protects the interests of unsecured creditors, considering that this class of creditors faces a more detrimental risk when a company becomes insolvent than secured creditors.

As already indicated, the process is a development of previously existing mechanisms and is set to be quick; however, it may extend over a longer period in cases of more complicated administrations. In this regard, the court can extend the administration time to over a year. The mechanism is also favoured for being more accessible and faster to implement as it only requires the company's board of directors to adopt a resolution to enter into administration without court involvement. Further to this, the mechanism is also favoured since the appointment of an administrator presupposes

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751 ibid.
752 Corporations Act 2001 Cth.
753 ibid.

that it can be assumed that directors will be free from liability from insolvent trading. In this case, the company continues to exist and trade regardless of the outcome, without a risk of liability for directors as opposed to continuing to trade while reasonably away or suspicious of insolvency, which would attract liability.

The voluntary administration procedure is regarded to have similar objectives to the US Chapter 11 reorganisation procedure, which is to rehabilitate a financially struggling company.[754] Regardless of these similarities in objective, there are some differences worth noting, such as that in Australia's voluntary administration, company directors are deprived of their management power, and the company falls under the management and administration of an independent insolvency practitioner who should be registered as a liquidator. In this regard, unlike in the US Chapter 11, the debtor company will continue being managed by its general directors. Additionally, in Australia, voluntary administration takes place without court intervention, and if any court involvement happens, it will be minimal, which is different from the US Chapter 11 reorganisation procedures. Lastly, secured creditors with a security interest over an asset or assets of the debtor company are entitled to enforce the security interests within 13 business days from the day of appointment of the administrator or a longer period as may be approved by order of the court or by the administrator, which is also not the case in the US Chapter 11 reorganisation process.[755]

To invoke voluntary administration, as already noted in the passing above, the company's directors need only resolve as such and adopt a resolution that, in their opinion and assessment, the company is insolvent or reasonably expected to become insolvent. As a result, an administrator is appointed.[756] It is, therefore, less common for secured creditors to advocate for or resolve to appoint an administrator, which is essential since affected creditors must approve and consent to the proposed administration. Approval from the proposed administration must be obtained before the administrator's appointment. It is also normal for a company to have more than one administrator appointed jointly or severally to ensure continuity in case of absence or illness. Once appointed, the administrator controls all company affairs and

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[754] ibid. see Voluntary administration under Corporations Act 2001 and US Chapter 11 Reorganisation under US Code.
[755] McKenzie (n750) 4.
[756] Corporations Act 2001.

business, acting as an agent or functionary. The administrator is deemed a fiduciary to the company, almost similar to other board members, and thus bound by the fiduciary duties those members owe.

Regarding section 420A of the Corporations Act, the administrator has broader authority to manage and dispose of assets as he or she may deem fit.[757] To encourage other parties such as employees, other creditors, stakeholders, customers, or suppliers to continue trading with a company under administration, the Act provides for the administrator's liability for all conduct of business and affairs of the company, which may attract further debt during administration.[758] The liability only applies from the appointment day and not to pre-appointment debt or liabilities. In this case, the mechanism key role player is also placed in a position where, to ensure the protection of the creditor’s interests fully, the administrator is forced to trade, perform, or contract with available resources only where it will benefit the company or ultimately benefit the creditors. The administrator is also entitled to indemnification of the company's proceeds for any liabilities or debt incurred in the administrator role and must receive remuneration. This indemnification and remuneration are prioritized over unsecured and secured creditors whose debts are secured by a circulating security interest. This can be argued to be a mechanism to motivate the administrator to do their job while also ensuring the company is not adding further debts by owing the administrator as well, a point which the critical creditors of the company would be aware of at the time of approving the appointment of an administrator at that cost.

During administration, regardless of the directors being suspended, they are expected to assist the administrator, particularly in investigating the company’s affairs. Sometimes, the administrator can also retain board members to help them, subject to discharging their duties and submitting to the administrator's directives. It then follows that only the administrator can deal with company property or assets. This is to the extent that a transfer of shares or alteration of the status of shareholders after administration has commenced will be considered void except when done with the administrator's approval or following an order of court. The appointment of the administrator does not mean that contracts to which the company is a party are

[757] s 420A of the Corporations Act 2001 Cth.
[758] ibid.

repudiated, akin to the US position. In 2018, Australia amended the position to further prohibit counterparties from relying on ipso facto termination clauses in an instance of insolvency, subject to some exceptions.[759] However, the administrator may have to repudiate some contracts that require company performance where such performance is likely to prejudice the position and objective of undertaking administration, such as the lack of funds to perform a contract. These are exceptional circumstances under which the administrator may repudiate contracts, unlike in liquidation, where the liquidator has more authority to reject any contract during liquidation, as will be shown in forthcoming discussions. Where contracts are repudiated in this regard, counterparties may only pursue further legal action under breach of contract where applicable.

Key to this procedure and to ensure the administration is capable of realising proceeds and returns for creditors is the moratorium, which provides that creditors, inclusive of some classes of secured creditors, are prohibited from taking legal action against the company in a bid to recover debts or enforce security interests or even petition for winding up. Furthermore, suppliers or lessors of property being used by the company, including those whose lease agreements contain a retention of title clause or purchase money security interest terms, are also restricted from seizing or reclaiming their relevant property regardless of being contractually entitled to do so. The moratorium will, however, not apply to instances where enforcement measures had already been invoked before the administration was undertaken. It will also not apply in cases of secured creditors whose security interest over part or all of the company's property, where relevant, has been perfected under the Personal Property Securities Act of 2009 and can enforce their security interests within 13 days period from the day of appointment of the administrator.[760] It follows that there is a limitation to the administrator's ability to administer and deal with all property as they cannot deal with property subject to a security interest without consent of the related creditor or approval of the court.

Throughout the process, creditors are required to meet at least on two different occasions. The first meeting of creditors is set to be held immediately after the

[759] Corporations Act 2018 amendment to repudiation of contracts by counterparties *ipso facto* in the event of insolvency or default.

[760] Personal Property Security Act 2009 read together with Corporations Act 2001.

administrator has been appointed, generally within eight business days of appointment. This first meeting is for the creditors to assess and decide whether the appointed administrator is staying in an office or being removed, as well as electing and appointing a committee of inspection: the latter, a committee of inspection, works on the consultative note with the administrator. The second meeting of creditors is generally held five days after the end of the convening period, with the convening period of administration being regarded as the operation of 20 business days from the first day of appointment of the administrator, except for where the court has extended the convening date. At the second meeting, the administrator is expected to provide a report to the creditors that captures the company's business property, affairs, and financial standing. The report must also provide relevant information on the proposed deed of the company arrangement for the creditors. Lastly, the report must have a conclusive opinion of the administrator regarding whether or not the company should adopt and implement the proposed DOCA, for administration to be terminated and management of board members to be retained, or for the company to be subjected to winding up. Reasons and justifications must follow each of the recommendations or opinions.

If a report recommends the adoption of the DOCA, this needs to be fully justified to the effect that the DOCA will result in better returns and benefits for the creditors. However, the report must also consider the difference in returns through either the adoption of DOCA or the winding up of the company. The second meeting will have to be adjourned with a resolution of the creditors in up to 45 business days and, where applicable, a more extended period than that. In each meeting, the administrator must obtain proof of debt for voting purposes by the creditors or proxies for those in absentia.[761] Where a resolution is adopted through a vote by the creditors, for instance, a vote to adopt the DOCA, such a resolution, and DOCA will be binding on the company, creditors, officers, shareholders, and administrators. However, secure creditors will be bound only where they voted for the resolution or DOCA.[762]

The process of administration generally comes to an end after the second meeting of creditors. It is resolved for one of 3 options: ending administration and handing the

761 Corporations Act 2001.
762 Corporations Act 2001.

company back to directors' control, which is less common, or implementing the DOCA or taking the company for winding up through a transitional process to creditors' voluntary winding up.[763]

In this regard, it is essential to note that a DOCA is a crucial statutory contract between the company and its creditors, aimed at governing the relations of the company and the creditors according to the termination of administration.[764] The Corporations Act prescribes minimum standard for a DOCA by noting that the DOCA must address the nature and duration of any moratorium, property available to discharge creditors' claims, order for payments to creditors as per statutory priority applicable to winding up, and the release of company debts.[765] The DOCA is, therefore, a significant deed concerning the eventual impact of undertaking administration to safeguard the interests of the company's creditors. In practice, a DOCA has also been noted to allow the company to trade on, including under the management of its directors, and with provision for a fund for distribution to creditors.[766] A DOCA may not prescribe a compromise of the claims of the creditors in any manner against third parties, even when third parties are funding the DOCA's implementation. The DOCA will also not affect the rights and interests of future creditors where the company continues to trade and incur debt. Where the DOCA has served its purposes, it is set aside, and the company affairs are returned to the management of the company directors. If terminated prematurely, this can lead the company to liquidation.

In essence, the procedure for voluntary administration, as the latest addition to Australia's insolvency procedures, is well crafted, with the interests of the creditors being the recurring objective. The process will thrive on the will of and the promise to benefit the company's creditors. It can be argued that the mechanism is geared to succeed where all involved parties act in good faith within their prescribed roles and duties.

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763 ibid.
764 ibid.
765 ibid.
766 McKenzie (n750) 9.

6.2.3.2. Creditors’ schemes of arrangement

The Corporations Act provides in Chapter 5.1 a creditors’ scheme of arrangement, which is a form of compromise between the company and the creditors.[767] For this mechanism to exist, a draft of scheme documents must be drawn and sent to all affected creditors at least 14 days before the first court hearing to implement the scheme petition.[768] The creditors must meet at the first court hearing to convene a meeting to decide whether or not to approve the material of the creditors’ scheme of arrangement. The affected creditors will, therefore, have to vote for the proposed scheme of arrangement. A second court hearing must be held where the proposed scheme of arrangement gets approved if it has received a majority vote from the creditors during their meeting before the second court hearing. The majority threshold needed for the scheme of arrangement to pass must constitute the creditors whose debts or claims against the debtor company aggregate to at least 75% of the total amount of debts and claims furnished by all present creditors or by proxy in each relevant class of creditors. In the case of *First Pacific Advisors LLC v Boart Longyear Ltd,*[769] it was held that the court avoids a diligent approach to voting class composition to avoid a dissenting creditor having a veto right on whether the scheme is approved. Where the court orders the implementation of the proposed scheme of arrangement, it will become effective.[770] Regardless of attaining the statutory majority requirement, the court retains overbearing discretion regarding whether or not to approve the creditors’ scheme of arrangement.

As outlined above, the whole process generally takes up to 3 months to be completed in cases where the proposed scheme of arrangement had been previously negotiated with other key parties. However, the company must provide evidence that it will become solvent as an outcome of effecting and implementing the compromise or arrangement set out in the scheme of arrangement. This means that the process sets towards a return to solvency, a state favourable for creditors when the debt becomes due, and the company can settle the debt. In the case of *Re Ovato Print Ltd*[771] [2020] NSWSC 1683, the process was described as adopting a mechanism to remove cancer

[767] Chapter 5.1 of the Corporations Act 2001.
[768] ibid.
[769] [2017] NSWCA 116 78.
[770] ibid.
[771] [2020] NSWSC 1683.

in a relatively healthy company. This is, therefore, a good and quick alternative mechanism for helping a company rehabilitate and restore creditors without going through liquidation.

Regardless of its simple outlook, the scheme of arrangement process is considered time-consuming, expensive, and cumbersome, so Australian companies prefer to undertake voluntary administration and DOCA mechanisms. One factor leading to this is the high involvement of the court as set out in the requirement for two court hearings to occur on separate occasions, which is not the case in the administration process.[772] Regardless of these cons, the mechanism is commended for its advantages and effectiveness in corporate insolvency and restructuring companies towards protecting creditors. For instance, arrangements present some flexibility such that a third party can contribute funds for the benefit of creditors under the arrangement that such a party will be effectively released from all claims by the creditors through the relevant scheme of the arrangement, and this cannot be done with the utility of a DOCA. While the high involvement of the court contributes to expenses and time consumption, it brings certainty, considering that once a scheme of arrangement has been adopted through an order of the court, it cannot be set aside, unlike a DOCA that can be set aside with a resolution of creditors. In this case, schemes of arrangement assure the ultimate implementation of the proposed compromise or arrangement.[773]

Furthermore, schemes of arrangement are malleable enough to allow customisation of terms and approaches such that a compromise can be made with a particular class of creditors to exclude others, as held in the case of *Re T & N Ltd [no 4*].[774] For instance, secured creditors can be compromised to exclude trade creditors whose rights can be left unaffected, and they will not be entitled or required to vote for the scheme of arrangement in such a case. Schemes of arrangement also offer better management of any unforeseen diminution of value resulting from a creditors' scheme of arrangement.[775]

This mechanism is a crucial creditor protection tool as it allows creditors and debtors to reach a working compromise outside the scope of insolvency procedures. The

772 *First Pacific Advisors LLC v Boart Longyear Ltd* [2017] NSWCA 116 78.
773 ibid.
774 [2007] 1 Bus LR 1141.
775 Corporations Act 2001.

compromise in this regard can be best captured and argued to be a tool to set the company towards rehabilitative or restructure capacity lane while also attending to the imminent needs of particular creditors who accept the proposed compromise. This means that with the implementation of a compromise or arrangement, it can be deemed that the creditor would be satisfied with the arrangement; otherwise, other mechanisms would be available. On its implementation, a scheme of arrangement binds all creditors in the relevant class of creditors, including secured creditors.[776]

6.2.3.3. Receivership

The Corporation Act refers to a receiver as an appointed manager who acts more like an agent acting on behalf of the possessor of a mortgage.[777] Receivers are, therefore, independent managers of particular secured assets or assets acting on behalf of a secured creditor. The receiver's primary duty is to manage and realise the asset or assets subject to the security interest of the appointing creditor and pay the proceeds towards the creditor's debt settlement or reduction, whichever would be applicable. In some instances, receivers can be court-appointed instead of privately appointed, which would be the exception.[778] Receivership commences when the creditor appoints the receiver with the issuance of a deed of appointment and the subsequent compliance with other procedural formalities according to the security agreement or compliance with provisions of applicable statutes.[779]

The receiver is the key role player in ensuring that the interest and rights of the creditor are well safeguarded in this regard. In his role, the receiver is expected to deal with the relevant asset or assets in a manner that likely discharges the debt owed to the appointing creditor. The receiver will not have any link or role towards unsecured creditors. In this regard, receivership is common and practical and can occur concurrently with administration or liquidation processes. A receiver will also be noted in the security and appointment documents as an agent of the debtor company instead of an agent for the secure creditor. In this case, a receiver will have duties and capacities similar to company officers. It will, however, have defined duties to manage,

776 ibid.
777 ibid.
778 ibid.
779 ibid.

preserve and realise the company's asset or assets for the benefit of the secured creditor, in which a security interest already lies.

The implementation of receivership does not have the roles and powers of members of the company. However, if a receiver is appointed for all or a more considerable and significant amount of the company's assets, then the directors will be left with little to do. Unlike administration, the appointment of a receiver does not impact shareholder dealings with their shares except that such shares are also subject to the security interest of the creditor in question. Additionally, the appointment of a receiver does not amount to or lead to the repudiation of a contract the company is part of. The receiver may, however, have the power to repudiate company contracts that require the company to act or perform in a manner that leaves counterparties entitled to damages for breach of contract against the company. There is, however, no applicable moratorium to stay proceeding or other claims in the case of a receivership being implemented as would occur in cases of administration and winding up.

In this case, a receiver is the vital and main driving factor for safeguarding the interests of a secured creditor and a secured creditor who wishes to pursue their claim outside the scope of insolvency procedures of liquidation or administration. Upon realisation of the asset or assets, the receiver will be required to return any surplus to the company before being discharged from the office. Where receivership occurs concurrently with administration or liquidation, the administrator or liquidator will focus on the claims and debts of unsecured creditors. In contrast, the receivers focus on realising proceeds for appointing secured creditors. Section 420A of the Corporations Act obligates the receiver to exercise the power of sale of property with due diligence and consideration of the market value to the extent that the best price obtainable should be preferred.[780]

In essence, the position of secured creditors is catered for by several mechanisms, including receivership, which can be a quicker and less complex approach to protecting the creditors' interests and rights. Without waiting for other mechanisms, such as administration or winding up, a secure creditor is better placed to pursue their claims through receivership. A key advantage in this regard is that receivership can

[780] s 420A of the Corporations Act 2001.

occur concurrently with liquidation and administration, which waters down the effect of moratoriums applicable to the later procedures.

6.2.3.4. Winding up of a company

The Corporations Act also provides for the winding up of a company, which, like in other discussed countries, is generally the primary and ultimate mechanism to ensure that corporate debtors do not evade paying debtors, ultimately protecting the interests and rights of creditors. In Australia, the winding up of a company can occur either through court-ordered or compulsory winding up or creditors' voluntary winding up.[781] A court-ordered or compulsory winding up can arise and be implemented through an order of the Federal Court of Australia or the Supreme Court of the States and Territories of Australia.[782] In this case, creditors and other eligible company parties must apply to the court to have the company wound up based on insolvency. The common ground or bringing about the application for winding up in this referred is the failure of a company to meet a payment demand within 21 days after a statutory payment demand was made. This is regarded as leading to a presumption of insolvency, which under South African circumstances would be an act of insolvency.[783] In the case of *Pacific Dairies Limited v Orican Pty Ltd*,[784] it was held that the court tends to be unwilling to interfere in shareholder disputes arising during winding up and instead focuses on the utility of the procedure based on just and equitable as the option for both dissident shareholders and dissatisfied creditors. In this case, the just and equitable standard was further illustrated as an effective mechanism for simultaneously addressing creditor distress and shareholder oppression.

In the case of voluntary winding up, it can commence with a special resolution adopted by company members when the directors have not declared solvency.[785] In addition, creditors' resolutions adopted at the second meeting during voluntary administration can also lead to the commencement of voluntary winding up of the company. While the court is highly involved in compulsory or court-ordered winding up, which can only

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781 Corporations Act 2001 cth.
782 ibid.
783 ibid.
784 [2019] VSC 647.
785 ibid.

commence with an order of the court, the same does not apply to voluntary winding up, which can begin without court involvement.

With the elements mentioned above being met, a liquidator must be appointed. The liquidator takes complete control of the company and is endowed with fiduciary duties that members owe to the company. The liquidator's primary duty is to preserve, collect, and sell the company's assets and then distribute the proceeds to creditors in terms of priority prescribed by the Corporations Act.[786] The liquidator can also compel the production of necessary books and documents as may aid in investigating the company's affairs and public examination of persons or members who served as functionaries of the company. In this regard, a liquidator comes into play for one specific task: finalizing all company affairs and ensuring creditors' interests are met. As a result, the liquidator does not trade the company's business.

The order for winding up will have immediate legal consequences, such as suspension of the company's directors' powers.[787] The transfer of shares or alteration of the status of shareholders after the winding-up order will be *ab initio void* except where it happened with the liquidator's approval or the court's consent.[788] Furthermore, there is a moratorium on the stay of proceedings against the company and restriction of claims by unsecured creditors against the company except with the liquidator's consent or with leave of court. This also means that any other dealings for the company's property or assets will also be void.[789] The liquidator will also be able to disclaim onerous property burdened with onerous covenants or property that is impossible to sell, including unprofitable contracts. In this regard, the liquidator does away with anything that adds to the debt value or burdens the company further in any way. The idea from the onset is to realise available assets or profitable prospects and convert them into proceeds distributable across company creditors.

The creditors can also formulate a committee of inspection, which will be responsible for assisting, consulting, and being available for the liquidator. The committee will also

786 Corporations Act 2001 Cth.
787 ibid.
788 ibid.
789 *Re Intellicomms Pty Ltd (in Liq)* [2022] VSC 228.

have the power to approve some company transactions entered into during liquidation and ensure the liquidator is remunerated.

In the winding-up process, unsecured creditors whose debts and claims include contingent and future claims and unliquidated claims against the company must partake in the claim for dividends from available assets regarding their debt. These claims must have arisen before the day the winding-up order was given. Each claim is submitted to and received by the liquidator for adjudication in a quasi-judicial capacity according to the proof of debt mechanisms in the Corporations Act.[790] On the other hand, secured creditors are entitled to enforce the security interest during liquidation. This brings back the issue of utilising a receiver concurrently as the company undergoes liquidation. Other claims that take priority over claims of unsecured creditors include expenses incurred by an administrator or liquidator in preserving and realising the available assets, costs, expenses incurred in obtaining a liquidation order, and priority employee entitlements.[791] The employee priority entitlement complies with the Commonwealth Fair Entitlements Guarantee (FEG), which seeks to protect the interest of employees of a company undergoing the winding-up process.[792] All other unsecured debts and claims are ranked equally in the *pari passu* principle. Where company assets are insufficient to cover all the claims, the affected creditors will receive a proportional amount.

The Corporations Act also provides for automatic set-off during winding up in cases where a creditor asserts a claim against the company, and the company also has a claim against the creditor. In such a case, only the net balance after the automatic set-off will be payable to the creditor. However, the automatic set-off will not apply where the claims are not held in the same capacity or where the creditor was aware or reasonably knew of the company's insolvency at the time of granting the credit to the company or receiving credit from the company.

As consolidated in the recent case of *Re Intellicomms Pty Ltd (in Liq)*[793] to maximize the liquidation process's ability to recover and meet the interests and rights of creditors, the liquidator is further capacitated with extensive power to go above and

790 Corporations Act 2001.
791 ibid.
792 Common Wealth Fair Entitlement Guarantee Agreement.
793 [2022] VSC 228.

beyond. For instance, the liquidator can investigate the company's affairs to the extent of taking legal action against directors and third parties to recover assets or undo certain transactions to increase the asset pool for the benefit of creditors. The liquidator has recovery tools to void any unwarranted transactions they may uncover. For instance, a liquidator may act on unfair preferences and uncommercial transactions. In the case of *Re Intellicomms*, the court addressed the provisions of section 588 FDB of the Corporations Act to redefine unfair preferences or uncommercial transactions as 'creditor-defeating dispositions.'[794]

McKenzie notes that unfair preferences are the most common transactions recovered by liquidators to increase available assets for the benefit of creditors. [795] Unfair preferences are all transactions where a company's creditor receives a benefit for an unsecured debt owed by the company within six months before the invocation of the winding up.[796] In this case, it must also be clear that the unsecured creditor was preferred over other unsecured creditors, proven on a test of whether or not the creditor received more than they would have received under a typical winding-up process in respect of the debt and as a matter of the *pari passu* dividend.[797]

Additionally, it is an unfair preference where payment or advancement of the benefit was made when the company had become insolvent or if the company became insolvent due to making such a preference.[798] Any other payment to a creditor can be regarded as an unfair preference regardless of reasonable and actual consideration in the form of services or goods to the company. The power to recover unfair preference is designed to ensure equitable distribution of proceeds across all unsecured creditors while ensuring that some unsecured creditors are not preferred to the disadvantage of others. In other instances where a creditor had several benefits according to continuous and several transactions, the unfairness in this regard would have to be assessed based on the overall indebtedness of the company to the creditor over time and the consideration given to the company by such a creditor over time. The amount recoverable as unfair preference in such a case would be the net reduction in the company's indebtedness throughout the relationship between the

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[794] ibid.
[795] McKenzie (n750) 9.
[796] ibid.
[797] Corporations Act 2001 cth.
[798] ibid.

company and creditor up to six months before liquidation was undertaken. Creditors can be protected in defence of claiming recovery based on unfair preference reasons if they can prove they were a party to the transaction in good faith and had no reasonable suspicion or expectation of the company being insolvent due to the transaction. Any other reasonable person in their position would made the same deductions and must have also furnished valuable consideration in exchange for the benefit.[799]

The liquidator can also pursue recoveries of benefits given to the company through uncommercial transactions. These voidable transactions entered into at least two years before the invocation of winding up either led to the company's insolvency or were done at a time when the company was already insolvent. The test for an uncommercial transaction is carried out based on various factors, such as weighing the benefit and detriment value to the company and other parties after the transaction is concluded. In other words, this would also be a transaction whose magnitude cannot be explained by standard commercial practice.[800] The overbearing test in most cases would be whether or not the property or disposition was made at an under-value as opposed to maximising proceeds that can be channelled towards creditors. The same defences applicable to unfair preferences also apply to recoveries of uncommercial transactions.

Insolvent trading is another critical issue the liquidator deals with to maximise returns for creditors. In terms of the Corporations Act, directors are entitled to act positively in conducting the business and affairs of the company.[801] As a result, directors may not trade when the company is insolvent in terms of the Act.[802] At the very least, directors may not trade in a manner further detrimental to the company. In this regard, directors may not trade the company business while aware of or suspecting insolvency, which amounts to a breach of their duty to prevent the company from incurring debt. Limited defences are available for directors apprehended in matters of insolvent trading, such as that there was a reasonable expectation for the company to be solvent or to remain solvent, reasonable belief that competent and reliable personnel was acting in

[799] Corporations Act 2001 Cth.
[800] McKenzie (n752) 21.
[801] Corporations Act 2001.
[802] ibid.

fulfilment of obligations to acquire adequate information on the solvency of the company or whether the company would remain solvent and based on such information thus acted with belief solvency would be maintained, or that they did not take part in the management of the company at the time of the trading, or that reasonable steps were taken to prevent the company from being insolvent and or further reliance on safe harbour provisions.

In 2017, the safe harbour principle was introduced to the Corporations Act under section 588GA.[803] The safe harbour applies when the directors become aware of solvency or expected solvency but continue to trade and incur debt under the guise of an adopted mechanism to reasonably drive the company further from insolvency. In this regard, the incurred debt must be directly or indirectly linked to a course of action or mechanism adopted to curtail insolvency. To ensure that the course of action undertaken at that time was reasonably likely to lead to a better outcome, several factors are considered, such as whether the parties had adequately oriented themselves with the company's financial circumstances, any steps taken to curtail misconduct by other members or employees of the company which could have adversely affected the company's ability to meet creditors' demands, steps taken to acquire advice from appropriately qualified entities who can give effective and appropriate advise as well as development and implementation of a restructuring plan aimed at bettering the financial position of the company.[804]

6.3. Conclusion

In conclusion, Australian developments indicate that the processes for protecting mechanisms are designed to complement the other's shortcomings. These processes are all set to help objectively protect and realise creditors' interests and rights. Before considering insolvent procedures, the Corporations Act ensures that effective mechanisms are primarily available to secured creditors. It can be summed that secured creditors enjoy a better and safer position in the Australian corporate jurisprudence. While unsecured creditors must depend mainly on more formalistic processes such as administration and liquidation, other debtor-restricting mechanisms

803 Corporations Act 2001 section 588GA.
804 ibid.

help protect all creditors. The liquidation process is set in a manner that considers this a measure of last resort in trying to recover from the debtor company and pay creditors. The process of liquidation tasks the liquidator with the overbearing duty to ensure that all angles that can help add and maximise available liquidity are pursued to cater for all classes of company creditors.

CHAPTER 7: CONCLUSION AND RECOMMENDATIONS

7.1. Introduction

The previous chapters have explored different creditor protection mechanisms in the UK, the US, Australia, and South Africa protection mechanisms. This has been executed to draw lessons from the developments in other countries with developed corporate law regimes, thus ascertaining best practices on effective creditor protection in the South African corporate sphere. This chapter will give a brief overview of the whole thesis. It will reconcile all fruitful conclusions drawn from selected legal systems and thus ensure that the conclusions of the entire thesis are drawn for recommendations that may influence future directions and possible developments to South Africa`s corporate laws.

7.2. Study summary and chapter-by-chapter major findings

7.2.1. Chapter one

The first chapter of this study defined the problem in a broader sense. The chapter shows that South Africa adopted the 2008 Companies Act to respond to the much-needed legal reform of corporate laws. This is a reform and process facilitated by the emergence of the Republic of South Africa`s Constitutional Act of 1996, which, on a general note, has triggered change and reform across all various fields of South African law. In this reform, the corporate laws were to be aligned with constitutional values while also being shaped by the ever-changing and leading global trends and practices, thus a constitutional reformation goal for all laws. In this regard, chapter one identified that corporate laws are no longer an economical vehicle enhancing shareholders` profit maximisation goals and capitalist motives but also underpin socio-economic goals catering to the rights and needs of all stakeholders. In this regard, a distinction is made that in common law, the corporate stance is shareholder-centric.

In contrast, modern corporate laws focus on the interests and rights of those who invest in corporate success in different ways, thus undoing the idea that the shareholder-centric approach is ultimate. Consequently, the chapter brings up the circumstances of the creditors of companies. The argument made in chapter one is that while at common law, directors would operate a business for the benefit of

shareholders, it is imperative that in modern corporate law, that regard be paid to the stakeholders who stand to lose much if a company fails, namely creditors. The chapter acknowledges that the Companies Act notes that it seeks to provide appropriate redress for investors, which is read to include creditors. Thus, the study took the initiative to critically examine the effectiveness of creditor redress/ or protection mechanisms and, to execute the mandate successfully; it explored other relevant legal systems. In essence, chapter one paints the overbearing idea that the focus of the overall study is the interests of creditors of a company on the rationale that they have a significant stake and interest in the running of a company in which they have debtor-creditor relations.

The chapter justifies why the study explores corporate law developments, including common law, considering that the court avenue is characterised by inherent constraints and limitations unfavourable to the creditor's circumstances. In this regard, the study shies away from the courts as the only key enforcement platform of creditor rights. Consequentially, to define the course of action in this research work, the chapter had also outlined the following set objectives that had to be pursued through the study and thus,

- To determine whether it is justified to protect creditors by mandatory corporate laws beyond the protection afforded to them by contract laws.

- To critically examine the sufficiency and effectiveness of creditor protective mechanisms under South African laws in advancing creditors' interests.

- To compare the efficacy of South Africa`s creditor protective mechanisms with those of comparable legal systems to determine whether South Africa`s mechanisms are congruent with international standards.

- To assess the overall effectiveness of corporate laws in advancing creditor interests among the interests of other stakeholders in company affairs.

- To identify flaws in creditor protection laws and to recommend necessary legal improvements.

7.2.2. Chapter 2

The second chapter of the study explored creditor protection in South Africa and looked at how the Companies Act is geared towards this objective. The chapter looks at all varying and detached creditor protection mechanisms available in South Africa, from common law to current and repealed acts and other principles of debtor-credit laws. The chapter thus focused on those mechanisms that are imperative only to insolvency circumstances. The investigation identified that insolvency-related mechanisms include liquidations, creditor compromise, business rescue, and the solvency and liquidity test. The chapter found that creditors' interests seem to get more assuring protection through the solvency and liquidity test, business rescue, liquidation, and compromise process under the Companies Act. The chapter indicated a greater need to reform company insolvency law, particularly for protecting stakeholders such as company creditors.

The chapter also identified that in addition to liquidation and creditor compromise mechanisms, introducing a rescue-oriented mechanism comes with prioritisation of creditors' interests. In as much as an attempt is made to rescue the embattled company through rescue mechanisms, South African developments consider the ends between the ultimate benefit and the possible detriment to the circumstances of creditors. Finally, the solvency and liquidity test is the crucial element in this chapter as it ensures that the company at all material times, regardless of whatever transaction engaged in, should be in a position to pay creditors` debts as they become due and payable (liquidity) and further should be able to keep the company in a solvent state and thus securing assets for creditor security.

7.2.3 Chapter 3

This chapter explored mechanisms, relevant company law provisions, common law credit systems & principles, and provisions in non–company laws that are also imperative in enhancing creditor protection in juristic and natural persons. The investigation identified that available mechanisms include sanctioning directors and prohibiting reckless trading, the *Turquand* rule, piercing the corporate veil, derivative action, and enforcement mechanisms. The *Turquand* rule is another critical mechanism that offers better safeguards for creditors dealing with companies with

internal procedures that must be complied with when establishing and facilitating debtor-creditor relations. The rule ensures that the debtor company is bound and liable to the debt or claim of the creditor regardless of whether the creditor was aware or ought to have been reasonably aware of the internal procedures that must be complied with. The chapter also showed that, while directors seemed to have loopholes that they could use to evade liability or abuse the company`s persona to the detriment of creditors, this may quickly be curtailed by employing "the piercing of the corporate veil" mechanism. The chapter shows that the use and dependency on this mechanism remain largely dependent on the courts' discretion and ability to adduce evidence to obtain the intended redress through this mechanism.

Further, the Companies Act also deters directors and threatens them with civil and criminal liability, in some circumstances, against fraudulent and reckless trading that may affect the company's interest, including its creditor interest. A more radical approach could have been taken to employ criminal sanctions against trespassing directors and, thus, in conjunction with civil liability. The derivative action also allows creditors to stand as whistle-blowers when a company that has its interests decides to put them at stake by failing to uphold "the best interests of the company," which should then be given priority by this remedy. Additional avenues to the ordinary court process were created in the Companies Act in the form of the Companies Tribunal, CIPC, Takeover Regulation panel, and the employment of Alternative Dispute Resolution. This is to ensure creditors have various options to explore in consideration of costs and the nature of the process in the chosen platform for creditor rights enforcement. Various common law credit systems, some already statutorily adopted, and various principles from non-company legislation were explored briefly to reflect on other possibilities that complement company laws.

7.2.4. Chapter 4

The fourth chapter of the study explored the creditor protection approach in the UK. This is one of three succeeding chapters focused on how South African corporate law can best align with DTI Policy recommendations to develop and evolve from the traditional shareholder-centric view to one that also caters to all stakeholders, including creditors. A study of the UK in this regard indicated that the UK underwent

commensurable developments and commendable changes considering the ceaseless changes they have effected to their corporate laws. A shift is noticeable from the 1980s to curtail director abuse of companies to the detriment of creditors, adopting rescue-oriented mechanisms, redefinition of creditor rights in the 2000s, and the overall connectedness of all mechanisms to the liquidation and insolvency procedures. The chapter finds that the UK has various creditor protection mechanisms for different corporate circumstances, such as debtor control mechanisms embedding provisions for minimal capital, restriction on payment of dividends, powers of courts to pierce the corporate veil, directors' duties and liability, and public enforcement. The chapter also identifies that the UK has various credit contract mechanisms, including liens, set-offs, security interest contracts, debentures, and retention of title. Lastly are the insolvency mechanisms aimed at corporate reorganisation and liquidation for realising proceeds that can be distributed to creditors. Thus, the UK Companies Act has a more explicit stance on ensuring creditor interests are given preference over member interests when insolvency situations arise and thus vehemently asserts that creditor interests automatically form part of the company`s interests in these circumstances, something South Africa should consider adopting.

7.2.5 Chapter 5

The fifth chapter explored the development of creditor protection mechanisms in the USA. The chapter finds that America has also come a long way in shaping its current corporate law landscape regarding protecting company creditors. The chapter identifies that the first corporate laws had no entrenchment of creditor protection mechanisms. Minimal creditor protection could be derived from common law principles; however, the USA has developed its corporate landscape in this regard. The critical feature of USA creditor protection has been restrictions placed on capital share and capital stock, which have also influenced creditor protection in the USA. The chapter shows that many creditor protection laws in the USA are entrenched in the established bankruptcy laws under the US Code, which, like the South African Companies Act of 2008, responds to and complies with its Constitution. The mechanisms identified under the USA creditor protection mechanisms are judicially based, such as replevin, garnishment and attachment, debtor control mechanisms,

credit contracts, and rescue & insolvency procedures. The chapter shows that Chapter 11 reorganisations of America are unique and well-favoured before petitioning or adopting Chapter 7 liquidation mechanisms.

7.2.6 Chapter 6

The sixth chapter presents the final comparative study of Australia's creditor protection mechanisms for South African lessons. The chapter shows that, as opposed to state-based law, the Australian legal system is a Commonwealth with traces of common law aspects. The chapter shows that Australia has been the subject of study on creditor protection mechanisms, which are argued to be quite effective. Like the UK and the US, Australia has debtor activity restraining mechanisms and credit contract mechanisms, which are well-articulated and applicable before resorting to insolvency and rescue-oriented mechanisms. The chapter further shows that, like the UK, Australia provides for what can be argued to be softer insolvency procedures whose objectives are not to dissolve the company but to attempt to revive the company as a going concern through reorganisation, rescue, or rehabilitation. However, in all these processes, mechanisms are triggered that favour and protect the interests of the creditors. These include voluntary administration, receivership, and schemes of arrangement, which are unique and effective tools outside the liquidation procedure. Ultimately, Australia also provides for the winding up or liquidation of a company and realising all available assets for distribution among creditors.

7.3. Lessons for South Africa from the comparator legal systems (UK, US and Australia)

7.3.1. Lessons for South Africa from the UK legal system

This study has adopted the UK as a worthy comparator for its advanced corporate laws and frameworks. In addition, English common law is market-friendly as it provides significant shareholder and creditor protection, leading to economic and financial development. The English corporate law caters to an enlightened shareholder value approach to justify corporate governance, which further justifies creditor protection. The UK is also the legal system from which mechanisms such as liens, set-off, trust, and mortgage originate, and it has been subjected to voracious tests and

developments as mechanisms of security and safeguard in debtor-creditor relations. In essence, the UK position is such that a creditor ought to have a security interest from the time of granting credit, which serves as a safeguard for the invested interests. While some of these mechanisms apply to South Africa, they have been exposed in their operation in the UK to be susceptible to exploitation by functionaries of companies to a certain extent, which has led the UK also to develop its stakeholder and creditor protection mechanisms with further development of mechanisms such as those of insolvency.

Like the UK, South Africa has adopted radical corporate rescue/ or restructuring operations, creditor arrangements, and a more straightforward approach to liquidating solvent companies, thus ensuring creditor protection. South Africa would need to reform its Insolvency laws to ensure that Insolvent Companies' long and complex liquidation process is divorced from complexities and thus easy to implement. Furthermore, the UK has a clear stance on protecting creditors in its Companies Act of 2006, something South Africa must learn from. As discussed in Chapter 4, the UK Companies Act is more explicit in outlining that directors, in carrying out their primary duty under section 172(1), which is to ensure the best interests of the company for the benefit of its members, they are also under a secondary obligation to have regard "amongst other matters" to the considerations listed in paragraphs (a) to (f). Such matters necessitate good relationships with suppliers/ or creditors and other stakeholders. Section 172(3) further clearly requires a company to consider the interests of the company as interests of its creditors in certain circumstances, such as in factual or commercial insolvency situations. The researcher thus concludes that creditor interests and those of members should be considered by directors, in their course of exercising their duty to the company, and not to creditors or members, and thus to ensure the best interests of the company subject to the interests of the *duo* being given interchangeable preferences or priority depending on the company's financial position.

7.3.2. Lessons for South Africa from the US legal system

The USA adopts some of the UK common law concepts just the same as South Africa has; thus, it was quintessential to explore how much further the US has advanced and

developed along those lines. Despite adopting English common law, the US has developed its bankruptcy law to actuate protective reorganisation procedures before insolvency and ultimate liquidation. In this instance, the law is designed so the embattled entity can still incur debt on the notion that new lenders will enjoy high-priority preference, notwithstanding the moratorium stays on claims or other creditors. The US bankruptcy law is based chiefly on statutes that consider various factors, such as the interest of previous management and creditors, when insolvency or bankruptcy ought to have been perceived.

In this regard, processes such as Chapter 11 of the US have been commended. They are noted in this study to be the leading facilitators of the business rescue culture as opposed to immediate winding up or liquidation, which may not favour both creditors and all other affected stakeholders. The rescue culture in American corporate law has also influenced the leading UK corporate law from which the US borrowed some aspects. The gap between the US and UK corporate developments is arguably more theoretical than factual, as these two legal systems keep drawing and developing their corporate laws from toe to toe. Capital and minimum capital maintenance have been one of the most extended splitting factors. The US is seemingly more developed and stable in this regard, thus a worthwhile contribution and lesson for South Africa.

7.3.3. Lessons for South Africa from the Australian legal system

Australia also adopted aspects of the English common law concepts but seems to have the longest and a more defined creditor protection tone within its corporate laws. The critical framework, the Corporations Act, and its relevant sub-regulations and schedules seem more definitive of the creditor protection position than in the US and UK, which is also subjective. While piercing the corporate veil has been more developed under English common law, it has been adopted into the US & Australian legal systems and South Africa. Australia found a way to interweave this mechanism in its statutory provisions. Under the Corporations Act, a holding company is liable for insolvent trading in its affairs and for insolvent trading by a subsidiary company. While South Africa provides a similar notion in its Companies Act, it is not as clear yet as in the Australian jurisprudence.

Furthermore, Australia has developed laws relating to retention of title mechanisms by making it a statutory requirement for retention of title to be registered in terms of the Personal Property Securities Act 2009. This is a development made to ensure that providers of credit in the corporate world can have a mechanism by which to rightfully enforce their claims against debtors in a manner that does not necessarily discourage business in the first place.

One of the most unique and well-articulated mechanisms under the Australian developments is the creditors' scheme of arrangement, which offers a compromise. While it is correct that South Africa also provides an option for compromise, it is not of the same articulation and precision in being creditor-interest-oriented as the Australian one. The affected creditors are central and highly involved in developing and adopting a scheme of arrangement in Australia. The schemes are also subject to flexibility such that they can focus on particular creditors to a specific and defined extent without affecting the rights and interests of other creditors.

In addition to this is Australia's approach to voluntary administration, a process aimed at the reorganisation of the company. This mechanism is compared to Chapter 11 of the USA. The Australian approach is more airtight because an independent administrator undertakes the process. In contrast, in the American case, the incumbent management or board of directors retains control and oversees the Chapter 11 reorganisation procedures. The Australian procedure also gets implemented without court intervention yet yields effective results for creditors, curtailing unnecessary administrative delays and procedures. The Australian case also allows secured creditors to enforce their claims during voluntary administration within a particular set timeframe of 13 days from the commencement of administration or a longer period with the administrator's consent or leave of court. In the Australian case, no moratorium will curtail claims of other secured creditors, which is not the case under USA chapter `11 reorganisations. In this regard, the Australian legal developments are more advanced and offer a better chance at enhanced and learned safeguards for creditors if adopted and customised to fit South African circumstances.

7.4. Shortcomings of creditor protection mechanisms

Considering all discussed creditor protection mechanisms, it is essential to note that while there are many different mechanisms, insolvency procedures seem to be the most detailed and ultimate mechanism for creditor protection. Almost all of the mechanisms present a challenge and shortcomings. For instance, while some mechanisms, such as receivership, are well thought-out and effective, they only apply to a particular class of secured creditors to exclude others. It can further be argued that most of the mechanisms seem to favour and infer that being a secured creditor is a more favourable position than being an unsecured creditor. This is shown by how most of the mechanisms are redundant to the circumstances of unsecured creditors. In these select jurisdictions explored in the study, the implementation of mechanisms such as rescue, reorganisation, or administration would generally come with a moratorium that has a more adverse impact on unsecured creditors who, in that case, cannot act until the process is terminated or completed or otherwise with leave of court granted ability to pursue a claim. In this regard, unsecured creditors seem to depend on the ultimate mechanism, which would be winding up or liquidation, where they are also not the priority group and only receive a residue of the available assets after priority creditors have been paid. In essence, the position of unsecured creditors is not guaranteed total protection compared to that of secured creditors. The mechanisms and the laws and principles envisaged in this study imply and allude to the fact that the secured creditor can employ a host of mechanisms before and during liquidation and still get priority, while the unsecured creditor may and cannot enjoy the same and may have to wait for all administrative and procedural processes to unfold until liquidation occurs and proceeds are then distributed. To further expose this shortcoming about the protection of creditors, the practitioners or liquidators are even endowed with the authority to take legal action to pursue and recover any benefit received by unsecured creditors before or when a company became insolvent under the guise of notions such as unfair preferences and dispositions or uncommercial transactions.

While the majority of laws and mechanisms in this regard hint at the need to ensure equitable distribution of available proceeds to creditors, in the event of residue being shared among unsecured creditors, the actual impact in terms of either benefit or loss suffered by each creditor in this regard is not considered or assessed. This could also

be argued to infer that the stakes for unsecured creditors remain undetermined under the current creditor protection mechanisms even after liquidation occurs. Liquidation is, therefore, not a guarantee of protection and restoration of the actual claim or debt owed to a creditor as it can result in partial settlement depending on the nature of insolvency of the company's inter-alia claims against such company in place of available or recoverable assets.

7.5. Recommendations

The study makes the following recommendations:

- The study recommends that the Companies Act, in particular section 76(3)(b), give meaning to the duty of the director to ensure “the best interests of the company” to primarily entail the benefit of shareholders as a whole and secondarily, to entail the benefit of non member stakeholders, *inter alia* creditors, who all contribute towards the success of a company. Section 172(3) of the UK Companies Act of 2006 and UK courts are evident in this regard and thus require creditor interests to be considered at all material times and hence be given priority over those of members in insolvency circumstances.

- The researcher recommends that the Companies Act be revised to ensure that the solvency and liquidity test mechanism is applied strictly and consistently in all relevant transactions covered by it and that it be a prerequisite requirement as well for the conclusion of certain or other fundamental transactions, such as disposal of a greater, all or part of a company`s assets (Section 112), scheme of arrangement (section 114), on takeovers (Sections 117 -127) and thus to ensure that creditor interests are protected.

- The researcher recommends that Section 46(3)(a) of the Companies Act be amended to reduce the 120 days, perhaps to 30 or 60 days, within which to effect a distribution once the solvency and liquidity test has been applied because of distribution. 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 negatively changes before a distribution is effected.

- The study recommends the adoption of certain developments from Australia by South Africa concerning the approach towards schemes of arrangement and, thus, their flexibility and efficacy. The affected creditors should be central and highly involved in developing and adopting a scheme of the arrangement and focus should be given to a particular creditor(s) or a class of creditors to a defined extent without affecting the rights and interests of other creditors. The Companies Act should be amended to give creditors *locus standi* to initiate a compromise or creditor arrangement. In Section 155 (2) of the Companies Act, only directors and liquidators (as the case may be) have *locus standi* to propose a compromise. Section 311(1) of the 1973 Companies Act was prudent as it gave creditors and shareholders *locus standi* to propose a compromise.

- The study recommends that reorganisations/ rescue procedures be developed in line with Australian laws to allow for voluntary administrations wherein moratoriums are inapplicable since debts are managed in a way that ensures that creditor interests are safeguarded during these reorganisations. The legislature should also reconsider refining section 135(3) of the Companies Act on the ranking of creditors and employees in line with the US Bankruptcy Code that gives priority to post-commencement creditors over all other categories of creditors & stakeholders to incentivise creditor investments to the ailing company during rescue proceedings and thus ensuring a successfully funded and revived company. 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. Moreover, it is also recommended that section 133 of the 2008 Act be amended to lay out grounds that creditors may use to approach court during business rescue proceedings despite the temporary moratorium of their rights, including the right to institute legal action.

- The researcher recommends that section 81 of the Companies Act, on liquidation of solvent companies, be revised to give creditors also *locus standi* to approach the court to move for liquidation where they may notice the occurrence of certain circumstances outlined in section 81. Creditors may not benefit from it whatsoever. They could benefit from liquidation if they fold their

hands and wait for someone with *locus standi* to approach the court for their interests.

- The researcher recommends that the Minister of Trade and Industry reform the insolvency laws (Insolvency Act 1936) so that there will be a total shift from the 1973 Companies Act when it comes to the liquidation of insolvent companies. Some cumbersome requirements, such as the need to furnish the Master with the security of liquidation costs, may be done away with, among other cumbersome features of the insolvency liquidation procedure. Thus, more concise, flexible, and convenient provisions on liquidation of insolvent companies from the Australian legal jurisprudence may be adopted as opposed to South Africa's provisions, which one has to perceive through precedents and judicial developments since they are still unreformed and are governed by the relevant provisions of the old Companies Act of 1973.

- It is recommended that the legislature consider using civil and criminal sanctions to deter directors from abusing their position of control and power to ensure absolute protection of creditor interests among other stakeholders` interests. The Companies Act has relied much on civil sanction or liability, which may not be sufficient deterrence. Criminal sanctions could have been enhanced and employed in a broader perspective to deter directors from unlawful activities that pen against various stakeholders, thus, in conjunction with civil sanctions, ultimately safeguarding creditor interests.

- It is recommended that section 20(9) of the Companies Act be amended to give guidelines on what conduct may result in excessive abuse of the legal personality. There are uncertainties as to when courts may pierce the corporate veil as there is no definition of unconscionable abuse in section 20(9) of the Companies Act. Some guidelines are derived from the case laws and common law principles in the UK and our jurisprudence; however, there is no counter–provisions from select jurisdictions on this aspect. Section 20(9) also does not specify who interested persons must bring an application to declare a company not to be a juristic person to lift the veil. Thus, the legislature should be clear in this regard and include creditors on its list since they may be affected by acts of those who hide behind the veil and thus risk creditor investments.

- It is recommended that the legislature refine the derivate action mechanism and thus translate it into an avenue that creditors may take advantage of to secure their interests, which are secondarily included in the meaning of the company`s best interests. The disadvantage that a creditor or that other person unmentioned in subsection 2(a)-(c) of section 165 of the Companies Act may face would be that of a prolonged process wherein they have first to obtain leave to obtain permission to serve a letter of demand at own cost and after that obtain leave to institute legal proceedings; what a cumbersome process technically denying one access to courts. UK laws are comparable in this regard.

- The study further recommends that some American judicial mechanisms, such as replevin, attachment, and garnishment, can be elaborated and adopted in South African creditor laws and not be as salient or almost far from reach.

- The study recommends that, overall, while mechanisms are available, they still have shortcomings with particular reference to the class of unsecured creditors. Mechanisms are more imminent now than ever to boost investor confidence through protective mechanisms that equally see and value the role and importance of unsecured creditors.

- The study recommends that additional research studies be conducted across regional and other legal systems to broaden further understanding of the landscape of creditor protection under corporate laws.

7.6. Conclusion

The study concludes that creditor protection mechanisms are essential in corporate development. The study shows that even out of four developed economies from different continents, the overriding mechanism for protecting creditors remains vested in insolvency procedures. The study indicates that mechanisms have been developed, incorporated, or entrenched into day-to-day corporate laws and made mandatory practice over time. However, creditors are not entirely protected until a company is liquidated and there is no debtor. In essence, creditor protection mechanisms offer

partial protection, and liquidation gives finality to the creditor recovery but not an actual guarantee of complete restoration and full realisation of what is owed by the debtor company. The stakes continue to be higher for unsecured creditors as secured creditors continue to enjoy more stable mechanisms and priority in invoking mechanisms and getting recoveries of debts. While South Africa's corporate law and practice continue to be influenced by global trends, it is essential to note that South Africa could break away from the traditional secured creditor-centric approach and ultimate reliance on solvency or liquidation procedures.

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