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**University of Cape Town**

**School for Advanced Legal Studies – Faculty of Law**

**Department of Commercial Law**

**Master of Laws-Commercial Law**

**Advancing and Protecting the Interests of Creditors and Employees under the Companies Act 71 of 2008**

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Research dissertation presented for the approval of Senate in fulfilment of part of the requirements for the degree of Master of Laws in Commercial Law in approved courses and minor dissertation. The other part of the requirements for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of Master of Laws in Commercial Law dissertations, including those relating to length and plagiarism, as contained in the rules of the University, and that this dissertation conforms to those regulations.

**Signature:** \_\_\_\_\_ **Date:** \_\_\_\_\_

## TABLE OF CONTENTS

(i)	<b>Abstract</b>	<b>5</b>
(ii)	<b>Dedications</b>	<b>6</b>
(iii)	<b>Acknowledgements</b>	<b>7</b>
(iv)	<b>List of abbreviations</b>	<b>8</b>
<b>Chapter 1- Introduction</b>		
1.1	General Background	9
1.2	Research Question and Scope	11
1.3	Significance of Dissertation	13
1.4	Overview of Chapters	14
<b>Chapter 2- The Theoretical Debate</b>		<b>16</b>
2.1	Introduction	16
2.2	Arguments for Continued Adherence to the Shareholder Primacy Model	17
2.2.1	The Ownership Argument	18
2.2.2	Deficiencies of the Ownership Argument	19
2.2.3	The Nexus of Contracts Theory	23
2.2.4.	Deficiencies of the Nexus of Contracts Theory	25
2.2.5.	The Residual Claimants and Ultimate Bearers of Risk Argument	26
2.2.6.	Deficiencies of the Residual Claimants and Ultimate Bearers of Risk argument	-27
2.3.	Team Production Theory	28
2.4	Conclusion	30
<b>Chapter 3- Creditors as a Corporate Constituency</b>		<b>31</b>
3.1	Introduction	31

3.2	Creditors Contribution to Corporate Resources	31
3.3	Risks that Creditors are exposed to	33
3.3.1	Abusive Transactions and the Expropriation Problem	34
3.3.2	Bargaining Power, Precontractual Information Asymmetry and Incomplete Contracts-	-35
3.3.3	Insolvent Trading	37
3.4	Creditor Protection in the United Kingdom and the United States	38
3.5	The United Kingdom	38
3.5.1	Legal Capital	38
3.5.2	Regulation of Repurchases and Redemption of Shares	39
3.5.3	Regulation of Distributions	40
3.5.4	Prohibition against Insolvent Trading	40
3.6	The United States of America	41
3.6.1.	Legal Capital	41
3.6.2	Regulations of Distributions	42
3.6.3	Share Repurchases, Redemptions and Reduction of Capital	42
3.6.4	Insolvent Trading	43
3.7	South Africa	43
3.7.1	Legal Capital	43
3.7.2	Regulations of Distributions	44
3.7.3	Restrictions against Financial Assistance	44
3.7.4	Insolvent Trading	45

3.7.5 Business Rescue	46
3.8 Conclusion and Recommendations	47
<b>Chapter 4- Employees as a Corporate Constituency</b>	<b>50</b>
4.1 Employees' Contribution to Corporate Resources	50
4.2 Constituency Statutes in the United States	55
4.3 The United Kingdom	56
4.4 Co-determination in Germany	58
4.5 Employees as Corporate Stakeholders in South Africa	61
4.5.1 Employee Protection in Takeover situations	63
4.5.2 Business Rescue	65
4.5.3 Social and Ethics Committee	66
4.6 Conclusion and Recommendations	68
<b>Chapter 5</b>	<b>70</b>
5.1 Conclusion and Recommendations	70
Bibliography	74

## ABSTRACT

South Africa's economic landscape still reflects the centuries of colonial domination and apartheid which resulted in skewed patterns of wealth distribution. South Africa enjoys the unenviable reputation of being one of the most unequal societies in the world. It is against this background that the Companies Act of 2008 was enacted with hopes not only to modernise the South African corporate regulatory environment but to steer the corporate world towards assisting in the achievement of a socio-economic transformation in South Africa.

Companies have long been viewed as essentially private organisations existing exclusively for the benefit of their members. This view is being increasingly questioned especially in an environment of extreme wealth disparity such as South Africa. An exclusive shareholder focus appears illegitimate in such an environment.

This dissertation seeks to assess the impact the new Companies Act will have on the socio-economic transformation of the South African society and point areas where corporate law can do more to help bring about this transformation.

It focuses on creditors and employees as key corporate constituencies whose interests the board of directors have to constantly consider in making decisions. It argues that an expansive approach to corporate governance that includes other corporate constituencies not only the shareholders is the best way to harness the impressive wealth generating capacity of the corporate form to bring about socio-economic transformation in South Africa.

## **DEDICATION**

I dedicate this thesis to my parents and siblings.

University of Cape Town

## **AKNOWLEDGEMENTS**

I am very grateful to my supervisor Dr Tobias Wiese for the invaluable input he gave me during the process of writing this thesis.

I am indebted to the Midlands State University for the sponsorship and assistance during my studies for an LLM. Lastly I thank the Almighty for seeing me through my studies.

University of Cape Town

## LIST OF ABBREVIATIONS

UK	United Kingdom
US	United States of America
DGCL	Delaware General Corporation Law
MBCA	Model Business Corporation Act
DTI	Department of Trade and Industry (South Africa)

University of Cape Town

## Chapter 1-Introduction

### 1.1 General Background

In the Department of Trade and Industry's (DTI) a policy document titled *South African Company Law for the 21st Century Guidelines for Corporate Law Reform*<sup>1</sup> pondered the question 'In whose interest should the corporation be run?'<sup>2</sup>. This question has been the subject matter of a great debate since the famous debate between Adolph Berle and Merrick Dodd<sup>3</sup> in the early 1930s and still proves to be an extraordinarily vexing question up to this day.<sup>4</sup>

The conventional way to answer that question, for much of the preceding century, has been that a company operates solely for the benefit of its shareholders<sup>5</sup>. This position was famously stated by Milton Friedman, a Nobel peace prize winning economist as "*there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game*"<sup>6</sup>

This approach is now increasingly being viewed as archaic<sup>7</sup>; the perception of the company is gradually changing. The modern company, compared to other forms of business structures, has proven itself to be the most successful vehicle of wealth creation<sup>8</sup> and today companies occupy a position of enormous economic power.<sup>9</sup>

<sup>1</sup> Released in May 2004 and which was the basis of the reform process that culminated Companies Act 71 of 2008

<sup>2</sup> DTI:- "*South African Company Law for the 21st Century Guidelines for Corporate Law Reform*" pp 20

<sup>3</sup> The debate was in a series of articles published in the Harvard Law Review starting with For Whom Are Corporate Managers Trustees? – E. Merrick Dodd Jnr- Harvard Law Review, Vol. 45, No. 7 (May, 1932

<sup>4</sup> Lynn Ann Stout:- "*Bad and Not So Bad Arguments for Shareholder Primacy*" 75 S. Cal. L. Rev. 1189 pp 1190, Anant K. Sundaram and Andrew C. Inkpen:- "*The Corporate Objective Revisited*" Organization Science, Vol. 15, No. 3 (May - Jun., 2004), pp. 350-363

<sup>5</sup> David Mellon: "*Communitarians, Contractarians and the Crisis in Corporate Law*" 50 Wash. & Lee L. Rev. 1373; John F Olson:- "*South Africa moves to a global model of corporate governance but with important national variations*" pp 219 of **Modern Company Law for a Competitive South African Economy** edited by Tshepo Mongalo [Juta 2010]

<sup>6</sup> Milton Friedman: – "*The Social Responsibility of Business is to Increase its Profits.*" The New York Times Magazine, September 13, 1970

<sup>7</sup> R C Williams:- Concise Corporate and Partnership Law 2<sup>nd</sup> Ed [Butterworths 1997] pp 168

<sup>8</sup> Farouk Cassim; Chapter I of Contemporary Corporate Law- Farouk Cassim, Jacqueline Yeats, Maleka Feminda Cassim, Rehana Cassim, Richard Jooste; Joanne Shev [Juta publications 2011] pp 3

<sup>9</sup> Of the 100 largest economies in the world, 51 are corporations; only 49 are countries (based on a comparison of corporate sales and country GDPs). The Top 200 corporations' combined sales are bigger than the combined economies of all countries minus the biggest 10 [Top 200 Companies: The Rise Of Global Corporate Power - Sarah Anderson and John Cavanagh Institute for Policy Studies 2000]

Companies are pivotal to the economic well-being of the modern nation.<sup>10</sup> Consequently the role of companies in society is receiving increased attention, with their impact on employees, the environment, local communities, as well as their shareholders, becoming the focus of debate<sup>11</sup> and this debate is particularly intense in the South African context where the political reforms that saw the holding of the first democratic elections in South Africa were not followed by equally transformative economic changes.

The unbridled pursuit of maximizing shareholder value to the exclusion of all other interests is increasingly being viewed as being illegitimate, a perception currently exemplified in a spectacular fashion by the on-going 'Occupy Wallstreet' protests around the world.<sup>12</sup>

The demands that the economic activities of companies should be tempered by social considerations are steadily growing in the current climate of an economic depression that was triggered by the sub-prime mortgage crisis in the United States and amplified by the on-going debt crisis in the European Union.

The pressure to bring about such a transformation in the manner in which companies are governed is more pronounced in South Africa than in most other parts of the world. The economic landscape of South Africa is still characterised by a dual economy comprising on the one hand a well-developed first world economy and on the other, an under-developed and informal one.<sup>13</sup> This is as a result of South Africa's legacy of apartheid which engendered one of the most extreme disparities in wealth distribution patterns in the world<sup>14</sup>, structural unemployment, widespread poverty and low levels of education<sup>15</sup>. These challenges are by no means peculiar to

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<sup>10</sup> DTI:- (Op cit note 2) pp 4

<sup>11</sup> Irene Marie Esser & Adriette Dekker:- "The Dynamics of Corporate Governance Principles" Journal of International Commercial Law & Technology Vol3 (2008) pp 159; Michele K Havenga :- "Directors' Fiduciary Duties under our Future Company Law Regime" 9 South Africa Mercantile Law Journal 310, 312, 314 (1997); Anant K. Sundaram and Andrew C. Inkpen(Op cit note 4) 351, John F Olson:- (Op cit note 5) pp 220

<sup>12</sup> The Occupy Wall Street is an on-going protest movement which started in Zuccotti Park in New York wallstreet financial district and has since developed into a global movement which is protesting against the domineering influence of big business over government policy and the unequal distribution of wealth.

<sup>13</sup> DTI:- (Op cit note2) pp 8-9

<sup>14</sup> Irene Marie Esser & Adriette Dekker (Op cit note 11) pp 161

<sup>15</sup> Ralph Hamman: -"Universalizing Corporate Social Responsibility? South African Challenges to the International Organisation for Standardization's New Social Responsibility" Standard Business and Society Review pp 110

South Africa but South Africa's history has given them 'a particular character and severity'<sup>16</sup>

It is this unique context of a dualised economy and a new constitutional framework that necessitated the reform of South African company law in order to make it more socially responsive and to reflect the Constitution of South Africa and the principles of equality and fairness that it embodies.<sup>17</sup> The patterns of wealth distribution in South Africa demand, at the very least, a re-examination of the corporate objective.

## 1.2 The Research Question and Scope

The research question that this dissertation seeks to address is, to what extent does the new company law regulatory framework characterised by the new Companies Act 71 of 2008 and the King Reports protect and advance the interests of key non-shareholder corporate constituencies?

For purposes of this dissertation, the focus will be on two non-shareholder constituency groups namely corporate creditors and employees as key providers of inputs without which companies cannot successfully operate. This view is supported by the DTI in its policy document where it describes investors of a company as consisting of shareholders, creditors and employees.<sup>18</sup>

The Companies Act 71 of 2008 is generally regarded as having made significant strides in creating a regulatory framework that can support broader economic and social aims.<sup>19</sup> It was preceded by ambitious language employed by the DTI in its policy document<sup>20</sup> that South African company law needs to take into account the legitimate interests of stakeholders such as its customers and employees. The question that follows is, to what extent will this new regulatory environment steer the South African culture towards a more stakeholder inclusive approach?

Corporate governance models are generally divided into two groups, the Anglo-American, which is shareholder-centric and European models which are generally

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<sup>16</sup> *ibid*

<sup>17</sup> DTI :- (Op Cit note 2) pp 8-9;

<sup>18</sup> DTI:- (op cit note 2) pp 37; see also Esser and DuPlessis:- *The Stakeholder Debate and Directors Duties*" (2007) 19 SA Merc LJ 346–363

<sup>19</sup> John F Olson (Op cit note 5) pp 219

<sup>20</sup> DTI:- (Op cit note 2) pp 26

more stakeholder centric and there is a general consensus amongst scholars that South African corporate law and governance structures adhere to the Anglo-American model.<sup>21</sup>

Attempts to enact more stakeholder friendly company law statutes in traditionally shareholder-centric jurisdictions are by no means new, numerous American states in the 1980s passed a series of corporate law statutes that came to be known as 'constituency statutes' that permitted directors to take into consideration the interests of stakeholders in their decision making processes in takeover situations and the United Kingdom's Companies Act of 2006 which similarly permits directors to consider the interests of other stakeholders. It will therefore be useful to evaluate the probable impact against the background of the experience with comparable enactments passed in the other shareholder-centric jurisdictions.

However, the attempts to expand the scope of directors' duties in the UK and the US have been criticised for their failure to bring about positive changes in the manner in which companies are governed because they merely permit directors to take into consideration the interests of other stakeholder but does not allow them to make trade-offs between their respective interests and therefore still subordinate the interests of the other constituencies to those of the shareholders.

The unbridled pursuit of shareholder value still appears, by all accounts, to be the prevailing norm in the United States and the United Kingdom in spite of the enactment of constituency statutes in numerous American states and the Companies Act of 2006 in the UK. The US has been plagued by a series of corporate scandals including the collapses of Enron, WorldCom and Tyco at the start of the first decade of the millennium and the sub-prime crisis that emerged in 2007. This raises questions about the practical efficacy of the 'enlightened shareholder approach'. If South Africa is to make a substantial impact on stakeholder interests, then its reform efforts would have to go further than a mere replication of the reforms in the United Kingdom and the United States.

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<sup>21</sup> Andrew West:- "*Theorizing South Africa's Corporate Governance –Journal of Business Ethics*" (2006) 68:433-448 pp 434; Stefan Andreasson:- "Understanding Corporate Governance Reform in South Africa; Anglo-American Divergence, the King Reports and Hybridization" - Business Society OnlineFirst, February 18, 2009 as doi:10.1177/0007650309332205 pp

This dissertation, in its assessment of the extent to which the Companies Act 71 of 2008 protects and advances the interests of creditors and employees will draw from the experience of the comparable jurisdictions of the United Kingdom and the United States and will also look at the traditionally stakeholder-centric jurisdiction of Germany and the lessons that can be drawn from their experiences.

The scope of this dissertation will be limited to an assessment of the legal devices designed to protect the interests of employees and creditors as the two most important stakeholder groups in terms of the contributions to companies other than the shareholders and pays particular attention to the reconstitution of directors' duties as a method of affording greater protection to employees and creditors. This assessment will be made by focusing on the main corporate law statutes, judicial decisions and codes of best practices in South Africa and the other jurisdictions listed in the preceding paragraph.

### **1.3 Significance of the Dissertation**

This dissertation assesses the effectiveness of the Companies Act and the corporate regulatory environment augmented by the King Reports and with respect to public companies the JSE requirements in protecting and advancing the interest of corporate creditors and employees as key corporate constituencies.

As previously mentioned, South Africa's economic landscape still reflects the centuries of colonial domination and apartheid which resulted in the creation of a dual economy.<sup>22</sup> The less developed of the two which is the informal and unskilled economy which lags behind the impressive gains made by the first economy and, as the DTI observed, the second economy is at a risk of further marginalization if there is no decisive government intervention.<sup>23</sup>

Companies can play a decisive role in the economic transformation of the lives of the majority of South African citizens and a greater stakeholder focus especially on employees will go a long way in helping bring about this transformation. Stronger creditor protection measures will likely lower the costs of borrowing and encourage

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<sup>22</sup> Andrew West:- *ibid*

<sup>23</sup> DTI:- (Op cit note 2) pp 10

lending to small to medium enterprises and therefore assist in the upliftment of the other, less formalised economy by providing cheap access to debt finance.

This dissertation seeks to assess the impact the new Companies Act will have on the socio-economic transformation of the South African society and point areas where corporate law can do more to help bring about this transformation.

#### **1.4 Overview of the Chapters**

Chapter One has introduced the subject-matter of the dissertation and outlines the conceptual framework for the dissertation. It also outlines the research question and the scope for the dissertation.

Chapter two lays the foundation for the evaluation of the adequacy of the measures designed to protect the legitimate interests of non-shareholder corporate constituencies by engaging in a thorough analysis of the theoretical foundations of corporate law with the view to evaluate the basis for the exclusive protection of shareholders that are afforded by the fiduciary duties of directors to the exclusion of other corporate stakeholders and the persuasiveness of the justifications for the exclusion.

It demonstrates the inadequacies of the traditional justifications for shareholder primacy by illustrating that a company requires inputs from different constituencies and that there is no empirically valid basis for the exclusion of the interests of non-shareholder constituencies in the decision making processes of the board of directors. Furthermore Chapter Two also lays the theoretical basis for the postulation of a more expansive conception of the company that pays due regard to the legitimate interests of key corporate constituencies such as creditors and employees.

Chapter Three analyses the contributions to the capital base of the modern company that are made by creditors and postulates that creditors constitute a key and indispensable corporate constituency. The chapter gives an outline of the unique risks that creditors are exposed to especially by the potential abuse of limited liability. It then proceeds to evaluate the adequacy of the measures in the Companies Act to protect creditors. In this evaluation, the chapter engages in a comparative analysis of similar provisions in the United Kingdom and United States and the court decisions in these jurisdictions.

Chapter Four similarly analyses the indispensable contribution made by employees of a company to the asset base of that company. It outlines the emergence of a 'new economy' based on the growing value of knowledge as an input and output making it the most valuable resource of modern commerce. It illustrates how the emergence of the new economy has transformed the perception of employees from being viewed as an expense for accounting purposes to being seen as the providers of human capital without which companies cannot successfully operate.

The chapter also assesses the impact of new measures introduced by the Companies Act, such as extending the right to bring a derivative action to employees and also the power to apply for the initiation of business rescue proceedings, on employees as a key corporate constituency. It argues that company law provides greater protection for employees through directors' duties and enfranchising employees to vote for a portion of the board of directors.

Chapter Five concludes the dissertation and recommends an expansive interpretation of the duties of directors to permit directors to take into consideration employees and creditors of their companies in their decision making processes.

## Chapter 2- The Theoretical Debate

### 2.1 Introduction

Shareholders have traditionally enjoyed exclusive governance protection at the most fundamental level, the fiduciary duties of the directors. Directors have a fiduciary duty to act in a manner that is in the ratable best interests of shareholders.<sup>24</sup>

Generally company law has been reluctant to extend the protection afforded by directors' fiduciary duties to non-shareholder constituencies.<sup>25</sup>

Section 76(3) (b) of the Companies Act 2008 which provides that “a *director of a company, when acting in that capacity, must exercise the powers and perform the functions of director ...in the best interests of the company*” appears to have maintained that traditional approach.

The reconstitution of directors fiduciary duties to permit them to validly consider non-stakeholder interests in the discharge of their fiduciary duties and the enfranchisement of core stakeholder groups like employees and creditors have been identified as the most critical areas to be reformed if the advancement of stakeholder interests is to move away from being merely superficial to something of substantial and practical value.<sup>26</sup>

A shift away from the exclusively shareholder orientated conception of what constitutes the best interests of the company is a necessary prerequisite for any meaningful advancement and protection of stakeholders. The extent to which the interest of non-shareholder constituencies will be advanced under the Companies Act 2008 will largely depend on the meaning the courts will attach to the words ‘*the company*’ as they are used in s76 (3) (1).

<sup>24</sup>Michael P Spisto:- “*Legal Aspects of Corporate Governance in the Republic of South Africa: Towards a Possible Model for Improved Stakeholder Relations within the Corporation*” [ PhD Thesis- University of the Witwatersrand April 2006] pp 87:- “*The Shareholder Primacy Norm*” 23 J Corp L 277 1997-1998 pp 277

<sup>25</sup>Michael P Spisto :- *ibid*

<sup>26</sup>Allen L White:- “*The Stakeholder Fiduciary : CSR, Governance and the Future of Boards*”[2006] – Business for Social Responsibility [www.bsr.org](http://www.bsr.org) ; Irene Marie Esser& J. J Du Plessis:- “*op cit note 18; Michael P Spisto (Op cit note 23) pp 86-87*

The courts have been granted an opportunity to re-examine the precise meaning of the word 'company' and clarify the issue.<sup>27</sup> The courts should be guided by the stated objectives the DTI sought to achieve with the new Companies Act as expressed in their policy document preceding the Act. They should be guided by section 7 of the Act which inter alia provides that the purposes of the Act are to “...promote compliance with the Bill of Rights...reaffirm the concept of the company as a means of achieving economic and social benefits...”<sup>28</sup> and also by the King Reports.

In order to gain this much needed fresh perspective on the question of what constitutes the company and in whose benefit should it operate requires a thorough analysis of the claims of the three main corporate groupings the shareholders, the creditors and the employees. The logical starting point is the shareholders who have traditionally enjoyed exclusive corporate law protection.

## 2.2 Arguments for Continued Adherence to the Shareholder Primacy Model

In their policy document, the DTI noted that there are theoretical underpinnings to the traditional shareholder-centric approach. The policy document identified three, enumerated as follows;

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

The foregoing captures the prevailing standard arguments for shareholder primacy. The first one is based on the property theory which posits that since shareholders are the investors in the capital of the company they consequently own it and are

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<sup>27</sup> Irene Marie Esser & J. J. Du Plessis (Op cit note 26)

<sup>28</sup> Section 7 (a) (d)

therefore exclusively entitled to its proceeds. The second is based on a mixture of the residual claimant theory and the nexus of contracts theory.

Shareholders unlike the other main corporate constituents, the creditors and employees, do not contract for fixed returns but to uncertain returns in the form of dividends or in the increased value of the shares themselves and a return of capital on winding up after all other claims have been paid and consequently bear the ultimate risk of the failure of the company.<sup>29</sup> The last one is based on the 'trickle down' effect that an efficient market driven by the shareholder value maximization mandate is ultimately more beneficial to societies.

However, the policy document merely states some of the standard arguments and treats them as virtually beyond reproach and fails to conduct a thorough evaluation of the veracity of these standard arguments and establish if they still warrant further, virtually unquestioned, adherence.

It is consequently imperative to conduct a critical analysis of the main arguments of shareholder primacy.

### 2.2.1 The Ownership argument

Whenever the inquiry 'who owns the company?' is made it is invariably answered 'the shareholders'.<sup>30</sup> The structures of company law are designed to benefit shareholders above any other corporate constituency. Shareholders have been characterised as the owners of the company because they can control the affairs of the company through the election and removal of directors, ratifying the ultra vires acts of the directors and approving fundamental transactions and can therefore ensure that the company is run in their interests.<sup>31</sup>

The notion that a company is owned by shareholders is the basis of the agency theory that equates the relationship between shareholder and directors with the principal and agent relationship, the shareholders being the principals and the

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<sup>29</sup> Kathleen Emmarencia Van der Linde:- *"Aspects of Regulation of Share Capital and Distribution to Shareholders"* [PhD thesis University of South Africa] pp 9

<sup>30</sup> LE Talbot:- *Critical Company Law* [Routledge- Cavendish 2008] pp10

<sup>31</sup> Kathleen Emmarencia Van der Linde (Op cit note 27)

directors being agents who have a duty to act in the best interests of the shareholders as a body.<sup>32</sup>

### 2.2.2 Deficiencies of the ownership argument

The assertion that shareholders own the company is the least credible of the arguments supporting shareholder primacy. It is easily refutable, firstly on the grounds of the misconception that shareholders are the sole investors in a company yet they are in reality only providers of equity capital and a company requires more than equity capital to function. Creditors and employees provide inputs by way of the provisions of debt financing, labour and knowledge.

Secondly the courts have been consistently clear that a company is not capable of being owned. The seminal decision in *Salomon v Salomon & Co Ltd*<sup>33</sup> established the concept of separate corporate personality<sup>34</sup> as the cornerstone of corporate law and accordingly once a company has complied with registration formalities and has been duly issued with a registration certificate it becomes a fully-fledged separate judicial entity<sup>35</sup>.

The case of *Macaura v Northern Insurance Co Ltd*<sup>36</sup> is even more instructive because it brought the question of 'who owns the company?' to the fore. In this case the sole director and shareholder of a limited company was unable to claim for fire damage to the company's property on his own personal insurance. The court held that a claim could only be made on the company's own insurance as a shareholder had no 'insurable interest' in the company's assets. This decision clearly established that shareholders do not have a direct interest in the assets of a company and the ramifications of this decision are that companies were characterized by the court as being incapable of being owned.

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<sup>32</sup> Andrew Keay:- "Tackling the Issue of the Corporate Objective: An Analysis of the UK'S Enlightened Shareholder Value Approach" 29 Sydney L Rev 578 2007 pp583; Margaret M Blair:- "Director's Duties in a Post Enron World; Why Language Matters" Wake Forest Law Review Vol 38, Fall 2003 pp 886

<sup>33</sup> [1897] AC 22

<sup>34</sup> LE Talbot:- Op cit note 28

<sup>35</sup> Section 19 (1) of the Companies Act 2008

<sup>36</sup> [1925] AC 619

The courts have upheld the company's separate personality even in the wake of immense social pressures<sup>37</sup> to do otherwise as is illustrated by the American case of *People's Pleasure Park Co v Rohleder*<sup>38</sup> and the South African case of *Dadoo Ltd v Krugersdorp Municipal Council*.<sup>39</sup>

The former case involved a company whose total issued shares were owned by a former slave, who bought a piece of land that was subject to a restrictive covenant that restricted transfer to black people. The question before the court was whether the company itself could be said to have a colour and thus be restricted from owning the property. The court held that a corporation was incapable of having a colour and that it was a distinct legal being separate from its owners and incorporators. Accordingly it was the company that owned the property and not Johnson its sole shareholder.

The latter case involved a company whose members were both Indian and the company had bought land in an area designated for white people only. The court similarly refused to ascribe the racial designation of the company's members to the company and accordingly held that the property was owned by the company and not its members.

Both decisions were reached when both countries were at their respective heights of institutionalised racial prejudice where the court in both countries could have found some legal device to uphold the prevailing notions of racial prejudice and claim that this was an abuse of the corporate form but the judicial inclination to uphold the concept of separate personality overrode all other considerations.

There is a plethora of cases that unequivocally indicate that, strictly legally speaking, shareholders do not own the company but own their shares. A very apt description is contained in the case of *Short v Treasury Securities*<sup>40</sup> where the court declared that;

*"Shareholders are not, in the eyes of the law, part owners of the undertaking. In other words, a share in the share capital of the company does not imply ownership of*

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<sup>37</sup> LE Talbot:- op cit note 28 pp 23

<sup>38</sup> 1 61 SE 794 (Va 1908)

<sup>39</sup> 1920 AD 530

<sup>40</sup>[1948] 1 KB 116 (CA) @ 122

*a part of the assets or property of the company as the company's assets belong to the company and not its members.*"<sup>41</sup>

A share gives the shareholder a bundle or conglomerate of rights<sup>42</sup> some statutory some depending on the terms of issue and the memorandum of incorporation (MOI). Significantly, shareholders do not have the right to exercise control over the company's assets or help themselves to its earnings.<sup>43</sup>

The only time shareholders can receive a portion of the earnings is when the board declares a dividend and it is the norm that large listed companies take the lion's share of profits as retained earnings for future projects.<sup>44</sup>

Shareholders do not have a right to have dividends declared but have an expectation for declared dividends when the company is performing well enough to do so. Shareholders therefore do not have direct control or a direct claim to the company's underlying assets.<sup>45</sup> The power to manage the affairs of a company is vested with the board of directors.<sup>46</sup>

So even if shareholders can be characterised as owners of the company because they appoint and remove directors and approve fundamental transactions<sup>47</sup> and any other matters that are reserved for shareholder approval in the constitutive documents of the company or statute, the influence they have on the manner in which a company is run is, at best, indirect.

The language of ownership in describing the relationship between shareholders and the directors of a closely held private company, where often the shareholders are the directors or can exert a great of influence over the directors is perhaps excusable. To describe such a company as being 'owned' by its shareholders is more reflective of the reality of the manner in which small closely held companies are run than the strict legal position.

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<sup>41</sup> See also *Bradbury v English Sewing Cotton Co Ltd* [1923] AC 744 (HL) 746 where the court said "...a share is a fractional part of the share capital...It forms, however, a separate right of property. The capital is the property of the corporation. The share is the property of the incorporator."; *Cooper v Boyes* 1994 (4) SA 521 (C) 535

<sup>42</sup> *Standard Bank of South Africa Ltd v Ocean Commodities Inc & Ors* 1983 (1) SA 276 (A) at 288

<sup>43</sup> Lynn A Stout:- (Op cit note 4)

<sup>44</sup> *ibid*

<sup>45</sup> Irene Marie Esser & J. J Du Plessis:- (Op cit note 14) pp 358; Lynn A Stout:- (Op cit note 4)

<sup>46</sup> See section 66(1) of the Companies Act 2008

<sup>47</sup> Kathleen Emmarencia Van der Linde:- (Op cit note 29) pp 10

However, to describe a widely-held public company as being owned by its shareholders is misleading both factually and legally. The influence shareholders may have on the board of directors of a public company maybe so minuscule as to be negligible.<sup>48</sup> Scattered shareholders are an unwieldy body that cannot easily organise itself into concerted action and this is compounded by general shareholder apathy in attending and voting at meetings.

The traditional rights attaching to shares, notably the rights to vote at general meetings and receive declared dividends are not fixed and can be varied in an infinite number of ways which in most cases erode the ability of shareholders to control the company in any meaningful way.

Since shareholders do not negotiate with the management of large listed companies regarding the terms of issue or the contents of the MOI and their only option is not to buy the shares<sup>49</sup> they may sometimes hold shares that carry very little voting power, as is the case with respect to preference shares which typically carry a right to receive a modest fixed percentage dividend and very limited rights to voting in most cases restricted to voting in certain matters only.<sup>50</sup> This reduces the practical efficacy of any oversight function shareholders exercise over the manner in which the company is being run. The Act even now permits in certain circumstances, the issuance of shares that carry no voting rights at all.<sup>51</sup>

This already weakened position of shareholders of public companies is reinforced by the now widespread use of uncertificated or intermediated shares which are in electronic format and held by a series of intermediaries for the ultimate benefit of their owners. In a multi-tiered system such as the one in use in South Africa<sup>52</sup> where the top-most tier does not have details of the beneficial owner of the securities they

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<sup>48</sup> Lynn A Stout:- (Op cit note 4)

<sup>49</sup> Lee Roch:- "*The Paradox of the Traditional Justifications for Exclusive Shareholder Governance Protection Expanding the Pluralist Approach*" [available on <http://ssrn.com/abstract=1754670>]

<sup>50</sup> Dennis Davies (Ed) & Farouk Cassim (Ed) :- *Companies and other Business Structures in South Africa* [Oxford University Press Southern Africa 2009] pp 45

<sup>51</sup> Section 37

<sup>52</sup> Maria Vermaas:- "*Reform of the Law of Uncertificated Securities in SA Company Law*" pp 105 of *Modern Company Law for a Competitive South African Economy* edited by Tshepo Mongalo [Juta 2010]

hold, which will be held by an intermediary on a lower tier of the system, the concept of full legal ownership of shares is not readily applicable.<sup>53</sup>

Consequently it is highly misleading to describe the relationship between directors and shareholders in a large listed company as one of principal and agent. The relationship barely resembles the principal-agent relationship. Under the law of agency an agent has a duty of obedience owed to the principal and can only operate within the confines of the principal's mandate which is usually defined with a degree of particularity. A principal has control over and has the power to direct the actions of an agent.

The board of directors sits at the very apex of the decision-making process in a company and are not subject to the control or direction of anyone. A director acting in that capacity has a positive duty to act independently.<sup>54</sup>

Shareholders are vested with the power to elect and remove directors but they cannot tell them what to do. The nature of the mandate of directors is by nature open ended and they have a great deal of discretion in the manner in which they execute their duties which agents do not have.

Directors of a widely held company occupy such an exalted position and wield so much power that Professor Bainbridge describes this status quo as 'director primacy'.<sup>55</sup> It is submitted that this is a far more accurate description of the reality of the position of the board of directors compared to the analogy of agency. The board of directors is best understood as a *sui generis* organ of modern corporate structure.<sup>56</sup>

### 2.2.3 The Nexus of contracts Theory

The nexus of contracts theory proffers more credible arguments why shareholders are the exclusive beneficiaries of directors' duties. The nexus of contracts theory rejects as irrelevant the notion that a company can be owned and views the

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<sup>53</sup> *ibid*

<sup>54</sup> Professor R C Williams: - *op cit* note 7

<sup>55</sup> Steven M Bainbridge: - Director Primacy and Shareholder Disempowerment *Harvard Law Review*, Vol. 119, No. 6 (Apr., 2006), pp. 1735-1758 pp 1735

<sup>56</sup> Steven M Bainbridge: - "*The Board of Directors as Nexus of Contracts*" 88 *Iowa L. Rev.* 1 2002-2003.

company as an institution existing primarily to facilitate contracting between various parties that have claims against the company.<sup>57</sup>

The main claimants of the company, the shareholders, employees and creditors all deal with the company on the basis of contract. Employees contract for fixed salaries and creditors for a fixed rate of interest and shareholders contract for the residual benefits of the activities of the company after all the other claimants have been satisfied and have thus been described as residual claimants or residual beneficiaries.

The main thrust of the nexus of contracts theory is that shareholders deserve exclusive governance protection afforded by directors' fiduciary duties because they face the most complicated contracting problems amongst the main groups of claimants which make them the most vulnerable corporate constituency.<sup>58</sup>

Whereas employees and creditors can negotiate for contractual terms with a relatively greater degree of particularity the contractual relationship between the company and shareholders is by its very nature more open ended and due to its inherently uncertain nature cannot be framed in very particular terms<sup>59</sup>. It can therefore be said that shareholders are at the mercy of the board of directors<sup>60</sup> and accordingly should enjoy the protection afforded by directors' fiduciary duties.

It is argued that other claimants such as employees and creditors are either in a better bargaining position<sup>61</sup> or they are adequately protected in other legislation or through specific gap-filling measures contained in the primary company law statute. Shareholders do not generally enjoy any protection outside the primary company law statute. Fiduciary duties are accordingly seen as a special gap-filling measure to fill in the void created by the indeterminate nature of the contractual relationship between the company and its shareholders.<sup>62</sup>

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<sup>57</sup> Ibid; Lee Roch:- (Op cit note 42)

<sup>58</sup> Jonathan R Macey & Geoffrey P Miller:- "*Corporate Stakeholders: A contractual Perspective*" - The University of Toronto Law Journal, Vol 43, No 3 Special Issue on Corporate Stakeholders Debate; the Classical Theory and its Critics (Summer, 1993) 401- 403 pp 404; Steven M Bainbridge:- Op cit note 51

<sup>59</sup> David Millon:- (Op cit note 5)

<sup>60</sup> Lee Roch:- (Op cit note 44)

<sup>61</sup> Andrew Keay:- ( Op cit note 32) pp 584; Jonathan R Macey & Geoffrey P Miller:- Op cit note 53 pp 404

<sup>62</sup> Jonathan R Macey & Geoffrey P Miller:- op cit note 58; Steven M Bainbridge:-op cit note 55

The DTI appears to subscribe to this line of reasoning. The DTI argued in its policy document that employees are protected under labour law and large creditors protect themselves through contracts and that shareholders are generally exposed to the greatest risk.<sup>63</sup>

True as it maybe that shareholders face extraordinarily complex contracting problems and deserve protection against potential self-dealing tendencies on the part of the board of directors; the nexus of contracts theory does not explain why shareholders should be the exclusive beneficiaries of directors' fiduciary duties to the exclusion of other corporate constituencies.

#### **2.2.4. Deficiencies of the Nexus of contracts theory**

The nexus of contracts theory has a lot to commend it but its fundamental weakness is that it is anchored on the notion of freedom of contract between parties of equal bargaining power. The terms of the contracts entered into between a company and stakeholders are for the most part, not a product of free contracting but are simply dictated by corporate managers or by statute<sup>64</sup>.

Shareholders who purchase the shares of a well-established and listed public company do not negotiate the terms of issue or the rights attaching to the shares and have only the option to buy or decline to purchase the shares. Similarly lower level employees do not make any meaningful input in determining the terms of employment and invariably just append their signatures on standard form contracts.

Employee cardinal interests are typically job security and increased remuneration and such interests cannot be provided for in a contract with any degree of particularity. The types of harm that might affect employees as a constituency such as lay-offs, plant closures or stagnant salaries are difficult to foresee and adequately provide for in a contract. If it was at all possible to adequately provide for such issues in a contract then typical employee contracts would be voluminous and would invariably lead to complicated legal issues regarding enforcement.<sup>65</sup>

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<sup>63</sup> pp 1137

<sup>64</sup> Lee Roch:- op cit note 44

<sup>65</sup> ibid

Further, the negotiating positions between employees and the company are inherently unequal because of; inter alia, information asymmetries in favour of management and unequal bargaining power in favour of the employer.<sup>66</sup>

Creditors, in some cases, may have a better bargaining position but some of their primary concerns such as maintaining default risk within acceptable limits are difficult to adequately provide for in a contract and require proactive monitoring on the part of the creditors which has cost implications.

According to the OECD this problem is especially pronounced in developing countries which are characterized by weak judicial systems which render the enforcement of contracts ineffective which in turn renders the distinction between 'residual' and 'non-residual' claimants of doubtful applicability in practice.<sup>67</sup>

The reality is that all three constituencies face contracting problems and contracts cannot fully protect any of the parties and they accordingly require protection from other sources such as statutory provisions and directors' fiduciary duties.

### **2.2.5 The Residual Claimants and Ultimate Bearers of Risk Argument**

Shareholders are characterized as residual beneficiaries of corporate activities and consequently they bear the greatest risk of the failure of the company.<sup>68</sup> The quintessence of the argument is that since shareholder contract for the unspecified surplus from the activities of a company after all other claims have been met they accordingly have the greatest interest in the outcome of a company's activities unlike fixed claimants whose only interest is that their fixed claims be met.<sup>69</sup> Accordingly they have the greatest incentive to police the manner in which the company is being run and value fiduciary duties more than any other corporate constituency.<sup>70</sup>

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<sup>66</sup> David Millon:- op cit note 5

<sup>67</sup> The OECD- Corporate Governance in Developing, Transition and Emerging–Market Economies by Charles Oman, Steven Fries and Willem Buiters pp 11

<sup>68</sup> Kathleen Emmarencia Van der Linde:- op cit note 28 pp 9

<sup>69</sup> Andrew Keay:- op cit note 32 pp 582

<sup>70</sup> Jonathan R Macey & Geoffrey P Miller:-op cit note 58 pp 401

However, this argument again fails to explain why shareholders should be the exclusive beneficiary of the fiduciary duties of directors to the exclusion of all other corporate constituencies.

### **2.2.6 Deficiencies of the Residual Claimants and Ultimate Bearers of Risk Argument**

The only time shareholders have an unfettered claim to the residual assets of the company after all claims have paid is upon dissolution of the company and not while it is a going concern.<sup>71</sup> The board of directors has virtually unfettered power over what appears on the balance sheet as profits and the extent of dividend that is declared which is routinely modest with the company retaining the lion's shares of profits to finance future projects.<sup>72</sup>

Shareholders do not necessarily bear the greatest risk of the failure of the company. This notion is based on a very myopic conception of company which views the company as being comprised solely of capital assets, which is what shareholders contribute to the company, and restricts the meaning of risk to financial risk.<sup>73</sup>

Companies comprise of a lot more than financial assets and the term capital should have a broader meaning than just financial assets. There is very little doubt that employees are considered to be a key asset<sup>74</sup> and the term 'human capital' is becoming common place. This is truer in the 21<sup>st</sup> century than before as there is a general shift from industrial based to knowledge based economies whose central economic activity is the provision of knowledge services.<sup>75</sup>

Yet because a company is generally conceived as comprising of only financial assets the meaning of risk is also accordingly restricted to financial risk.<sup>76</sup> The risks that other corporate constituencies are exposed to when a company is under-performing or fails such as increased default risk, plant closures, lay-offs and the prospects of lengthy periods of unemployment or getting an inferior job with

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<sup>71</sup> Lynn A Stout:- op cit note 4

<sup>72</sup> Ibid; Kathleen Emmarencia Van der Linde:- op cit note 28 pp 9

<sup>73</sup> Lee Roch:- op cit note 49

<sup>74</sup> ibid

<sup>75</sup> Robert A G Monks and Nell Minow:- Corporate Governance 3<sup>rd</sup> Ed [Blackwell Publishing, 2004] pp 70

<sup>76</sup> Lee Roch:-op cit note 73

considerably lower remuneration levels are not accorded due weight in the decision-making process of the board of directors and are subordinated to financial risk.

At, times, especially in the scenario of a plant closure, the board of directors' adherence to the profit maximization mandate may simply mean transferring the prospects of materialization of financial risk to other constituencies such as employees and the community. A company in financial trouble may embark on high risk projects that exponentially increase default risk.<sup>77</sup> Simply put, directors may avoid losses for shareholders by simply transferring risk of harm to the other corporate constituencies.

The modern and prevalent practice of diversifying shareholdings significantly reduces the financial risk faced by shareholders. A policy of diversifying the portfolio of shares, that is, holding shares from a diverse number of companies means that the overall risk as the variations in returns will be reduced as the different fortunes of the companies will offset one another.<sup>78</sup> This illustrates that share ownership in actual fact may not be a particular risky investment.<sup>79</sup>

### 2.3 Team Production Theory

The team production theory, developed by professors Margaret M Blair & Lynn A Stout provides, it is submitted, a more accurate description of the modern company and can serve as an alternative and more credible normative foundation for company law. It is a descriptive and instrumental theory of the company which is anchored on the premise that the critical factors of production and the continuing inputs necessary for a company to operate successfully are contributed jointly and inseparably by different groups chiefly the shareholders who provide initial capital, skilled labour which provides human capital and creditors who provide debt capital.<sup>80</sup> The DTI in its policy document acknowledges this inescapable fact and describes the investors of a company as its shareholders, employees and creditors.<sup>81</sup>

Companies are constantly competing not only for market share but also for acquiring and retaining the best employees, the most favourable supply terms and obtaining

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<sup>77</sup> *ibid*

<sup>78</sup> Lee Roch:-op cit note 73

<sup>79</sup> *ibid*

<sup>80</sup> Lynn A Stout & Margaret M Blair: - A Team Production Theory for Corporate Law 85 Va. L. Rev. 247 1999;

<sup>81</sup> DTI:- op cit note 2 pp 37

debt and loan finance on the most favourable terms.<sup>82</sup> Success on all these fronts requires management of stakeholder relations in order to acquire a competitive edge and to lower the cost of obtaining capital.

Since all the inputs necessary in successful corporate activities come inseparably and indivisibly from different corporate constituencies it is difficult to attribute any proportion of the corporate output to any particular group's contribution.<sup>83</sup> Consequently and fundamentally no single corporate constituency, the shareholders, managers, creditors or employees has any natural entitlement to the exclusive benefits of the proceeds of corporate activity.<sup>84</sup>

The team production theory recognises the reality that the board of a public company occupies a very powerful position. The notion that the ultimate responsibility for governing a public company lies with its board of directors is a defining attribute of the modern day public company.<sup>85</sup>

This separation gives management a great deal of latitude in the manner in which they pursue the activities of the company and securing its objectives.<sup>86</sup> Section 66(1) of the Companies Act 71 of 2008 acknowledges and entrenches the exalted position of the board by providing that the business and affairs of a company must be managed by or under the direction of its board.

The team production theory describes the board of directors as a 'mediating hierarchy'.<sup>87</sup> Instead of being beholden to any particular group, the team production theory postulates that the primary purpose of the board of directors is to protect the contributions of its corporate constituencies for the interest of the enterprise as a whole.<sup>88</sup> It is an inclusive approach aimed at balancing the interests of the constituencies that constitute the company and recognises that an interest that may

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<sup>82</sup> Janice Dean:- Directing Public Companies [Cavendish Publishing Ltd, 2001] pp 16

<sup>83</sup> Op cit note 80 at 249

<sup>84</sup> ibid

<sup>85</sup> Op cit note 1, at 251

<sup>86</sup> Op cit note 2

<sup>87</sup> Op cit note 83

<sup>88</sup> ibid

be primary at one point in a company's existence maybe secondary at a later stage.<sup>89</sup>

To make a more compelling case for the team production approach it is imperative to examine the contributions made by the other main corporate constituencies, that is the creditors and employees and this shall be the object of the succeeding chapters.

## 2.4 Conclusion

The standard arguments for continued adherence to the shareholder primacy norm do not adequately explain why shareholders should enjoy exclusive governance protection to the exclusion of all other corporate stakeholders and accordingly there are no valid reasons for taking a constrained view of what constitutes the company and its best interests under section 76 (3) (b).

The team production theory provides, it is submitted, a more accurate description of the reality that obtains in the modern public company. The inescapable reality is that the continuing inputs a company requires in order to operate successfully are contributed by a number of constituencies and not just shareholders and consequently the question of who should benefit from the fiduciary duties of the directors should depend on the nature, size and importance of contributions they make to the company and the risk they face as a result of their contribution and association with the company.

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<sup>89</sup> Irene Marie Esser: - The Protection of Stakeholder Interests in Terms of South African King III Report on Corporate Governance: An Improvement on King II? (2009) 21 SA Merc LJ 188-201 pp 199

## Chapter 3

### Creditors as a Corporate Constituency

#### 3.1 Introduction

Creditors are key providers of finance to companies and this chapter seeks to examine the importance of the inputs made by creditors to the capital base that a company requires to profitably conduct its activities and the unique challenges and risks that creditors as a corporate constituency are exposed to. It seeks to interrogate and critically examine the adequacy of South Africa's creditor protection measures in terms of the Companies Act 71 of 2008 and explores the question whether directors' duties should be extended to operate for the benefit of corporate creditors.

#### 3.2 Creditors contribution to corporate resources

The financial resources that a company requires to fund its activities are sourced mainly from either internal sources that is either equity capital and or retained earnings or by external sources that is debt. Debt financing constitutes an integral and indispensable part of the financial structure of most companies.<sup>90</sup>

Though equity capital has been described as the 'primary source' of capital it does not necessarily play a very significant role in the provision of the working capital for companies.<sup>91</sup> There is no prescribed minimum for what constitutes sufficient levels of share capital that a company needs to raise or maintain in order to be registered or to continue its business operations either under the old Companies Act 61 of 1973 or the new Companies Act 71 of 2008. A company can in-fact commence business operations with no paid up capital at all.<sup>92</sup>

Depending on the financial standing of the company, policy on the issuance of new shares, and the nature of the credit market, a company can rely much more on debt

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<sup>90</sup> Dennis Davies (Ed), Farouk Cassim (Ed) and Walter Geach:- op cit note 50 pp51

<sup>91</sup> Kathleen van der Linde op cit note 28 pp 4; Cilliers and Benade: - Corporate Law 3<sup>rd</sup> Ed [Lexis Nexis Butterworths 2000] pp 221

<sup>92</sup> Section 36 of the Act 71 of 2008 however, makes it mandatory for a company to have shareholders

financing to finance projects than on equity finance and in many respects reliance on equity finance is declining in favour of debt finance.<sup>93</sup>

The significance of equity finance as a financing tool for corporate activities is further diminished when one considers that the funds that shareholders contribute to a company as equity capital reaches the coffers of a company in the limited circumstance where there is a primary issue of shares.<sup>94</sup>

Owing to the complex legal rules designed to protect the investing public such as those contained in chapter 4 of the Companies Act 71 of 2008 that require inter alia the issuance of a prospectus and the attendant risk of legal liability, the cost of issuing a primary offer of shares, compared to issuing debt instruments or borrowing funds from a financial institution, can be very significant. Consequently most shares are traded on the secondary market as opposed to primary markets.<sup>95</sup> Primary offers after the IPO are not common place.

This means that the funds earned from most of the share trading activities on the world stock markets do not reach the coffers of the companies that have issued the shares, but to the holders of the shares who are disposing of them in secondary markets. This fact diminishes the significance of equity capital as a source of working capital.

Companies frequently retire their own equity through share buy-backs which reduces the number of shares of that company which are available in the market which further diminishes the importance of equity capital and is indicative of a greater reliance on other sources of financing like retained earnings and debt financing.

Equity capital, in the light of the facts and practises described in the preceding paragraphs, should be viewed not as an indication that shareholders make a greater contribution to the corporate capital base than other corporate constituencies such as employees and creditors, but should be understood as a legal device and an

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<sup>93</sup> Kathleen van der Linde- Op cit note 28 pp4

<sup>94</sup> Marjorie Kelly:- The Devine Right of Capital: Dethroning the Corporate Aristocracy (Berrett-Koehler Publishers, San Francisco 2003)

<sup>95</sup> [www.investopedia.com](http://www.investopedia.com) : - A look at Primary and Secondary Markets (20 November, 2010); Justice H C Nell (Nell Commission):- The final Report of the Commission Inquiry into the Affairs of the Masterbond Group and Investor Protection in South Africa; Corporate Law and Securities Regulation in South Africa –2001

allocation system which organises the rights of the shareholders amongst themselves and in relation to creditors.<sup>96</sup>

### 3.3 Risks that creditors are exposed to

Limited liability poses a unique threat to creditors as a corporate constituency because it restricts creditors' claims to the assets of the company. Separate corporate personality and the attendant limited liability are legal devices designed to limit the liability of shareholders to the property adventured and Kathleen van der Linde has described it as 'defensive asset partitioning' because the liability of shareholders is restricted to their contribution to the share capital of the company.<sup>97</sup>

Since the seminal ruling in *Salomon v A Salomon & Co Ltd*<sup>98</sup> which emphatically upheld the separate personality of the company by ruling that creditors could not sue the dominant shareholder of that company for the recovery of outstanding debts, the law has upheld the separate personality with deviation only in the most exceptional of circumstances.

However, the separate personality of a company can be used to expropriate wealth from creditors to shareholders while shareholders are protected against claims by the company's creditors by limited liability and this problem is particularly acute in 'owner-managed' companies or companies with dominant shareholders that are capable of exerting influence on management.

The abuse of corporate personality has been identified by the OECD as the pressing governance problem in developing nations such as South Africa as opposed to the '*principal-agent*' problem that lies at the centre of corporate governance studies in the United States and the United Kingdom<sup>99</sup>

South Africa has a well-documented history of arrangements that magnify the powers of certain groups of shareholders.<sup>100</sup> At independence in 1994 South Africa

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<sup>96</sup> Kathleen van der Linde- Op cit note 29 pp 7

<sup>97</sup> Kathleen van der Linde- op cit note 28 pp 9

<sup>98</sup> [1897] AC 22

<sup>99</sup> Charles Oman, Steven Fries and Willem Buiter:- op cit note 67 pp 10

<sup>100</sup> Stephan Malherbe: - "Corporate Governance in South Africa" – OECD April 2001 pp 38

had (and still has) family dominated companies that made use of pyramid structures of control, and a vast network of cross-shareholdings and directorships.<sup>101</sup>

These corporate control arrangements distort the relationship between cash flow and voting rights and allow dominant shareholders to control a vast amount of corporate assets more than their actual equity ownership would justify thereby inviting abuses of corporate governance and weakening the oversight of the capital markets.<sup>102</sup>

However, the potentially adverse effects of these control structures has been somewhat mitigated by the fact that these control structures have largely, undergone transformative changes in the period after independence. The six main conglomerate groupings that dominated the JSE at independence unbundled many of their diversified interests.<sup>103</sup> The dominance of mining finance houses has been dismantled, however, other control structures like family-controlled companies and BEE shareholding structures that have largely followed the path of the conglomerates in order to gain control of companies with modest capital commitments still remains.

The DTI in its policy document stated that one of the key functions of company law is to provide protection for investors and that investors in a company are broadly constituted by equity investors, employees and creditors.<sup>104</sup>

It is imperative therefore to assess the changes ushered in by the Companies Act through the prism of the peculiar governance problems relating to abuse of minority shareholders and creditors that occur in developing economies such as South Africa, which is characterised by a high degree of concentration of wealth, and determine whether the interest of corporate creditors as a critical corporate constituency group have been adequately protected. To this end it is imperative to briefly look at the risks creditors are exposed to.

### **3.3.1 Abusive Transactions and the Expropriation Problem**

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<sup>101</sup> Neo Chabane, Andrea Goldstein and Simon Roberts: - "The changing face and strategies of big business in South Africa: more than a decade of political democracy" – Industrial and Corporate Change, Volume 15, number 3 pp 549- 577 at 549

<sup>102</sup> Stephan Malherbe: - op cit note 98 pp 38;

<sup>103</sup> Neo Chabane, Andrea Goldstein and Simon Roberts: - op cit note 99 pp 555

<sup>104</sup> The DTI:- op cit note 2 pp 37

Research over the years indicate that the corporate governance landscape of developing countries is plagued with an expropriation problem which is characterised by the transfer of assets and profits out of companies for the benefit of those who control them<sup>105</sup> in a manner that prejudices minority shareholders and creditors of their fair share of the income from corporate resources.

The expropriation problem manifests itself in many forms; it can assume the form of wealth transfer by the dominant shareholders through loans and loan guarantees, excessive compensation or self-serving transactions such as ‘asset-stripping takeovers’ or asset sales advantageous to the controlling shareholder or inordinately large dividend distribution that may constitute a partial liquidation.<sup>106</sup>

This problem is particularly pronounced within related companies which are ultimately controlled by a dominant shareholder where corporate wealth can be expropriated by insiders through setting unfair terms for intra-group transactions involving the sale of goods and services and transfers of assets and control blocks.<sup>107</sup>

### **3.3.2 Bargaining Power, Precontractual Information Asymmetries and Incomplete Contracts**

It has long been contended that creditors are in a position to sufficiently protect themselves through contract and accordingly do not require the protection afforded by fiduciary duties and consequently have no locus standi to sue on the grounds sounding in mismanagement or even-self dealing.<sup>108</sup>

However, to argue that creditors can be wholly protected from all possible business risks that they may be exposed to in their dealings with corporate debtors solely through contractual provisions, presupposes equal bargaining power between

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<sup>105</sup> Simon Johnson, Rafael La Porta, Florencio Lopez De-Silanes and Andrei Shleifer:- “Tunnelling”- The American Economic Review, Vol. 90, No 2, (May, 2000) pp22-27 at 22; Mara Faccio, Larry P Lang, Leslie Young:- “Dividends and Expropriation” – the American Economic Review, Vol 91, No 1 (March,2001) pp 54-78; Eric Friedman, Simon Johnson and Todd Mitton- Propping and Tunnelling- Journal of Comparative Economics 31(2003) 732-750

<sup>106</sup> Simon Johnson, Rafael La Porta, Florencio Lopez De-Silanes and Andrei Shleifer:- op cit note 103 pp 22

<sup>107</sup> Mara Faccio, Larry P Lang, Leslie Young:- op cit note 103 pp55

<sup>108</sup> Richard A Booth:- “The Duty to Creditors Reconsidered – Filling a Much Needed Gap in Corporation Law” – Journal of Business & Technology Law 415 at 416; Andrew Keay:- “Directors Duties to Creditors; Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors” – the Modern Law Review Vol 66, September 2003, No 5 at 665

creditors and corporate managers and a world of perfect markets where the contracting parties have full and perfect information and financial contracting is completely without costs.<sup>109</sup>

Creditors are not a homogenous group which make it impossible to make generalisations about their differing needs and levels of protection.<sup>110</sup> Credit markets are far from perfect and frequently a company occupies a position of greater market bargaining power and access to information than a creditor who will frequently be unaware of and cannot acquire critical information about the corporate borrower without incurring costs. Further, the contractual perspective fails to take into account involuntary creditors who do not contract at all with the company such as the victims of a delictual wrong committed by a company.

Contracts cannot provide for every possible contingency that might occur so much that even if the problem of pre-contractual information asymmetry can be addressed by legal rules aimed at mandatory disclosures, creditors are still at risk of post-contractual opportunism.

Where one party, for instance a company is better informed about the circumstances pertaining to the performance of its contractual obligations and the other party is not in a position to adequately monitor the other party's behaviour for possible deviation from agreed upon terms without incurring costs, then such a party is at a risk of incurring losses due to post contractual opportunism.

So creditors might assess the risk of loaning money to or buying the debt instruments of a particular company on the basis of the information that is available to it at the time and concerning specified projects. Corporate managers can, however, increase default risk by embarking on other riskier projects with potential of higher returns. The likelihood of such behaviour is greater in owner managed companies where the owner managers can put assets belonging to creditors in high risk ventures and if successful they get the profits and if not, the creditors face

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<sup>109</sup> Helen Anderson:- "Directors Personal Liability to Creditors" – Deakin Law Review Vol 8 No2 (2003) pp 209-218; John Armour:- "Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law" – The Modern Law Review, Vol. 63, No. 3 (May 2000) pp 355-378 at 357

<sup>110</sup> Helen Anderson:- op cit note 109 pp 219

default by the company and the shareholders, including the owner managers are protected by limited liability.<sup>111</sup>

This problem can be ameliorated by the use of restrictive 'loan *covenants*' which restrict the borrower's investment and financing policies or insisting upon directors' personal suretyships over the debts of the company. However, the efficacy of loan covenants is dependent upon the ability of the creditor to monitor the behaviour of the borrower and, in the first place, the bargaining power of the creditor to impose such restrictive covenant or to insist that directors personally guarantee the loan.

Further, insisting that directors guarantee the debts of the company they run is completely impractical when dealing with a large listed company where the directors often do not have a personal stake in the company and will serve to discourage borrowing.

Creditors that wield a great deal of bargaining power such as banks can insist upon such covenants and can afford to absorb the costs that come with monitoring the activities of a borrower but other classes of creditors such as trade suppliers for instance who may rely on that particular company for a large proportion of their business do not wield such bargaining power.

### 3.3.3 Insolvent Trading

It is a well-documented phenomenon that when a company is on the verge of insolvency, the directors and the shareholders have an incentive to embark on high risk business ventures in anticipation of trading out the company's financial troubles and saving the company from being liquidated. Because of the protection afforded by limited liability they stand to lose nothing by embarking on such a course of action.<sup>112</sup>

When a company is on the verge of insolvency, the shareholders' investment is already dissipated and what is put at risk are assets that would otherwise serve to

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<sup>111</sup> John Armour:- op cit note 109 pp 360

<sup>112</sup> D. D Prentice: - "Creditor's Interests and Directors Duties" – Oxford Journal of Legal Studies, Vol. 10, No. 2 (Summer, 1990), pp 265-277 at 265; Kathleen van der Linde;-op cit note pp 12; Andrew Keay:- op cit note 107 pp 668; Laura Lin :- "Shift of Fiduciary Duty Upon Insolvency: Proper Scope of Directors Duties to Creditors" 46 Vand. L. Rev. 1485 1993 pp 1489

satisfy creditors' claims. If the undertakings are successful the shareholders stand to gain but if not creditors' claims might not be met with the remaining assets.

### **3.4 Creditor Protection in the United Kingdom and United States**

In order to acquire a better understanding of the creditor protection measures under the South African company law regulatory framework and their effectiveness or lack thereof it is necessary to engage in a comparative analysis of similar measures in the comparable jurisdictions the UK and US.

Company law has generally tried to provide for protection of creditor in company law by judicial decisions and by the provision of detailed rules rather than general standards and directors' fiduciary duties.<sup>113</sup> Creditor protection is the normative basis for rules on the raising of capital and the notions of legal capital, capital maintenance and restrictions on some forms of distributions and insolvent trading. The detailed rules on corporate creditor protection take numerous forms but are directed at ensuring that a company has adequate assets to satisfy the claims of creditors in the event of insolvency and in these jurisdictions courts have an existence of a fiduciary duty operating in favour of creditors when a company enters the brink of insolvency.

## **3.5 United Kingdom**

### **3.5.1 Legal Capital**

Share capital has been described as a 'protective cushion' for creditors' claims and corporate law has generally prohibited distributions being made out of a company's share capital. It follows that one obvious method to protect creditor interests would be to ensure that companies acquire certain levels of capital before they can trade. English company law, on account of the operation of the Second Company Law Directive<sup>114</sup> provides for minimum levels of capital for public companies.<sup>115</sup>

This provision is clearly designed to counter the potentially adverse consequences to creditors of undercapitalization. Since the rules of capital maintenance simply directed that share capital could not be returned to shareholders if the amount of the

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<sup>113</sup> Gower and Davies:- Principles of Modern Company Law 7<sup>th</sup> Ed [Thompson- Sweet & Maxwell] pp 225

<sup>114</sup> 77/91/EEC of 13 December 1976

<sup>115</sup> Section 761 of the Companies Act 2006

share capital is very low, then obviously the share capital would be woefully inadequate to satisfy creditors' claims because even if it is adequately maintained, on winding up it would still not be able to satisfy all of the creditors' claims.

However, minimum capital requirements are an ineffective measure of protecting creditors for the following reasons. Firstly, it is impossible to determine what would constitute adequate levels of capitalisation for all companies and any figure arrived at will necessarily be arbitrary. Secondly, capital requirements are concerned with the value of contributions to the share capital of a company at the commencement of trading when the greatest risk of prejudice to creditor interests occurs at insolvency.<sup>116</sup>

Thirdly, and in any event, English company law provides for a bare minimum<sup>117</sup> which bears no relation to the riskiness of the business that a particular company is engaged in but is in fact an arbitrary figure.<sup>118</sup> Minimum capital requirements are either too little to provide adequate protection of creditor or too high as to depress competition by discouraging new entrants.

### **3.5.2 Regulation of Repurchases and Redemption of Shares and Reduction of Capital**

A common method of transferring wealth from the company to its shareholders is through share buy-backs and if not subject to some form of constraints, share buy-backs can impoverish a company to the prejudice of the company's creditors. Section 658 of the Companies Act 2006 codifies the English common law restriction against a company buying its own shares with some exceptions provided for by section 659. A company can only repurchase its shares otherwise than for valuable consideration in a duly made reduction of capital or pursuant to a court order.

Private companies are allowed to issue redeemable shares and public companies are also allowed provided that their articles permit the issue of redeemable shares.<sup>119</sup> Shares can only be redeemed if they are fully paid up and in the case of

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<sup>116</sup> Gower and Davies:- op cit note 113 pp 229

<sup>117</sup> Section 763(1) of the Companies Act 2006 prescribes a minimum of £50 000 or its Euro equivalent

<sup>118</sup> Gower and Davies:- op cit 113 pp 225

<sup>119</sup> Section 684

public companies can only be done out of distributable profits of the company or from the proceeds of a new issue made for the purposes of the redemption.<sup>120</sup>

Companies with a share capital can reduce it in terms of a special resolution confirmed by the court and in the case of a private company by special resolution accompanied by a solvency statement.<sup>121</sup> Creditors are entitled to object to a reduction of capital and the court can direct the company to secure the claim of the objecting creditor.<sup>122</sup>

### 3.5.3 Regulation of Distributions

Shareholders are rewarded for their investment through distributions, for instance by declaring dividend. However, without some regulation, distributions can impoverish a company to the detriment of its creditors. It follows therefore that to adequately protect creditors there is need for some form of regulation of distributions. This is the rationale behind the traditional English company law prohibition of paying dividends out of the share capital of a company. The Companies Act of 2006 in section 830 (1) still maintains this principle that distributions can only be made out of distributable profits.

### 3.5.4 Prohibition against Insolvent Trading

The English Courts appear to recognise some sort of directors' duty running in favour of the creditors of a company that is on the brink of insolvency. For instance in the English case of *Winkworth v Edward Baron Development Co Ltd*;<sup>123</sup>

*'...the conscience of the company, as well of its management, is confided in its directors. A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors'*.<sup>124</sup>

<sup>120</sup> Sections 686(1) and 687 (2)

<sup>121</sup> Section 641

<sup>122</sup> Section 646 (2) and (3)

<sup>123</sup> [1986] 1 WLR 1512

<sup>124</sup> See also the case of *Lonrho Ltd v Shell Petroleum Co Ltd* [1980] 1 WLR. 627 where Lord Diplock held that what constitutes the best interests of the company "are not necessarily those of the shareholders but may include those of the creditors"

This approach has to some extent been codified by section 172 (3) of the Companies Act 2006 which provides that in certain circumstances directors should consider or act in the interest of the creditors of the company. It is submitted that financial difficulties that might result in insolvency are one set of circumstances that will require directors to act in the best interests of the creditors of the company.

The prohibition against insolvent and fraudulent trading contained in section 993 of the Companies Act of 2006, which provides that any person who carries on business with the intent to defraud the creditors of the company shall be guilty of an offence, augments the notion that in certain circumstances directors have a duty to act in the interests of the creditors of the company.

### **3.6 United States of America**

The formation and regulations of companies in the United States falls within the individual jurisdictions of the states in the federation and consequently is governed by several different statutes. However, some attempts to harmonize the corporate law in America have been made and the Revised Model Business Corporations Act<sup>125</sup> is an embodiment of such attempts.

Further, since fifty percent of listed companies and sixty percent of all Fortune 500 companies are domiciled in the state of Delaware<sup>126</sup>, the Delaware General Corporate Law has a decisive influence on the American corporate law landscape and the Delaware Court of Chancery has over two hundred years of being at the forefront of setting corporate law precedents in America.

#### **3.6.1 Legal Capital**

Neither the Delaware General Corporations Law (DGCL) nor the Model Business Corporations Act (Model Act) prescribes a minimum capital level. Both statutes provide for an authorised share capital to be set out in the company's certificate of incorporation. Although it may appear that the capital raising and maintenance rules of both the DGCL and the Model Act afford creditors very little protection, the solvency and liquidity test provide some genuine protection for creditors.

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<sup>125</sup> Of 1984 which is the most recent version (with its amendments) which replaced the 1969 version

<sup>126</sup> Wikipedia- Delaware General Corporation Law

### 3.6.2 Regulation of Distributions

Rather than imposing an arbitrary minimum capital level for public companies, the Model Act and the DGCL provides for restrictions against distributions that impoverish the company to the detriment of the creditors.

The Model Act provides that a company is prohibited from making a distribution that would render the company unable to pay its debts as they become due in the usual course of business or that would result in the company's total assets being less than the sum of its total liabilities.<sup>127</sup> The DGCL similarly provides that the board of directors can only declare dividends out of the distributable profits of the company.<sup>128</sup>

The American solvency and liquidity test, like minimum capital and capital maintenance rules is aimed at preventing directors from favouring shareholders through partial liquidations and recognition of the expectation of creditors to be paid timeously.<sup>129</sup> The solvency and liquidity test, which has a direct relationship to the actual financial standing of a company, will prevent any transaction in favour of a group of shareholders which will deplete the assets of the company and potentially prejudice the company's creditors.

In the event of an unlawful distribution, the directors under whose administration the breach occurred shall be jointly and severally liable for a period of six years after paying such unlawful dividend or after an unlawful share repurchase or redemption.<sup>130</sup> The Model Act similarly provides for personal liability to the company for a director who votes for an unlawful distribution.<sup>131</sup>

### 3.6.3 Share Repurchases, Redemptions and Reduction of Capital

Both the DGCL and the Model Act unlike the English Companies Act 2006, grant companies the general power to purchase or redeem its own shares except in certain specified circumstances. The DGCL allows share repurchases except in circumstances where it would impair the company's capital<sup>132</sup> and directors who

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<sup>127</sup> Section 6.40

<sup>128</sup> Section 170

<sup>129</sup> Kathleen van der Linde; op cit note 28 pp 240

<sup>130</sup> Section 174 of the DGCL

<sup>131</sup> Section 8.33 (a) of the MBCA

<sup>132</sup> Section 160 of the DGCL

make an unlawful share repurchase will incur personal liability in terms of section 174. The Model Act similarly allows share repurchases provided they meet the equity insolvency test or the balance sheet test.<sup>133</sup>

### 3.6.4 Insolvent Trading

The influential Delaware Court of Chancery recognised the need for greater protection for creditors when a company is experiencing financial difficulties and found the existence of a director's duty running in favour of creditors. In *Credit Lyonnais Bank Nederland, N.V v Pathe Communications Corp*<sup>134</sup> Chancellor Allen held that;

*“Where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the [stockholders], but owes its duty to the corporate enterprise...in such circumstances management is not disloyal in failing to act in the interests of the stockholders ...rather, management owes a supervening loyalty to the corporate entity. It has an obligation to the community of interest that sustains the corporation, to exercise judgement in an informed, good faith effort to maximize the corporation's long term wealth creating capacity.”*<sup>135</sup>

In the more recent case of *Production Resources*<sup>136</sup> the Delaware Chancery Court adhered to the same line of reasoning and held that in financially distressed firms creditors become the residual claimants and consequently directors have a duty to maximize, in these circumstances, the value of the company on behalf of its creditors.

## 3.7 South Africa

### 3.7.1 Legal Capital

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<sup>133</sup> Section 6.40 of the MBCA

<sup>134</sup> Civ. A. 12150, 1991 WL 277613 (Del.Ch.Dec.30,1991);

<sup>135</sup> See also *Production Resources Group, LLC v NCT Group, Inc* **863 A.2d 772 (Del. Ch.2004)**; *New York Credit Men's Adjustment Bureau Inc. v Weiss* 110 N.E.2d 397 (N.Y 1953) at 398 where it was held that 'if the corporation was insolvent at the time [of the alleged breach of duty], it is clear that the [officers and directors thereof], were to be considered as though trustees of the corporation's property for the corporate creditors...'

<sup>136</sup> *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*- ibid

The Companies Act 2008 adopts the American approach and does not provide for a minimum share capital and instead affords protection for creditors by the more effective solvency and liquidity test.

### 3.7.2 Regulation of Distributions

The board of directors must not make any proposed distribution without first conducting the solvency and liquidity test as it is set out in section 4 of the Act.<sup>137</sup>

The Act defines distributions in very broad terms and includes transfers of money or other property, the incurrance of obligation and the forgiveness or waiver of an obligation for the benefit of one or more holders of the shares of that company, or of another company within the same group companies by way of, inter alia, payment of dividends, payments in lieu of capitalisation shares, share buybacks and financial assistance.

If the board of directors authorises a dividend distribution in breach of section 46, then the directors present and who voted or failed to vote against the resolution authorising the distribution will incur personal liability for the losses sustained by the company as a result of the distribution in terms of section 46(6) as read with section 77 (3) (e) (vi). Incurring personal liability will be a strong deterrent against transferring wealth from a company that would impoverish or drive it into insolvency.

### 3.7.3 Restrictions against Financial Assistance

Financial assistance falls under the definition of distribution and the Act restricts the board of directors from passing a resolution authorising the provision of financial assistance by way of a loan, guarantee or the provision of security or otherwise to any person for the purpose of, or in connection with the subscription of any options, or any securities of the company or related company.<sup>138</sup> This provision is designed to curb the mischief of '*asset stripping*' that may occur in a debt-laden takeover or leveraged buyout, whereby a purchaser with insufficient funds borrows heavily to

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<sup>137</sup> section 46 (1)

<sup>138</sup> Section 44

finance the purchase of a majority holding in the target company and upon acquiring the majority holdings, sells off the target company's assets to discharge the loans.<sup>139</sup>

The regulation also extends to financial assistance rendered to directors and prescribed officers and related and inter-related companies.<sup>140</sup> Since directors, especially of a large public company occupy a position of great power with respect to the affairs and resources of a company, they can perpetrate all sorts of abusive and self-serving transactions especially by using the company to provide loans or security for their loans and deplete the asset base of the company.

### 3.7.4 Insolvent Trading

One of the traditional justifications for exclusive shareholder protection by directors' fiduciary duties is that they are the residual beneficiaries of the proceeds of a company's activities and consequently bear the greatest risk from the failure of the company. However, when a company is on the verge of insolvency the creditors have a greater interest in the assets because creditors' claims rank higher in liquidation proceedings than those of shareholders, they effectively become the residual beneficiaries of the company.<sup>141</sup>

It follows therefore that if shareholders are supplanted by creditors as the residual beneficiaries or risk bearers when a company approaches insolvency then there are very compelling grounds for establishing a fiduciary duty to protect creditors in these circumstances.

In the circumstances surrounding insolvency, what would be in the best interests of the shareholders as a body is inherently at crossroads with the interests of creditors? Equating the best interests of the company to the best interests of the shareholders will be contrary to the reality that creditors. In these circumstances creditors have a greater interest in the assets of the company, and will lead to unjustified prejudice to the interests of the creditors, who constitute a key corporate constituency.

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<sup>139</sup> Richard Jooste:- Contemporary Company Law Op cit note 8 pp 287; John Armour:- Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law – The Modern Law Review, Vol. 63, No .3 (May 2000) pp 355-378 at 368

<sup>140</sup> Section 45

<sup>141</sup> Helen Anderson;- Directors Personal Liability to Creditors – Deakin Law Review Vol 8 No2 (2003) pp 209

The Companies Act 2008 in section 22 prohibits a company from carrying on business recklessly, with gross negligence or for fraudulent purposes and against trading under insolvent circumstances.<sup>142</sup>

A director who acts in breach of the provisions of section 22 will incur liability for any loss, damages, or costs sustained by the company as a result of the breach in terms of section 77(3). The prospect of incurring personal liability will, no doubt, deter the directors from embarking on a course of action that is unduly prejudicial to creditors.

Section 22 is augmented by section 218(2) which provides that any person who contravenes any provision of the Act is liable to any other person who suffers any loss or damage as a result of such breach. Creditors will be entitled to such redress from the company or its directors for breaches of section 22 that causes losses for them.

As a result of these provisions of section 22 read with 218(2) and the wide definition accorded to distributions and the requirement to conduct a solvency and liquidity test before authorising a distribution, directors in South Africa would have to keep themselves closely acquainted with the financial state of the company in order to avoid incurring personal liability. It is submitted that the practical effect of these provisions is that directors of companies will from time to time have to actively consider the interests in their decision making process especially if the company is experiencing financing difficulties. In fact in such circumstances the prudent course of action to take would be to place the company under business rescue proceedings.

### **3.7.5 Business Rescue**

These are proceedings meant to rehabilitate a company that is financially distressed.<sup>143</sup> Instead of gambling with the assets of a company which is experiencing financial difficulties and risk incurring liability for breach of section 22 which prohibits insolvent trading, the board of directors should instead place the company under voluntary business rescue proceedings in terms of section 129(1).

These provisions provide a substantial measure of protection for creditors by essentially preventing the board of directors from assuming greater risk when

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<sup>142</sup> Section 22

<sup>143</sup> Section 128 (1) (b)

creditors are faced with the greatest peril. This is buttressed by the fact that creditors' fall within the definition of affected persons<sup>144</sup> and are entitled to apply to the courts for an order placing a company under supervision and commencing business rescue proceedings.<sup>145</sup> Once business rescue proceedings commence creditors are entitled notice of each court proceeding, decision or meeting or other relevant event and to vote on a proposed rescue plan.<sup>146</sup>

### 3.8 Conclusion and Recommendations

The specific creditor protection measures adopted in the Companies Act 71 of 2008 are robust and are equal to the task of providing protection to creditors. However, creditor protection in South Africa would be more comprehensive if it is contained in a fiduciary duty operating in favour of creditors instead of being wholly dependent upon specific statutory provisions.

Though there is, to date, no South African ruling that recognises any duty on the part of directors to protect creditor interests when a company is experiencing financial difficulties, the South African courts have, with the enactment of a new company law statute, been afforded with a golden opportunity to review what constitutes 'the best interests of the company'.

It remains to be seen whether they will adhere to the myopic conception of the company taken in the *Greenhalgh v Aderne Cinemas Ltd* ruling or whether they will take a more expansive approach.

A compelling case can be made for the South African courts to take that direction. The corporate governance environment in South Africa has undergone some transformations as a result of the enactment of the Companies Act 71 of 2008 and the presence of the King reports.

In the light of these restrictions, it is untenable to hold that the words 'in the best interests of the company' as they are used in section 76(3) of the Act still carry the same common law connotations as exemplified by the *Greenhalgh v Aderne Cinemas case*.

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<sup>144</sup> Section 128 (1)

<sup>145</sup> Section 131 (1)

<sup>146</sup> Sections 145 (1) (a)-(d) and 145(2)

It is submitted that the prohibition against insolvent and fraudulent trading and restrictions on distributions modifies the traditional conception of the company and compels an active consideration of creditor interests, at least when a company is on the brink of insolvency, before authorising any distribution and deters fraudulent or reckless trading.

If a company is facing financial difficulties then the prudent course for the directors to take would be to voluntarily place the company under business rescue proceedings in terms of section 129(1) which provides that the board of directors may resolve to place the company under business rescue proceedings if it believes that the company is financially distressed and that there appears to be reasonable prospects of rescuing it. This reinforces the approach that the directors of a company owe a duty to the company itself as a separate entity and to keep it as a going concern.

The cumulative effect of the restrictions against distributions that impoverish the company and prohibitions against insolvent trading is that it creates a duty on part of directors in favour of creditors. It might not be created in the same mould as fiduciary duties or expressly mentioned in section 76 and creditors might not be able to bring an action based on the breach of a fiduciary duty or mount a derivative action but section 218 (2) achieves the same results for all intents and purposes as an action grounded on the breach of a fiduciary duty.

It is submitted that the scope of the protection cumulatively provided to creditors by section 22 as read with section 218 (2) would be amplified if the South African courts recognise that what constitutes the best interests of the company comprises a 'community of interests'<sup>147</sup> and that the board of directors have to take into account the legitimate interests of the other corporate constituencies.<sup>148</sup> In the event of financial difficulties from which the company, objectively viewed, is unlikely to recover from, what may constitute best the interests of the company may be to treat creditors' interests as paramount. The fact that courts in the comparable jurisdictions of Australia and the United Kingdom have recognised the existence of such a duty holds a substantial measure of persuasive authority that South African courts should consider.

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<sup>147</sup> Chancellor Allen in *Credit Lyonnais Bank Nederland, N.V v Pathe Communications Corp* **Civ. A. 12150, 1991 WL 277613 (Del.Ch.Dec.30,1991)**;

<sup>148</sup> DTI :- op cit pp 26

Further, considering that one of the stated objectives of passing the new Companies Act is the promotion of efficiency and the efficient distribution of resources which is reflected in section 7 (b) (i) which provides that the purpose of the Act is, inter alia, encouraging entrepreneurship and enterprise efficiency; there are cogent arguments in favour of the existence of the duty to creditors. It is submitted that a duty on the part of directors will promote the efficient distribution of resources.

This fiduciary duty would serve as a necessary counterbalance to the protection afforded to shareholders by limited liability, a sort of price for limited liability.<sup>149</sup> It would reduce the need for creditors to insist on lengthy and complex contracts with onerous terms and the need to engage in protracted negotiations.<sup>150</sup> This, it is submitted, would have the effect of reducing the cost of borrowing as the time and costs involved in protracted negotiations and the drafting of contracts will be reduced. This can have a positive overall effect on the economy and development of entrepreneurship as it would help to lower the cost of obtaining capital.

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<sup>149</sup> Gower and Davies:- op cit note 111 pp 275

<sup>150</sup> Andrew Keay:- op cit 107 pp 668

## Chapter 4

### 4.1 Employees' Contribution to Corporate Resources

At the dawn of the industrial age corporate activities relied primarily on scarce physical assets such as land, plants and buildings and financial capital and as a result modern company law crystalized in an era where the primary measure of enterprise wealth was based on tangible assets.<sup>151</sup> Employees had virtually no role in the dominant narrative of company law and it developed centred on the relationship between the shareholders, directors and managers of a company.<sup>152</sup>

However, there is an on-going shift of paradigm in the nature of most economies in the world that is seeing the decline of the industrial and manufacturing sector and the ascendancy of technology and service companies that rely on knowledge as their primary source of competitive advantage.<sup>153</sup>

This phenomenon is being described as the 'new economy or knowledge based economy.'<sup>154</sup> The new economy is based on growing the value of knowledge as an input and output making it the most valuable ingredient of modern commerce.<sup>155</sup>

These radical changes to economic production ushered in by technology revolutions driven by technology, software and telecommunications companies have forced business people and academics alike to examine exactly how wealth is generated in modern enterprises.<sup>156</sup>

The modern company now relies on the following sources of capital, physical (plant & equipment), financial (equity, debt and retained earnings) and intellectual capital (intangible resources such as human capital, relational capital, brand loyalty,

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<sup>151</sup> Lindsay Moore and Lesley Craig:- Intellectual Capital in Enterprise Success: Strategy Revisited pp5[John Wiley & Sons, Inc, 2008]

<sup>152</sup> Kent Greenfield:- The Place of Workers in Corporate Law 39 B.C.L Rev 283

<sup>153</sup> Anthony Wall, Robert Kirk & Gary Martin- Intellectual Capital Measuring the Immeasurable [CIMA Publishing, Elsevier Ltd 2004] pp 20

<sup>154</sup> Matti Pohjola:- Knowledge Based Economy OECD/GD(96)10; The New Economy: Facts, Impacts & Policies Information Economics and Policy 14 (2002) 133–144

<sup>155</sup> Thomas Stewart:- Brainpower: Fortune Magazine 1991

<sup>156</sup> Jay Chatzkel:- Intellectual Capital [Capstone Publishing 2002 ] pp 152

intellectual property) with the latter growing in importance.<sup>157</sup> Human capital has been described as the 'the new oil'<sup>158</sup>

South Africa is experiencing these changes and the nature of the South African economy is changing from being dominated by mining companies and a new economy is emerging which is centred on telecommunications, technology, media and financial services companies.<sup>159</sup> Presently four of these 'new economy' companies, namely Standard Bank group, MTN, Vodacom and First Rand are in the top fifteen of the largest companies in South Africa measured by market capitalization.<sup>160</sup>

This rise of knowledge driven technology and financial services companies around the world is compelling a re-examination of the status of employees which is transforming from previously being treated as an expense by traditional accounting practices to being the primary driver of wealth creation of the emerging new economy.<sup>161</sup>

However company law and its narrow definition of the duties of directors does not reflect the growing realisation in the world of commerce that intellectual capital is fast becoming the most important input in modern corporate activities making employees, as the generators of intellectual capital, an indispensable corporate constituency making contributions that rival that of the providers of finance that is the shareholders and creditors.

Employees have traditionally played no role in the governance of public companies under the shareholder centred Anglo-American model. However, as noted by Professor Robert Baxt that despite the fact that the law has yet to legally recognise any duties owed by directors to employees, 'things may be changing fast'.<sup>162</sup> It has

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<sup>157</sup> Anthony Wall, Robert Kirk & Gary Martin:- op cit note 151

<sup>158</sup> Mary Adams and Michael Oleksak:- Intangible Capital: Putting Knowledge to Work in the 21st-Century Organization [Praeger 2010] pp 5

<sup>159</sup> Stephen Malherbe and Nick Segal:- Corporate Governance in South Africa OECD Development - Centre April 2001

<sup>160</sup> FTSE/JSE Top 40 Index 2009; <http://tickertalk.co.za>

<sup>161</sup> Op cit note 157 at 5

<sup>162</sup> Tom Bostock and Mallesons Stephen Jaques: - To Whom Are the Duties of a Company Director Owed? [Australian Institute of Company Directors and Centre for Corporate Law and Securities Regulation (The University of Melbourne) Seminar 8 November 2008]

been argued that the real revolution surrounding the modern ‘knowledge worker’ is that people have, for the first time in history, control of what is increasingly becoming the most critical input in modern corporate production, that is their know-how or ‘brain-power’.<sup>163</sup>

As put by Charles Handy;

*“People now own the means of production in organisations that rely on intellectual capital, on knowledge and skills, because the people have them in their brains and can walk out of the organisation at any time ... and that is going to change the nature of capitalism ... they have market value and can walk out”*<sup>164</sup>

Employees are also investors in the company and often have a long-term interest in the success of their company that at least equals and in many cases exceeds the interests of the shareholders<sup>165</sup> and risk incurring substantial losses if the company fails.<sup>166</sup> The foregoing is aptly captured in the words of Professor Clyde Summers in the following manner;

*“...employees ...are as much members of the [company] as the shareholders who provide the capital. Indeed, the employees may have made a much greater investment in the enterprise by their years of service, may have less ability to withdraw, and may have a greater stake in the future of the enterprise than many of the stockholders”*<sup>167</sup>

Contrary to the position of the residual risk bearers’ theory which restricts the meaning of risk to financial risk<sup>168</sup> it is posited that employees are the most vulnerable of all the key corporate constituencies.<sup>169</sup> Employees, for example, are at risk of the expropriation of their investments by both managers and shareholders in

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<sup>163</sup> Op cit note 157

<sup>164</sup> Ibid

<sup>165</sup> Brett H McDonnell: – Corporate Constituency Statues and Employee Governance 30 Wm. Mitchell L. Rev 1228 2003 – 2004 pp 1240

<sup>166</sup> Katherine Van Wezel Stone:- Employees as Stakeholders under State Non-Shareholder Constituency Statutes 21 Stetson L. Rev 45 1991-1992 pp48

<sup>167</sup> C Summers:- Co-determination in the US: A Protection of Problems and Potentials, 4 J. Comp. Corp. L & sec.reg 155, 170 (1982) cited from Katherine Van Wezel Stone:- Employees as Stakeholders under State Non-Shareholder Constituency Statutes 21 Stetson L. Rev 45 1991-1992 pp48

<sup>168</sup> Lee Roch :- op cit note 49

<sup>169</sup> Irene Lynch Fannon:- Working with Two Kinds of Capitalism, Corporate Governance and Employee Stakeholding: US and EC Perspectives [Oxford –Portland Oregon,2003]

the course of a fundamental transaction especially a takeover<sup>170</sup> with resultant job cuts.

Employees derive their economic livelihood from and dedicate great proportions of their time to the companies that employ them.<sup>171</sup> Shareholders can limit their exposure to a particular company or even a particular type of companies by a policy of portfolio diversification<sup>172</sup> and have the added advantage of being easily able to exit the company. Employees on the other hand cannot readily exit the company unless there is a ready market for that particular employee(s) skill-set.<sup>173</sup>

Employees are usually bound to contractual terms that ensure their services are rendered to a specific company only at a time, if there is no ready job-market for particular skills they are at a tremendous risk of a sudden and adverse change in their economic circumstances if they are suddenly retrenched’.

Companies wield ‘social decision-making powers’<sup>174</sup> in shaping the lives of employees and the democratic imperative that those substantially affected by decisions made by institutions, whether private or public must be involved in the decision-making process<sup>175</sup> compels a re-examination of the corporate legal structures that govern the relationship between the company and its employees.

It has even been posited by some scholars<sup>176</sup> that co-determination involving an active involvement and the enfranchisement of the employee constituency would actually improve the efficiency of the company. Employees because of their intimate involvement with the company are in a far better position to overcome the problem of information asymmetry that has been a formidable challenge to scattered and passive shareholders. Employees are potentially more efficient monitors of managers than shareholders.<sup>177</sup>

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<sup>170</sup> L. E Talbot :- Op cit note 30 at 48

<sup>171</sup> The EC Green Paper-Employee Participation and the Company Structure in the European Community (1975) Bull Supp 8/75 pp9

<sup>172</sup> Tom Bostock and Malleons Stephen Jaques: - Op cit note 162

<sup>173</sup> Brett H McDonnell:- Op cit note 165 at 1240

<sup>174</sup> J.E Parkinson:- Corporate Power and Responsibility Issues in the Theory of Company Law pp 22 [Clarendon Press: Oxford 1993 reprinted in 2000]

<sup>175</sup> Irene Lynch Fannon:- Op cit note 173

<sup>176</sup> Brett H McDonnell:- Op cit note 165

<sup>177</sup> ibid

Because employees have a daily commitment to the activities of the company can better organise a collective action programme whereas shareholders of a widely held public company, on the other hand, are usually passive and cannot easily organise themselves into concerted action.

Advocating for greater employee participation in the corporate decision making process is by no means new and has been recognised at the highest level in continental Europe as far back as the 1970s as demonstrated by European policy documents such as the Draft Fifth Directive EC Green Paper on employee participation [Employee Participation and Company Structure, 1978].

More recent expressions of Europe's political will to provide for employees rights to information and consultation in the governance process are the following policy documents; The Directive on European Works Council (1994), Worker Involvement in the SE (2001), and Standards of Information and Consultation of Workers (2002). Germany is the most notable example of a country that has developed a system of corporate democracy built on the foundation of the principles of codetermination and employee direct participation in the governance process.

Three methods of protecting and advancing the interests of employees as a corporate constituency by legislative means seem to have emerged and legislative efforts to protect employee interests have followed one or more of the following trajectories;

- (i) Recognising a fiduciary duty owed by directors in favour of employees
- (ii) Or direct or partial-participation in the governance process by way of nominating and electing a section of the board of directors<sup>178</sup>
- (iii) Strengthening labour laws and passing specific legislation to protect employee interest in certain specific instances

In order to gain a better understanding of whether and to what extent the Companies Act 71 of 2008 advance and protect the interests of employees as a stakeholder constituency, it is imperative to conduct a brief study of the legislative

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<sup>178</sup> J.E Parkinson:- Op cit note 173 at 22; Brett H McDonnell:- Op cit note 174 pp 1238

developments surrounding this issue in comparable jurisdictions of the United States, the United Kingdom and Germany.

## 4.2 Constituency Statutes in the United States

The market for corporate control in the United States was very active in the 1980s and there was a wave of hostile takeovers that swept the corporate landscape across the country and left a trail of massive job losses.

This radical manifestation of profit maximization for shareholders and the extensive damage it wrought on employees as a constituency and whole communities through plant-closures and relocation of wealth from some states to others led to the enactment of non-shareholder constituency statutes as part of state legislative drives to stem the tide of hostile takeovers.<sup>179</sup>

Characteristically constituency statutes permit or require directors to give consideration to the interest of enumerated groups in dispensing their fiduciary duties.<sup>180</sup> However, most of the statutes are permissive as opposed to mandatory and merely permit but do not compel directors to consider non-shareholder interests and it is only in the case of Connecticut which passed a statute that compels directors to give consideration to the interests of other constituencies.

However, the mere fact of permitting directors to consider non-shareholder interests was a radical departure from the traditional exclusive shareholder concern of American corporate law and carried with them enormous potential of effecting revolutionary changes to context of corporate decision making in the US.

The American states that passed constituency statutes appear to have attempted to implement something like the first trajectory by attempting to create a fiduciary duty running in favour of non-shareholder, constituencies.<sup>181</sup>

However, constituency statutes raise questions of whether or not they extend the ambit of fiduciary duties and if non-shareholder groupings such as employees have a right to enforce them? Unfortunately the constituency statutes do not provide the

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<sup>179</sup> Bryan Horrigan:- 21<sup>st</sup> Century CSR Trends – An Emerging Comparative Body of Law and Regulation on Corporate Responsibility, Governance and Sustainability MqJBL (2007) Vol 4 pp 95

<sup>180</sup> Brett H McDonnell:- Op cit note 165 pp 1231

<sup>181</sup> Katherine Van Wezel Stone:- Op cit note 166 pp 47

answers to these questions, they are at best vague.<sup>182</sup> The ambit of their application was limited from the outset because the majority of them, even the mandatory provisions of the Connecticut statute, are explicitly restricted to transformative transactions and disposal of substantial assets.

They failed to address the critical issues of what weight should the directors attach to shareholder and non-shareholder interests? The steps directors should take when those interests cannot be reconciled, or when the interests of non-shareholder constituencies clash amongst themselves?<sup>183</sup>

Consequently, constituency statutes in the United States have had a minuscule impact on the advice furnished to board of directors and in courtrooms across America. To date very few cases that have appeared before the American courts have even mentioned constituency statutes<sup>184</sup> and there is yet to be a decisive decision from the American courts authoritatively ruling on the application of these constituency statutes.

But at least they add value by providing a starting point for developing a more inclusive approach. It has been suggested by Professor Bainbridge that the fact that the statutes permit directors to consider the interest of non-shareholder constituencies compels an interpretation that allows directors to make trade-offs that might even cause a reduction in shareholders' gains for enhanced stakeholder welfare or otherwise the provisions would be completely lacking in substance and significance.<sup>185</sup> There would be absolutely no point in giving directors the right to consider non-shareholder interests but without the right to protect those interests.

### 4.3 The United Kingdom

Sections 172 of the UK's Companies Act of 2006 embody the enlightened shareholder value approach which was recommended by the Company Law Review Steering Committee.<sup>186</sup> It permits directors to consider, inter alia, the interests of the

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<sup>182</sup> Brett H McDonnell:-;op cit note 165 pp 1231; Katherine Van Wezel Stone:- Op cit note 166 pp 1231

<sup>183</sup> Steven M Bainbridge:- op cit note 56 pp 973

<sup>184</sup> Roun S Davids: - Constituency Statutes: An Appropriate Vehicle for Addressing Transition Costs? 28 Colum. J. L & Soc. Probs. 145 1994-1995 pp147; Brett H McDonnell – Corporate Constituency Statues and Employee Governance 30 Wm. Mitchell L. Rev 1228 2003 – 2004 pp 1231

<sup>185</sup> Steven M Bainbridge:- op cit note 55 pp 992

<sup>186</sup> Op cit note 2

company's employees, the need to foster the company's business relationships with suppliers, customers and others, and the impact of the company's operations on the community and the environment.

Section 172 of the UK's Companies Act of 2006 is permissive as opposed to mandatory in a similar manner as the US constituency statutes. Despite the use of the phrase 'enlightened shareholder value' which creates the impression that it is a concept substantially different from the shareholder primacy norm, the reality is that the changes are minuscule.<sup>187</sup>

The section makes it clear that shareholder interests remain paramount and only seeks to modify the context in which shareholder value is pursued.<sup>188</sup> It does not authorise directors to balance the interests of the company's constituencies and make trade-offs between their respective interests and therefore they cannot pursue a course of action that might result in the reduction of shareholder value but increases the welfare of other constituencies.<sup>189</sup> The directors remain only directly accountable to shareholders and it is only the shareholders that hold the right to elect directors, bring derivative actions and vote on transformative transactions.<sup>190</sup>

Section 172 does not, in any significant way, reflect the indispensable contribution of the employees as a corporate constituency that is increasingly becoming paramount in the world of commerce. It does not extend fiduciary duties to protect employee interests because it denies employees and other non-shareholders constituencies an enforcement mechanism such as the right to bring a derivative action.

Employees in the United Kingdom are still disenfranchised as the Companies Act of 2006 does not give them the right to make any direct input in the governance process through voting for any section of the board of directors.

Section 172 permits directors to consider non-shareholder interests but denies them the power to protect these interests and stakeholders are denied the power to legally compel directors to protect their interests. Section 172 is, as the American constituency statutes, likely to have minuscule impact on the manner in which

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<sup>187</sup> Andrew Keay:- op cit note 32 pp590

<sup>188</sup> Australian Corporations and Market Advisory Committee : The Social Responsibility of Corporations 2006

<sup>189</sup> Andrew Keay:- Op cit note 32pp 590

<sup>190</sup> Virginia Harper Ho : -"Enlightened Shareholder Value: Corporate Governance Beyond the Shareholder-Stakeholder Divide" The Journal of Corporation Law [Vol. 36:1]

boards in the United Kingdom make their decisions due to the absence of effective sanctions to compel changes in corporate culture, the attempt at an inclusive form of corporate governance in terms section 172 is likely to prove ineffectual.<sup>191</sup>

#### 4.4 Codetermination in Germany

The corporate governance systems of continental European countries have a more pronounced stakeholder inclination as compared with the Anglo-American model. At least with respect to employee involvement in the corporate governance process, continental European countries are much more inclusive in their corporate governance systems.

They are firmly grounded in the notion of codetermination which provides for employee consultation and participation in the company decision making process and consequently the interests of the employees are systematically considered in the decision making process.<sup>192</sup> This basic principle is common to all the corporate governance systems in the eighteen EU countries<sup>193</sup> despite their formal differences.

Germany has the most famous and most highly developed systems of board-level codetermination. The system is characterised by a two-tier board system mandated by the Codetermination Act of 1976 and its subsequent amendments and comprises a managing board (Vorstand) and the supervisory board (Aufsichtsrat).

Employee participation in the governance process takes place at two levels, the establishment level through the system of workers councils and at the board level through the right to elect representatives to the supervisory board. Employees in companies that are mandated to have the dual board system have a right to elect a certain percentage of the members of the supervisory board. Employees in a company with between 500 and 2000 employees can elect up to a third of the

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<sup>191</sup> Steven M Bainbridge:- Op cit note 156 pp 992

<sup>192</sup> Norbert Kluge:- Codetermination in Europe [European Trade Union Institute for RESEARCH, Education, Health, and Safety; Brussels] contained in Co-Determination in Germany A Beginners Guide March 2006 [Hans Bockler Foundation]; Rebecca Page:- Co-Determination in Germany A Beginners Guide March 2006 [Hans Bockler Foundation]

<sup>193</sup> The UK, Belgium, Italy, Cyprus are the EU members that do not have co-determination legislation to govern their corporate governance systems

supervisory board members and if the company has more than 2000 employees then they have a right to elect half of the members of the supervisory board.<sup>194</sup>

As a matter of positive law, the German model of corporate governance provides for strong protection of employees as a key corporate constituency by providing them a direct role in corporate governance.<sup>195</sup> The pronounced role that employees play in the governance process under the German system of codetermination precludes the view of the company as merely a vehicle to maximize shareholder gains but considers other stakeholders, notably the employees as members of the company and accordingly management under German law is not obliged to maximize share prices.<sup>196</sup>

There are important advantages to the employee constituency that can be observed in the experience of Germany and its system of codetermination. German presents an example of progressive stakeholder legislation, at least with respect to employees.

Instead of the third trajectory of protecting employees through specific legislation which seems to be favoured here in South Africa which is aimed at curbing excessively harmful or socially unacceptable corporate practices<sup>197</sup> the German approach fosters positive engagement and dialogue between management and labour. Employee representation on the supervisory board forces direct negotiations of key employee concerns such as working conditions and remuneration.<sup>198</sup>

The potential benefits of employee involvement as a monitoring device for management can be observed in Germany, at least with respect to levels of executive remuneration. Directors in the United States, where the corporate landscape is characterised by passive dispersed shareholders are able to engage in self-serving practices such as excessive executive compensation which has been

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<sup>194</sup> Mark J Loewenstein:- What can we learn from Foreign Systems? Stakeholder Protection in Germany and Japan 76 Tul. L. Rev 1673 2001-2002 pp 1677; shareholders, however, have the right the chairperson of the supervisory board which ensures that board members elected by shareholders can outvote those elected by employees in the event of a deadlock

<sup>195</sup> Mark J Loewenstein:- Op cit note 194 pp 1677

<sup>196</sup> Theodor Baums:- Corporate Governance in Germany – System and Recent Development

<sup>197</sup> Janice Dean:- Op cit note 82

<sup>198</sup> Mark J Loewenstein:- Op cit note 194 pp 1680

described as the most egregious corporate governance failure of the 21<sup>st</sup> century.<sup>199</sup> The US has the highest levels of executive compensation in the world with the highest paid CEO in 2011 being paid US\$ 84, 3 million<sup>200</sup> which dwarfs that of the highest paid CEO in Germany who stands at €9. 3 million (US\$ 13.5 million).<sup>201</sup>

The relatively modest levels of executive compensation in Germany can, in part, be attributed to the presence of employee representatives on the supervisory board. If a portion of the supervisory board's composition comprises employee representatives, the character of the discussions of executive remuneration would be markedly different in its tone and results.<sup>202</sup>

The pronounced employee participation in the governance process under the German model is an example of a progressive corporate governance system, at least, to the extent of curbing management self-aggrandizement at the expense of other constituencies.<sup>203</sup>

The direct representation of employees on the supervisory board also appears to have a chilling effect on hostile takeovers.<sup>204</sup> There have been relatively fewer hostile takeovers in Germany compared to the US and the UK. For instance during the period of 1988 to 2003 473 takeover bids were announced in the US, 273 in the UK and only 7 in Germany.<sup>205</sup>

Takeovers generally tend to generate a great deal of wealth for the shareholders but simultaneously tend to impose grave costs on other corporate constituencies notably employees.<sup>206</sup> To the extent that employee direct representation at board level has a chilling effect on hostile takeovers, employees also serve as a proxy for the interest

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<sup>199</sup> Louis Lavelle:- The Best & Worst Boards, How the Corporate Scandals are Sparking a Revolution in Governance – BusinessWeek, October 2002 [www.businessweek.com/magazine/content/02\\_40/b3802001.htm](http://www.businessweek.com/magazine/content/02_40/b3802001.htm)

<sup>200</sup> Stephen Foley:- Viacom boss [Philippe Dauman] is highest paid CEO in US at \$84.3m [www.independent.co.uk](http://www.independent.co.uk) , 10 May 2011

<sup>201</sup> Elisabeth Zimmermann:- German executive pay, company profits rise sharply in 2010 <http://www.wsws.org/index.shtml> , 13 April 2011

<sup>202</sup> Mark J Loewenstein:- Op cit note 193 pp 1681

<sup>203</sup> ibid

<sup>204</sup> ibid

<sup>205</sup> Martin Conyon, Sourafel, Girma, Steve Thompson, and Peter W Wright: - Do Takeovers Destroy Jobs? Journal of Economic Behaviour & Organisation Vol. 45 (2001) 427-440 pp 430

<sup>206</sup> Brett H McDonnell:- Op cit note 165 pp 1236,

of other stakeholder constituencies such as the community that may be spared a potentially disastrous plant closure.<sup>207</sup>

#### 4.5 Employees as Stakeholders in South Africa

Employees in South Africa find themselves in a uniquely favourable position in that the South African constitution enshrines a number of employee rights as fundamental human rights such as the right to organise, the right to strike, the right to fair labour practices and the right to be represented by trade unions.<sup>208</sup> Statutes like the Labour Relations Act 66 of 1995 (the LRA) and the Basic Conditions of Employment Act 75 of 1997 (the BCEA) and even non-employment legislation such as the Competition Act 98 of 1998 give effect to the constitutional guarantees of fair labour practices.

Section 76(3) of the Companies Act 2008 which contains the statutory expression of the duties of directors does not explicitly permit or mandate directors to consider the interests of employees or any other stakeholder groupings when they are dispensing their fiduciary duties. South Africa clearly favoured the third trajectory of specifically legislating for stakeholder protection in separate legislation outside the main company law statute and the DTI in its policy document stated that the 'advancement of certain stakeholder interests' interest may be best effected through separate legislation.<sup>209</sup>

Accountability to non-shareholder constituencies can be achieved by a host of other methods and mechanisms for instance external statutes that directly regulate important issues such as workplace safety, health, job security during transformative transactions, affirmative action, collective bargaining and environmental protection.<sup>210</sup>

However, regard must be had of the fact that this approach is by no means new and external legislation aimed at curbing corporate excess and protecting labour interests have been in place for decades in different jurisdictions but their impact has not been

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<sup>207</sup> Mark J Loewenstein:- Op cit note 194 pp 1682

<sup>208</sup> See sections 23(1)-(5) of the constitution; Tronel Joubert, Stefan van Eck and David Burdette :- The Expected Impact of Labour Law Principles on South Africa's New Corporate Rescue Mechanism

<sup>209</sup> DTI:- Op cit note 2 pp 20

<sup>210</sup> Australian Institute of Company Directors and Centre for Corporate Law and Securities Regulation:- Directors' Duties; Recent Developments and their Implications for Directors and Advisers 8 November 2000

substantial because they are designed to rectify specific manifestations of harmful practices rather than to expand the rights of key stakeholders in the governance process.<sup>211</sup>

It is generally considered that South Africa due to its colonial history and ties to the UK has generally adhered to the shareholder-centred Anglo-American model. The new Companies Act and the King reports have introduced important modifications to the typical Anglo-American system of corporate governance so much that it can properly be described as a hybrid.<sup>212</sup>

The Companies Act gives employees certain enforcement remedies that have traditionally not existed in company law legislation. Employees have the right to institute a derivative action against company directors,<sup>213</sup> a right which is reserved only for shareholders in the UK and the US, a right to institute proceedings to have a director declared delinquent<sup>214</sup> and the right to apply for the initiation of business rescue proceedings<sup>215</sup> and also to be informed and consulted during business rescue proceedings and to vote on the business rescue plan to the extent that they can be considered to be creditors of the company. These rights give employees a considerably powerful voice in the governance process.

The enforcement devices that have been extended to employees indicate an expansive conception of the company that goes beyond the basic shareholder-centric view of the company as being merely a vehicle for maximizing shareholder value. They implicitly recognise not only that other stakeholders have a vested interest in the success of the company and require enforcement devices to protect those interests but also the monitoring function that employees can perform to reign in management self-serving practices<sup>216</sup>.

The question that therefore follows is that: are the interests of employees as a key corporate constituency adequately protected under South Africa's emerging 'hybrid' corporate governance system?

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<sup>211</sup> *ibid*

<sup>212</sup> Andrew West :- op cit note 21 pp434; Stefan Andreasson:-op cit note 21

<sup>213</sup> S165(1) (c)

<sup>214</sup> S162(2)

<sup>215</sup> S131(1) read with s128 (1)(iii) which includes employees in its definition of 'affected person'

<sup>216</sup> Cliffe Dekker Hofmeyr:- Employment Matter Spring 2010

#### 4.5.1 Employee Protection in Takeover Situations

It has been long contended that the interests of shareholders are best protected by an unrestricted market for corporate control which is seen as an effective tool to discipline managers.<sup>217</sup> Takeovers generally tend to produce a great deal of wealth for shareholders but raise the question whether this generation of wealth is a result of superior productivity and efficiency of a company or whether it comes substantially from imposing costs on other stakeholders notably the employees of the target company.<sup>218</sup>

Experiences in the United States during the wave of hostile takeovers in the 1980s clearly reveal that employees as a stakeholder group are at their most vulnerable during transformative transactions such as a hostile takeover, a merger and acquisition and the sale of the company as a going concern and require special protection during transformative transactions as was attempted by the constituency statutes in the United States.

The extent to which employees are protected under company law or extraneous legislation in the context of transformative transactions depends on the conception of the company in a particular jurisdiction. In countries that adhere to the shareholder-centric model transformative transactions are perceived to be consistent with economic efficiency and consequently the rules pertaining to transformative transactions especially takeovers are flexible and only shareholders have the right to approve such transformative transactions.<sup>219</sup>

With respect to transformative transactions South Africa clearly adheres to the shareholder-centric model. One of the stated aims of the new Companies Act is to facilitate business combinations.<sup>220</sup> The DTI clearly subscribes to the efficiency hypothesis and states that takeovers are a useful mechanism by which to replace inefficient management with a more competent management and therefore results in efficient allocation of resources.<sup>221</sup>

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<sup>217</sup> Martin Conyon, Sourafel, Girma, Steve Thompson, and Peter W Wright: - Op cit note 205 pp 430

<sup>218</sup> Brett H McDonnell:- Op cit note 165 pp 1236

<sup>219</sup> Martin Conyon, Sourafel, Girma, Steve Thompson, and Peter W Wright: - Op cit note 205 pp 217

<sup>220</sup> DTI:- Op cit note 2 pp42

<sup>221</sup> *ibid*

Chapter 5 has no provisions which deals with fundamental transactions that are meant to protect stakeholder interests. The board is prohibited by section 126 to take any frustrating actions once an offer has been made or is imminent in order to allow the shareholders to decide on the merits of the offer. However, since the voting rights of shareholders are an incident of property, they are entitled to vote to advance their interests and frequently do so in takeover situations often to the detriment of other groups or in the face of opposition from other stakeholders.

The recent takeover of Massmart by Wal-Mart is a case in point. The takeover was fiercely opposed not only by the biggest trade union COSATU together with Uniglobal Union but also by the government itself which feared that Wal-Mart would use its global standing to import merchandise at the expense of local supply chains and, considering the size of Massmart, this could negatively impact on local manufacturing concerns and consequently employment in these concerns.<sup>222</sup> However, the shareholders of Massmart still voted in favour of the takeover in spite of the concerns raised by the unions and the government about the potentially detrimental effects of the takeover.

Stakeholder protection in takeover situations comes from the Competition Commission which will consider the effect of a merger or takeover on the following areas; A particular industrial sector or region, employment, the ability of small businesses, or firms controlled or owned by historically disadvantaged persons, to become competitive, and the ability of national industries to compete in international markets.<sup>223</sup>

At least in the case of the Wal-Mart takeover of Massmart the Competition Tribunal approved the takeover with conditions that seek to protect employment, at least at Massmart, such as the reinstatement of the 503 employees that had been laid off in anticipation of the takeover and a moratorium on lay-offs for the next two years. However, the German experience with co-determination indicates that employees are in a far better position to protect their own interests when they have

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<sup>222</sup> Michael Bleby – [www.businessday.co.za](http://www.businessday.co.za). - 16 May 2011, Sikonathi Mantshantsha - May 31, 2011 10:06 [www.bloomberg.net](http://www.bloomberg.net), Brindaveni Naidoo [www.creamermedia.co.za](http://www.creamermedia.co.za) 10th May 2011

<sup>223</sup> <http://www.compcom.co.za/mergers-and-acquisitions/>

institutionalised legal mechanisms, such as the right to elect a percentage of the board members, at their disposal.<sup>224</sup>

Section 197 of the LRA incorporate the principles enunciated in the EU Directive 2001/23/ of 12 March 2001 which provides for employee protection in cases of business transfers. Despite the fact that s112 of the Companies Act which deals with disposals of assets or an undertaking doesn't enfranchise any non-shareholder constituencies, it is submitted that employee interests are adequately protected in the circumstances because of the operation of s197 of the LRA.

The section provides that whenever a business or any part thereof is transferred as a going concern the new employer must take over all of the employees on the same conditions of service, the rights of the transferred employees apply to the new employer, everything done by the old employer such as unfair dismissal is transferred to the new employer and the transfer does not interrupt the continuity of service.

#### **4.5.2 Business Rescue**

The strongest expression of the recognition of employees as a key stakeholder group with a vested interest in the enterprise success in the new Companies Act is contained in chapter 6 which deals with business rescue. The far-reaching right granted to employees under this chapter recognise the detriment that employees suffer when a company collapses. These range from unpaid entitlements to job losses.

Employees and trade unions are given the right to apply for commencement of business rescue at any time even after liquidation proceedings have been commenced<sup>225</sup> and to the extent that any monies relating to employment is still outstanding at the time of the initiation of business rescue proceedings or that become due and payable during the course of the proceedings,<sup>226</sup> the amounts are considered to be post commencement finance and the respective employees are to be treated as preferred unsecured creditors with 'super preference' ranking that is

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<sup>224</sup> Martin J Conyon, Sourafel Girma, Steve Thompson, and Peter W Wright: - op cit note 205 pp 430

<sup>225</sup> The board is prohibited by s129(2) (a) from passing a resolution to commence business rescue proceedings after liquidation proceedings have been initiated

<sup>226</sup> Section 135(1)

second only to the remuneration of the business rescue practitioner.<sup>227</sup> Further these preferences remain even if the company goes into liquidation.

The business rescue practitioner is given extensive powers to alter, suspend or cancel contractual agreements by s136 (2) but the employment contract is immune to these powers and is protected by s136 (1) which provides that employees will continue to be employed under the same terms and conditions that were applicable before commencement of business rescue proceedings and these provisions cannot be contracted out of. It is also very significant that chapter 6 is the only part of the Act which enfranchises employees to vote on key matters.

Section 144(3) enumerates extensive rights of the employees during business rescue proceedings that include the right to receive notice of every court proceedings, decision, meeting or any other relevant event concerning the business rescue proceedings and the right to vote on the motion to approve the business rescue plan to the extent that they are directors.<sup>228</sup>

#### **4.5.3 Social and Ethics Committee**

Employees and other stakeholders have been given an avenue through which their interests can be raised for consideration in the decision making process of the board of directors by the provisions of section 72(4) to (10) of the Act and regulation 43 of the Companies Regulations 2011. These create a social and ethics committee in every state owned company and listed public company and any other company that scores more than five hundred points in terms of regulation 26(2). The Social and Ethics Committee is a legislative device designed to advance, at the board level, the interests of non-shareholder constituencies by bringing these to the attention of board for consideration.

A social and ethics committee established in terms of the afore mentioned sections of the Act has a far reaching mandate to monitor the activities of the company having consideration to relevant legislation, other legal requirements or prevailing codes of best practice. These are the ten principles set out in the United Nations Global Compact Principles; the company's standing in terms of the International Labour

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<sup>227</sup> Section 144(3)

<sup>228</sup> Sections s144(3) (a) and (f)

Organisation on decent work and working conditions, the company's employment relationships, and its contribution toward the educational development of its employees. The Social and Ethics Committee is empowered by section 43 (b) of the regulations to draw matters within its mandate to the attention of the board of directors as and when circumstances require it.

The provision, by legislative means, for a mandatory social and ethics committee on the boards of all listed public companies and state owned companies is an attempt to entrench the enlightened shareholder approach. Social and ethics committees have the right to bring issues within their mandate, such as employee interests as canvassed in the International Labour Protocols and codes of recommended practices such as the King Reports to the attention of the board of directors.

The presence of a mandatory social and ethics committee with a statutorily defined mandate qualifies the traditional meaning attached to the word 'the company' which cannot, in the presence of such a requirement, continue to be viewed of as a the sum total of the shareholders of the company as was held in the case of *Greenlaugh v Adernne Cinemas Ltd.*<sup>229</sup> The effect of section 43(b) of the regulations is that the board of directors can legitimately consider the interests of other stakeholder groupings such as employees.

However, the main shortcomings of the creation of a social and ethic committee for public and state owned companies are, firstly, the social and ethics committee is empowered to bring to the attention of the board matters within its mandate but the regulations do not oblige the board of directors to take these matters into consideration in its decision making process or to act on the recommendations of the social and ethics committee.

Secondly, the members of the social and ethics committee owe no direct legal duty to the stakeholders whose interests the committee is supposed to advance and protect<sup>230</sup> and consequently the provisions of section 43 of the Regulations are unenforceable by stakeholders and their interests remain subordinate to the shareholder value maximization mandate.

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<sup>229</sup> [1951] Ch 286 @ 291

<sup>230</sup> Farouk H Cassim:- Op cit note 8 pp 475

The social and ethics committee is empowered to report to the shareholders of the company on matters within its mandate at an annual general meeting. The practical efficacy of this provision is doubtful as shareholders are legally entitled to vote in the advancement of their own selfish interests and the advancement of the interest of other constituencies might frequently mean diminishing the returns of the shareholders and consequently shareholders, for the most part would be reluctant to vote in favour of stakeholder advancement initiatives that are inconsistent with increased shareholder value.

#### **4.6 Conclusion**

The credentials of the Companies Act with respect to recognition of employees as an indispensable constituency, of the Companies Act are weakened by the failure of s76 (3) to clearly state that a company is more than the equivalent of the general body of shareholders and that directors can legitimately consider the interests of non-shareholder constituencies and still be acting in the best interests of the company.

The primary criticism of the constituency statutes passed by some American states and s172 of the UK Companies Act of 2006, which explicitly permit consideration of non-shareholder constituencies' interests, is that they are vague and fail to address key issues like the weight to be attached to non-shareholder constituencies and whether directors are allowed to make trade-offs between the conflicting interests of the corporate constituencies?

Therefore, it would be the more difficult to interpret section 76 (3) of the Companies Act as permitting the board of directors to take into consideration the interests of stakeholders such as employees in their decision making processes let alone permitting directors to make trade-off between the sometime conflicting interests of shareholders and other stakeholders and between the stakeholder groups themselves.

However, the requirement for public listed and state owned companies to have a social and ethics committee allows, albeit by indirect means, directors to consider the interests of non-shareholder constituencies and the meaning that the courts will attach to the word 'company' as it is used in section 76 (3) will have to be viewed

through the prism of the requirement of social and ethics committees for all public and state owned companies.

## Chapter 5

### 5.1 Conclusion and Recommendations

The DTI's in its policy document<sup>231</sup> appears to embrace the inclusive governance approach. The policy document provides that "...*the interests of shareholders should be balanced with those of other stakeholders when this is appropriate and or required by the constitution and related legislation*"<sup>232</sup> and even goes as far as describing employees and creditors with shareholders as comprising the investors of a company.<sup>233</sup> The King Reports from the very outset especially King III embraced an inclusive approach. King III states that directors must act in the best interest of the company but have to consider the interests of various stakeholders.<sup>234</sup>

The wording of section 76(3) (b) does not appear to capture this inclusive approach or any other interpretation other than shareholder value maximization mandate in its traditional sense. Section 76 (3) (b) does not explicitly permit, let alone oblige, directors to consider the interests of other stakeholders in the decision making process.

Professor Farouk Cassim argues that the clear implication of the wording of section 76(3) (b) and the conspicuous absence of mention of other stakeholder groups is that the interests of non-shareholder constituencies, have received no official recognition under the Act with the exception of the social and ethics committee.<sup>235</sup> He further argues that the courts will continue to accord the word 'company' the same common law meaning it has previously been accorded.<sup>236</sup>

Traditionally the use of the phrase '*best interests of the company*' has been interpreted to mean the best interests of the shareholders as a general body.<sup>237</sup> It has been argued that equating the interests of shareholders as a body and the company's best interests is the only logical interpretation of the word 'company' as it is irrational and contrary to reason to work in the best interests of an artificial entity

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<sup>231</sup> DTI:- Op cit note 2

<sup>232</sup> DTI:- op cit note 2 pp 26-27

<sup>233</sup> DTI:- op cit note 2 pp 37

<sup>234</sup> Principles 1.7 and 2.1

<sup>235</sup> Farouk H Cassim:- op cit note 8

<sup>236</sup> Ibid; see also Irene Marie Esser & J. J Du Plessis:- op cit note 26 pp 357

<sup>237</sup> (DTI):-Op cit note 2 pp19, Farouk H Cassim:- op cit note 236 pp 467; L E Talbot:- op cit note 3

as an end in itself.<sup>238</sup> Accordingly company law requires a residual beneficiary and shareholders have been traditionally viewed as the sole residual beneficiaries of corporate activity<sup>239</sup>.

There are numerous court decisions where the phrase '*best interests of the company*' has been interpreted as meaning the best interest of the shareholders as a body. In the case of *Greenhalgh v Aderne Cinemas Ltd*<sup>240</sup> the court held that;

"...a company as a whole does not mean the commercial entity as distinct from shareholders. It means the shareholders or incorporators as a general body."<sup>241</sup>

Probably the most famous and oft quoted judicial exposition of this position was in the case of *Dodge v Ford Motor Corporation*<sup>242</sup> where the court said;

"...a business corporation is organised and carried on primarily for the benefit of stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end..."<sup>243</sup>

The inescapable conclusion is that under the common law directors are obliged to discharge their fiduciary duties exclusively in favour of the whole body of shareholders.<sup>244</sup>

However, there has been a shift of paradigm towards the recognition of a variety of interests. The new dispensation in South Africa characterised by a new constitution and other legislation such as the Labour Relations<sup>245</sup> and the Broad Based Black Economic Empowerment Act<sup>246</sup> compel a different interpretation of what constitutes the modern company in the South African context.

It is untenable to continue to hold that a company solely exists for the benefit of one constituency. The extent to which creditor and employee interests are protected

<sup>238</sup> Farouk H Cassim:- op cit note 7

<sup>239</sup> Kathleen Emmarencia Van der Linde:- op cit note 29 pp 10

<sup>240</sup> [1951] Ch 286 @ 291; [1950] All ER 1120 pp 1126E

<sup>241</sup> See also *Percival v Wright* [1902] 2 Ch 421; *Caiman v National Association for Mental Health* [1970] 2 ALL ER 362; *Allen v Gold Reefs of West Africa Ltd* 1900 1 CH 656 671;

<sup>242</sup> 204 Mich. 459, 170 N.W. 668. (Mich. 1919)

<sup>243</sup> At 684

<sup>244</sup> Lee Roch:- op cit note 49

<sup>245</sup> Act 66 of 1995

<sup>246</sup> Act 53 of 2003

under the Companies Act 2008 will to a great extent depend on the meaning the courts will accord to the phrase “best interests of the company”, whether the words will be accorded an inclusive interpretation.

The reform of company law in South Africa has to be viewed in the context of trying to develop a hybrid corporate governance model that retains its English origins but with a distinct African character that is embodied in the spirit of ubuntu. The DTI expressed the policy aims of the company law reform process in the following manner;

*“On this approach, company law review in this country would not only follow the world trends but will take into account the country’s particular circumstances and the legislative environment”* and the King Reports are even more explicit, King II provides that governance in any context reflects the value system of the society in which it operates and the African worldview and culture in the context of governance of companies in South Africa should be taken into account in the governance process.<sup>247</sup> It goes on to enumerate some of the defining attributes of African culture which include spiritual Collectiveness which is prized over individualism and determines the communal nature of life and an inclination towards consensus building.<sup>248</sup>

It is within this context that directors’ duties as they are codified in the Companies Act should be interpreted by the courts. An exclusive focus on shareholder value enunciated in such cases as *Greenhalgh v Aderne Cinemas Ltd* and *Dodge v Ford Motor Corporation* would be inconsistent with the African values espoused in the King Reports.<sup>249</sup>

Further section 5(1) of the Companies obliges the courts to interpret the Act in such a manner as to give effect to the provisions of section 7 which inter alia includes the promotion of compliance of the Bill of Rights in the Constitution in the application of company law and the reaffirmation of the concept of the company as a means of achieving economic and social benefits.<sup>250</sup>

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<sup>247</sup> Paragraph 38 of the Introduction to King II

<sup>248</sup> *ibid*

<sup>249</sup> Andrew West:- Op cit note 213 pp 439

<sup>250</sup> Section 7 (a) and (d)

It is submitted that provisions such as section 165 that grant non-shareholder constituencies such as employees the power to have a director declared delinquent and to institute a derivative action or section 22 that prohibits insolvent trading or section 128 that gives employees and creditors the right to apply for the commencement of business rescue proceedings implicitly recognises the fact that they have an interest in the manner in which the company is being managed and to some extent have reconstituted directors duties and beg the question whether directors owe them fiduciary duties?<sup>251</sup>

This is buttressed by the requirement of a social and ethics committee which is mandated to monitor the activities of the company and in dispensing this duty, the social and ethics committee will be guided by relevant regulation, other legal requirements, prevailing codes of best practice in the field of social and economic development, good corporate citizenship, consumer relations and labour and employment and to bring to the attention of the board of directors matters that fall within their mandate.<sup>252</sup>

These duties might not be framed in the same manner as fiduciary duties in the sense that directors are not directly accountable to creditors and employees but these provisions certainly make them indirectly accountable to these non-shareholder constituencies.

Consequently, any interpretation of the ambit of directors' duties under section 76 (3), despite the conspicuous absence of mention of non-shareholder constituencies, must by necessary implication allow directors to consider the interests of non-shareholder constituencies, especially employees and creditors in their decision making processes.

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<sup>251</sup> Irene Marie Esser: - *A global perspective on African corporate governance: The protection of stakeholders' Interests* (2007) 32 SAYIL 406 – 429 pp416

<sup>252</sup> Regulations 50 of the Draft Companies Regulations

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