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SELECTED LEGAL ASPECTS
OF
CORPORATE FINANCE

by

MICHÉLE ANDRÉE FRANKE

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OF
CORPORATE FINANCE

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INTRODUCTION

As the title to this thesis indicates, *selected issues* arising in corporate finance/treasury will be discussed.¹ Corporate finance or treasury management is a new and developing field of law. It is a field which requires one to take into consideration economic, commercial and legal phenomena; and as a consequence, requires imagination and innovation on the part of a corporate treasurer. At the end of the day, this provides the recipe for the development of a very exciting and interesting branch of law. The diversity of the field of corporate finance can be seen from the list below. The subject-matters must not be treated in isolation; instead, at any given time, numerous aspects must be taken into consideration if efficiency is to be achieved and adequate risk-cover provided:

- . predicting a corporations cash flow
- . interest rates and exposure to such risk
- . foreign exchange rates and regulations, and exposure to such risk
- . futures, options and swaps
- . derivative products and markets
- . bonds and hybrids
- . commercial paper
- . equities
- . mergers and acquisitions; and management buyouts and buyins
- . restructuring
- . security for finance
- . debt subordination, negative pledges, and other restrictive covenants
- . choosing between lease, rental or outright purchase
- . joint ventures
- . charges: bank services, revenue/taxes and stock exchange charges

¹ Note that corporate finance is not concerned with the financing of small privately held companies but with corporations and public companies - that is, large institutions.

. security markets.

Faced with this formidable list, the thesis has been divided into three parts: (1) preliminary issues affecting the raising of finance, (2) equity finance, and (3) debt finance. The 'preliminary issues' referred to, concern the issue of a prospectus in terms of the Companies Act 61 of 1973 and the various Revenue Taxes which are imposed upon securities and other transactions. Whether a corporation wishes to raise equity or debt by issuing securities, an important question to be answered is whether such an issue constitutes an 'offer to the public'. An answer to this question is essential given the costs which will be incurred and the time utilized in publishing a prospectus. The various Revenue Taxes which need to be considered range from the Marketable Securities Tax Act 32 of 1948, through to the Stock Exchange 'listing fee' and the Brokerage rates. While under equity financing, one is faced with a number of concerns: for example, the protection of the preference shareholder's rights, safeguarding creditors and minority shareholders upon a reduction of capital, and preservation of the corporation's resources against the occurrence of the corporation extending financial assistance in regard to the purchase of its shares.

The risk becomes more one-sided when one considers debt financing. Here, the primary concern is the risk of default and, consequently, the concentration is upon the risk to which the lender is exposed. Generally, the lender can be afforded protection by imposing a duty upon the directors to consider the interests of creditors. But, for more specific protection of lenders' interests, one must look to the restrictive covenants employed in the contract. While there are the traditional areas of guarantees, surety etc, the thesis concentrates upon those fields where there has been recent development - namely, debt subordinations, negative pledges, and other 'standard covenants'. Then, there is the peculiar half-way house occupied by the lender under letters of comfort and notarial bonds: these two topics are linked by a common

thread - namely, while they appear to grant security and protection to the holder of such documents, in reality recent court decisions have exposed the folly of this supposition. And lastly, there has been the development, recently, of commercial paper (CP). CP's are forms of written acknowledgements of debt which now have the opportunity of being traded and even listed on a financial exchange.

Of all the provisions in the Companies Act 61 of 1973 concerning the issuance of a prospectus, none can be more difficult to understand than the phrase 'an offer to the public'. While it can be appreciated that the legislature has attempted to protect the unsuspecting investor from being taken advantage of, the result has been legal uncertainty as to whom constitutes 'the public'. Can one limit its meaning to someone who is a stranger to the offeror, or, does it depend on the particular circumstances of the case? It would seem that heading an offer 'strictly private and confidential', does not solve the problem - such an offer still can be regarded as an offer to the public. But, perhaps the best explanation to have emanated from the various cases, is that some degree of familiarity must exist between the offeror and the offeree and between the offerees and the actual agreement. The establishment of these factors can be said to 'depend on the circumstances of the case'.

The various revenue taxes and other costs imposed on the securities and transactions are easy to calculate. But, mention has been made of such costs as they are an important transactions cost which needs to be considered in establishing the efficiency of the particular transaction. The costs to which reference has been made are: (1) Marketable Securities Tax Act 32 of 1948; (2) Stamp Duties Act 77 of 1968; (3) Johannesburg Stock Exchange Listing Fees; and (4) Brokerage Rates.

Financing of a corporation through the medium of shares provides any corporation with a stable source of capital.

Admittedly it is a cheaper alternative to debt as it does not incur having to pay interest, and any declaration of dividends will be in relation to the profits available and not have to be paid if the corporation so decides. But, ownership is shared and questions concerning the rights of the shareholder thus become important. The expression of the content of such rights - whether contained in the memorandum, articles of association, or in an agreement - is a matter of 'construction': the central question (which must be answered) being, is the statement of the rights exhaustive in its content? The South African case-law is unanimous in its answer: the maximum *expressio unius est exclusio alterius* applies if there is no indication to the contrary. Another area in which the preference share is governed by contract is the right to receive a dividend and the right to vote. However, in respect of this latter right, the legislature provides for certain instances when the preference shareholder has a right to vote: namely, when their dividend is undeclared and/or unpaid, and when the rights and interests of the shareholder are being decided upon in a resolution. Of particular interest is the meaning attributed to the preference shareholder's interests.

Protection of preferent rights can be via a variation clause - either in the memorandum or the articles - and the statutory remedies made available in the Companies Act. Where the variation clause protects 'class rights', the problem which must be addressed, concerns which rights constitute class rights. Class rights can be defined as those rights annexed to particular shares; and it is such rights which are protected under a variation clause. However, rights conferred on an individual in his capacity as a shareholder, while not constituting class rights, are protected under the general section, s 252, of the Companies Act. Lastly, the discussion focuses upon the distinction between a variation of the shareholder's right and a variation of the enjoyment of such rights. Although comparisons have been made between the constitutional voter and the company law voter, the conclusion

reached is that such a comparison is not justified because the constitutional voter has a personal right in a democracy but the company law voter has a (partial) right of ownership to property, hence the shareholder's effective voting power is important where, for example, the total shares of the company are increased.

The rules governing maintenance of capital exist primarily to protect the creditors of a company and then the shareholders. Any previous open-ended authority which the company exercised in reducing its capital, has been curtailed. Consequently, the courts will not allow a reduction which leaves it at the company's discretion as to when to make payments in reducing its capital. Such an approach exists to protect future creditors and the general public. But, the courts have warned that the rules as to maintenance of capital do not exist to protect the shareholder from a bad bargain.

The exception to the rule of maintenance of capital, is the redeemable preference share. While any event is sufficient to trigger a redemption, it is important that such event must not be so remote as to take away the characteristic of redemption.

The last topic for consideration under Equity Financing concerns the prohibition against the offering of financial assistance in the purchase of the company's shares. Regrettably the courts, when defining the giving of financial assistance, have concentrated upon establishing some tangible loss. But, the relevant provision in the Companies Act, by referring to financial assistance in the form of a loan, guarantee or provision of security, must have contemplated something other than tangible loss. Nevertheless, the courts have developed various tests to establish the giving of financial assistance, for example, the impoverishment test, the 'sound business method' test and the *quid pro quo* test. Once the giving of financial assistance has been established, one must determine whether the financial assistance provision can

be severed from the rest of the share-sale agreement - such determination is governed by the law of contract. Where severability is not possible and thus contravention of s 38 occurs, the company itself is guilty of an offence. Although this seems harsh, it must be remembered that the company, in turn, can sue the directors for damages. This then, brings to an end Part II : Equity Financing.

Part III : Debt Financing commences with an analysis of directors' fiduciary duties to bondholders and other creditors. There is a visible difference in approaches between the American writers and the Commonwealth case-law. The Americans tackle the discussion from the point of view of economic efficiency and maximization of the value of the firm. In terms of the good faith duty, the directors owe a duty to the convertible bondholders where the bond contract fails clearly to allocate the risk which is the subject-matter of the dispute. An alternative approach is the implied duty of good faith which is premised on the theory that directors must protect the reasonable expectations of the convertible bondholder which were induced by promises made by the corporation in the indenture. The duty is owed to convertible bondholders as it is a hybrid security and consequently, reduces any potential conflict between stockholders and bondholders.

Different motivations underlie the argument that directors owe fiduciary duties to the bondholders. While the Commonwealth case-law relies upon an extended notion of the concept of directors acting 'bona fide for the benefit of the company', the Americans have relied upon the principles of economics. The contrast in approaches are further highlighted when the discussion considers whether derivative as well as direct suits may be brought against the directors: the Americans opting for both terms of remedies, but the Commonwealth adhering strictly to the rule and allowing only derivative suits to be brought.

While the development of fiduciary duties to creditors thus provides rather precarious protection, it becomes apposite to consider the protection offered through the use of restrictive covenants. The enforceability of subordinated debt agreements once the debtor is insolvent, has been affirmed. The premise upon which enforceability rests is that the subordinated creditor only has a claim against the debtor once the other creditors are paid in full; hence, once the debtor is sequestrated, the condition upon which enforceability of the subordinated debt depends (i.e. excess assets remaining), becomes incapable of fulfilment. Therefore, the senior creditor's right to prior payment, is protected.

The position of the negative pledge lender is perilous, given the South African law concerning the timing of registration of securities together with the difficulty of monitoring compliance with the negative pledge. It is best to use a negative pledge in the affirmative form as enforcement of compliance with the pledge is by means of specific performance as an obligation is imposed upon the borrower; whereas a negative form of the negative pledge merely states a condition. A remedy open to a negative pledge lender under both an affirmative and a negative covenant is to sue for damages based on the fact that the lender had bargained for something more. The use of negative pledge lending in the international arena has been possible as foreign jurisdictions do allow equitable principles to determine a decision in the law relating to securities.

In banking documents certain standard covenants and restrictions are imposed. It is important for the lender that he be able to monitor such covenants/restrictions, but, for the borrower, it is essential that covenants/restrictions he agrees to today do not bind him in respect of entering into more advantageous covenants/restrictions in the future. Generally, the trend has been for the content of what constitutes credit risk, to diversify: previously, risks which the borrower could control, were the subject-matter of standard covenants; now,

investors seek to protect themselves from those risks which are beyond the control of the borrower (for example, the effect of a take-over and 'change of control').

The use of letters of comfort has increased primarily as the issuer has attempted to escape either signing as a guarantor or having to disclose the 'security' as a contingent liability. Where comfort letters have been the basis of a dispute, it becomes a question of form as to whether they constitute contractual obligations: the distinction is between words of promise and words of fact. The intention of the parties should be the determining factor, however, usually the terms used are too vague and this results in the contract being void for vagueness, and regrettably one does find a 'twilight zone of merely honourable agreements'. From a business perspective one must decide which is better: a guarantee from a near-insolvent company or a comfort letter from a reputable company whose reputation will be at stake should it default?

The last form of creditor protection considered, is that of the special notarial bondholder. Whereas previously such a bondholder was accorded preferential treatment as a preferent creditor, now he ranks as a concurrent creditor. Given all the forms of bonds which no longer constitute a general mortgage bond, the existence of s 102 of the Insolvency Act 24 of 1936 seemed senseless. The question then arises as to whether the court was influenced in reaching its decision that a general notarial bond is a general mortgage bond, because it did not want to conclude that s 102 has no relevance any more? But, the factor which does require emphasis is that the list of statutory preferences indeed is a closed list and does not permit the inclusion of the common law preferences. Thus, the only conclusion that can be reached, is that reform is needed.

Finally, Part III is concluded with a discussion about commercial paper (CP). CP is a new development in South Africa and is an attempt to meet with international advances in this area. CP's are, basically, written acknowledgements of debt.

In attempting to facilitate a market in CP's a regulatory framework has defined certain standards with which the issue of CP must conform. The requirement that the issuer must have a net asset value exceeding R100 million, or alternatively the CP must be listed on a financial exchange or endorsed by a Deposit-taking Institution, necessarily implies that only a certain quality company will be issuing CP. And the financial information which is required to be published in the placing document or prospectus attempts to prevent fraudulent disclosure of a company's well-being, and simultaneously allows the company's credit risk to be adequately assessed by potential lenders.

But, no matter how a corporation combines its blend of equity and debt financing, ultimately the investor and lender seeks two ingredients, namely, legal certainty and speed of recovery in the event of default. While the borrowing corporation must concentrate on the efficient financing of his business entity if it is to be internationally competitive. The macro-economic effect of this is that "the private sector serve[s] as the engine of economic growth [This] is the fundamental determinant of the long-run success of any nation, the basic source of rising living standards, and the key to meeting the needs and desires of [a country's] people."²

² *Economic Report of the President*; Transmitted to the U.S.A. Congress, February 1991. United States Government Printing Office, Washington 1991.

PART I

PRELIMINARY ISSUES AFFECTING

THE RAISING OF FINANCE

CHAPTER 1

PROSPECTUS REQUIREMENTS

Section 145(1) of the Companies Act 61 of 1973 requires that a prospectus accompany an offer for the subscription for shares/debentures/securities where such offer is an offer to the public. The concepts 'offer' and 'offer to the public' are defined in s 142(1) of the Act:

'Offer' ... means an offer made in any way, including by provisional allotment or allocation, for the subscription for or sale of any shares, and includes an invitation to subscribe for or purchase any shares;

'Offer to the public' ... means any offer to the public and includes an offer of shares to any section of the public, whether selected as members or debenture-holders of the company concerned or as clients of the person issuing the prospectus concerned or in any other manner.

The Act does not define the scope of who constitutes 'the public'.¹ But, as was noted by the majority in *Corporate Affairs Commission v Australian Credit Union*:²

"the use of the word 'including' indicates ... the [definition] is expansive of what would otherwise be included in the notion of an offer or invitation to the public. That does not, however, mean that none of the cases which the [definition] includes would have been included in that notion in any event. The function of such an inclusive 'definition' is commonly both to extend the ordinary meaning of the particular

¹ For a discussion concerning the debate surrounding the meaning of when an offer will be a public offer, one can consult the following sources:

(1) PA Delpont: *Die verkryging van kapitaal in die Suid-Afrikaanse Maatskappyereg*; Doctoral thesis; 1987, University of Pretoria.

(2) D Matlala: *Public offer of shares*; Masters dissertation; 1988, University of Cape Town.

² *Corporate Affairs Commission (South Australia) & Another v Australian Central Credit Union* [1985] 157 CLR 201.

word or phrase to include matters which otherwise would not be encompassed by it and to avoid possible uncertainty by expressly providing for the inclusion of particular borderline cases."³

While this 'inclusive definition' provides some certainty as to those who are included in the concept of 'public', the only other source of assistance in the Act is s 144 which provides for exclusions to the concept 'public offering'.

PRIVATE OFFERS

There are four instances when the offering of shares/debentures/securities may be a private offer:⁴

- 1) The intention is that the shares/debentures/securities are to become available only to those to whom the offer was made;
- 2) The offer is to existing holders of shares/debentures/securities, without a right to renounce the offer in favour of other persons;
- 3) The offer is a domestic affair between the maker and receiver thereof; or
- 4) A rights offer.

*S v National Board of Executors*⁵ considered the first exception. The court allowed the case to proceed on the assumption that the word 'calculated' meant 'likely' and not 'intended'.⁶ To establish that the offer was not calculated to be accepted by other persons than those to whom the offer was made, Harcourt J held that he could not "interpret the section as imposing a minimum set of precautions which must be taken

³ *ibid*; pp206-07.

⁴ s 144 of the Companies Act. Any reference to provisions will be to those contained in the Companies Act, unless otherwise specified.

⁵ *S v National Board of Executors Ltd & Others* 1971 (3) SA 817 (D).

⁶ *ibid*; p827H.

on peril of the invitation being held to be to the public";⁷ although the presense or absence of such precautions "may ... be one of 'all the circumstances' which must be regarded in terms of the section".⁸ The circumstances considered by the court were, for example:

- 1) the heading 'strictly private and confidential - for the information of addressees only' was on the front cover of the brochure;
- 2) the manner of payment for the shares/debentures/securities;
- 3) the characteristics of the investor, i.e. long-term, institutional investors;
- 4) evidence of whether outsiders accepted the offer; and
- 5) whether there was evidence of indiscriminate allotments to outsiders.⁹

In essence, one is dealing with "a question of fact to be determined by taking all the circumstances surrounding the offer into account."¹⁰

The third exception, i.e. where the offer is a domestic affair, is another instance where one must look to the circumstances of the dealing to reach a conclusion. *Henochsberg* offers the following advice:

"the type of offer which is contemplated is one which is made in the context of a private negotiation, i.e. where the offeror privately approaches one or more than one particular potential investor to subscribe for or purchase the shares either by himself or themselves or by another or others he or they might introduce In many cases an offer which is

⁷ *ibid*; p827G.

⁸ *ibid*.

⁹ *ibid*; pp829G-32G.

¹⁰ HS Cilliers and ML Benade (eds): *Corporate Law*; DH Botha, MJ Oosthuizen and EM de la Rey (authors); Butterworths, Durban, 1987; p143.

covered by this exception may in any event be covered also by the exception for which s 144(a) provides [i.e. the first exception]."¹¹

The remaining two exceptions provide no obstacles concerning meanings to be attributed to their wording.

However, these exceptions still do not provide an answer as to when an offer is a public offer. Especially when one considers the costs involved in issuing a prospectus, the understanding attributable to the concept of 'offer to the public', is important. The following insight into these costs was provided in an article published by the *Financial Mail*:

"Printing the prospectus could cost around R50 000, depending on its size and complexity, and publishing it in the newspapers, as is required, could add another R150 000 to the bill. The use of a registered broker is a requirement and the fees individual firms charge vary. Add to this the specialist services of reporting accountants, attorneys and any other [technical reports]... and the final cost could be close to R500 000."¹²

Bearing such costs in mind, it is appropriate now to consider the courts approaches to defining public offers.

PUBLIC OFFERS

Numerous attempts by the courts' have been made to define the concept *public*. For example: in *S v Rossouw (1968)*¹³ the court accepted that it referred to the community as a whole, to a section of the community (depending on the context);¹⁴ in

¹¹ *Henochsberg on the Companies Act*; PM Meskim (ed); Durban, Butterworths, 4th ed, 1985; p216.

¹² *Investing on the JSE*. A survey. Supplement to *Financial Mail*, October 2 1992. Article entitled "Pros and Cons of Listing"; pp4-6; p6.

¹³ 1968 (4) SA 380 (T).

¹⁴ *ibid*; p385GH. That is, its ordinary meaning.

S v Rossouw (1969),¹⁵ Van Den Heever J argued that the concept *public* can be resolved with reference to the circumstances of each case; but warned that a public offering is not synonymous with an offer to any person;¹⁶ while *Vlakspruitlandgoed v Mentz*¹⁷ rejected defining *public* "as ook enige lid van die publiek wat 'n vreemdeling is vir die aanbieder";¹⁸ and lastly, Harcourt J, in *S v National Board of Executors*, readily consented that "in principle an offer or invitation to the public is one which can be accepted by anyone who becomes aware of it."¹⁹ However, it is the case of *Corporate Affairs Commission v Australian Credit Union* which highlights the pertinent factors to be considered:

"The question whether a particular group of persons constitutes a section of the public for the purposes of [the section] cannot be answered in the abstract. For some purposes and in some circumstances, each citizen is a member of the public and any group of persons can constitute a section of the public. For other purposes and in other circumstances, the same person or the same group can be seen as identified by some special characteristic which isolates him or them in a private capacity and places him or them in a position of contrast with a member or section of the public. In a case where an offer is made by a stranger and there is no rational connexion between the characteristic which sets the members of a group apart and the nature of the offer made to them, the group will, at least ordinarily, constitute a section of the public for the purposes of the offer. If, however, there is some subsisting special relationship between offeror and members of a group or some rational connexion between the common characteristic of members of a group and the offer made to them, the question whether the group constitutes a section of the public for the purposes of the offer will fall to be determined by reference to a variety of factors of which the most important will ordinarily be: the

¹⁵ 1969 (4) SA 504 (NC).

¹⁶ *ibid*; p509D.

¹⁷ *Vlakspruitlandgoed (Edms) Bpk v J Mentz (Edms) Bpk* 1977 (1) SA 780 (T).

¹⁸ *ibid*; p786F. Such a meaning fell outside the intention of the Legislature. [*ibid*]

¹⁹ n.5; p826B.

number of persons comprising the group, the subsisting relationship between the offeror and the members of the group, the nature and content of the offer, the significance of any particular characteristic which identifies the members of the group and any connexion between that characteristic and the offer"²⁰

No single factor determines whether an offer is private or public. One should consider the familiarity (i.e. subsisting relationship) between the offeror/borrower and the offerees/lenders and the familiarity between the identification of the offerees/lenders and the actual agreement. In practice, corporate financiers/treasurers use institutional lenders and banks as sources of finance and restrict any documentation "to addressees only" or as being "strictly private and confidential". However, it would appear from the above that such phrases are not conclusive as to the privacy of an offering.²¹ And one must appreciate that the prospectus requirements exist to provide for disclosure to the uninformed potential offeree/lender.

²⁰ n.2; p208.

²¹ D Matlala; n.1; pp105-07.

APPENDIX

COSTS

1) Marketable Securities Tax Act 32 of 1948¹

A marketable security is defined as: 'security, stock, share, right of option or other interest sold or capable of being sold in a sharemarket or exchange or otherwise'.² On such 'security' the MST is 1% 'of the consideration for which such securities are so purchased',³ however a relevant exemption to this MST is the purchase of interest-bearing listed debentures.⁴

The following will incur MST:

- (i) A Commercial Paper with a buy back arrangement (ie. a right of option);
- (ii) Shares;
- (iii) Debentures which are not interest-bearing or, if they are interest-bearing, then they must be unlisted;
- (iv) No definition is given to the concept 'security'; hence it is possible that a Commercial Paper (without a right of option) can constitute a security, in which case it is subject to the MST.

In defining the exempted debenture the Act includes 'any other securities of a juristic person' as being a debenture in terms of s 3(d). Consequently, if a Commercial Paper (without an option) can be classed as security, then if it fulfils the requirements of the exemption - interest-bearing and listing on a stock exchange - it is exempted from the MST.

¹ Note the following abbreviation: MST = Marketable Securities Tax.

² s 1, MST Act.

³ s 2, MST Act.

⁴ s 3(d), MST Act.

2) Stamp Duties Act 77 of 1968

- (i) Promissory notes: Stamp duty is 5c per R100 of nominal value.⁵ The duty is levied on future value which is greater than the present value in long dated deals. One institution has observed that "it is debatable as to whether a floating rate promissory note can be issued to save on stamp duties, because bills of exchange should be certain in amount. Legal opinion suggests that it is legally feasible but not without uncertainties."⁶
- (ii) Marketable securities: With respect to the original issue of shares or debentures:
- a) where transfer is by registration: stamp duty is 5c per R20 of nominal value (i.e. 25c per R100 of nominal value);
 - b) where it is bearer or transferable by delivery: stamp duty is 20c per R20 of nominal value (i.e. R1 per R100 of nominal value).⁷

3) Listing Fees: Rules of the Johannesburg Stock Exchange:

Section 10

A fee is payable when listing is granted:

- (i) 1c per every 100 shares;
- (ii) 1c per every R100 of debentures,⁸ subject to the following:
 - a) a minimum fee of R500 and a maximum of R5000 for an initial listing or a listing of an additional class of securities;⁹ and
 - b) a minimum fee of R25 and a maximum of R5000 for an initial listing of additional securities of

⁵ Item 5, Schedule 1, Stamp Duties Act.

⁶ Banking document.

⁷ Item 15, Schedule 1, Stamp Duties Act.

⁸ s 10.20.1.2, J.S.E. Rules.

⁹ s 10.20.1.2.1. Amounts must be rounded off to the nearest R50.

a class already listed.¹⁰

4) Brokerage rates: See appendix.

¹⁰ s 10.20.1.2.2. Amounts must be rounded off to the nearest R25.

BROKERAGE RATES

**BROKERAGE CHARGEABLE ON PURCHASES OR SALES
(excluding Government and Municipal stocks, etc.)**

Type of Security	Basic Charge	% Brokerage on consideration
<p>Shares, listed options and debentures and notes having inherent option rights or which are convertible either wholly or in part or are capable of paying a variable interest rate:</p>		
Where total consideration is R200,00 or less	R30,00 or less or no charge at brokers discretion	See sliding scale, (Minimum R2.20)
Where total consideration is more than R200,00	Flat charge of R30,00	See sliding scale, (Minimum R2.20)
<p>Debentures and notes which have no inherent option or conversion rights and bearing a fixed rate of interest or a rate which varies solely with factors other than the profit performance of the company or any related ordinary shares.</p>		
	Nil	Maximum 0,60%

Purchase or Sale Consideration

Brokerage

Up to R	5 000				1.2%
Over R	5 000	up to R	10 000	R	60,00 + 0,85% on excess
Over R	10 000	up to R	100 000	R	102,50 + 0,75% on excess
Over R	100 000	up to R	250 000	R	777,50 + 0,65% on excess
Over R	250 000	up to R	500 000	R1	752,50 + 0,55% on excess
Over R	500 000	up to R1	000 000	R3	127,50 + 0,45% on excess
Over R1	000 000	up to R1	500 000	R5	377,50 + 0,35% on excess
Over R1	500 000			R7	127,50 + 0,20% on excess

- NOTE:**
- (i) Basic charge & brokerage are applicable to: all orders or portions of orders to buy or sell the same security for the same principal which are executed during any one day.
 - (ii) Brokerage levied shall be subject to a surcharge of 2,4%.
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PART II

EQUITY FINANCING

CHAPTER 2

PREFERENCE SHARES, AND THEIR RIGHTS AND VARIATION

There are basically four cardinal areas concerning which a preference shareholder has particular interests: (1) his rights, (2) variation of these rights, (3) remedies available to protect or enforce these rights, and (4) redemption of his redeemable preference shares. The subject-matter of (1), (2) and (3) will be discussed in this chapter, while the topic of redemption falls for discussion under Chapter 4 : Maintenance of Capital.

Given that a corporation has authority to issue preference shares, the *rights* of a preference shareholder have three hurdles to overcome: firstly, is the statement of their rights exhaustive in its content; secondly, when does s 194 of the Companies Act 61 of 1973 provide statutory relief, thereby requiring the preference shareholder to exercise his voting right; and thirdly, when does a preference shareholder have the right to receive a dividend? Concerning the *variation* of the preference shareholder's rights, the unravelling of what constitutes a variation of a *right* as opposed to the affecting of the *enjoyment* of such right, can be identified, perhaps, as a central concern, once the preliminary process of classifying such a right as establishing a "class of shares", has occurred. Then, the final field of enquiry is to consider the *protection* available to the preference shareholder - after all, what is the use of having a right but not a remedy.

AUTHORITY TO ISSUE PREFERENCE SHARES

The Companies Act requires that the memorandum of a company states the amount of the share capital and the division thereof into shares of a fixed amount (s 52(2)); but s 52 makes no mention of whether the memorandum should contain a reference

to the division of the shares into different classes. Rather, any materialization of the authority to issue preference shares is found in s 98(1) which provides that 'a company ..., if so authorized by its articles, may issue preference shares'; hence any express permission to issue preference shares must at minimum originate from the articles of association.¹ However, this would always be subject to any contrary indications appearing in the memorandum; consequently, if the memorandum provides that all shares are to have equal rights, then the articles cannot override this provision by themselves granting authority to issue preference shares. In fact, Table A art 3 provides that 'subject to the provisions, if any, of the memorandum ... any share may be issued ...'. Of course, there is nothing preventing a company in its memorandum granting the power to issue preference shares. Lastly, "[i]f the memorandum does not provide for ... equality and the articles contain no power to issue shares with special rights, or if the articles provide for such equality, the articles may be altered (under s 62(1)) to incorporate such power (*Campbell v Rofe* [1933] AC 91 (PC) at p 98)."²

Table A art 3 authorises the issue of different classes of shares by a company. Art 3 empowers a company to issue 'any share ... with such preferred, deferred or other special rights, or subject to such restrictions (whether in regard to dividend, voting, return of share capital or otherwise) as the company may from time to time determine'. One question arises: is the determination by 'the company' that of the directors or of an ordinary resolution of the general meeting?³ Consequently, to prevent ambiguity, it is best to specify whether the determination of the rights of and restrictions upon shares is to be by the directors or by means of a general

¹ Table A art 3 and Table B art 5 contain such authority to issue preference shares.

² *Henochsberg on the Companies Act*; PM Meskin (ed); 4th ed; 1985, Butterworths; p788.

³ The definition of 'company' in s 1 provides no assistance.

resolution. While the latter option would give the shareholders generally some power, the former approach does have its advantages - as Hill points out: "Where an issuing company wishes to have maximum flexibility in making future issues, it should ... [place] the power to issue shares solely with the directors."⁴

RIGHTS OF PREFERENCE SHAREHOLDERS

"Traditionally, the problems confronting the courts in regard to preference shares have been problems of construction - the difficulty of determining what rights are attached to preference shares when these are inadequately defined in the company's memorandum, articles or terms of issue. Although ultimately it is always a question of construction ..."⁵

Looking at the South African position, it does seem that confusion has emanated relating to the interpretation of the specific provisions granting the rights - that is, 'problems of construction'. The dilemma can be stated thus: once the rights of preference shareholders have been stated in the memorandum or articles, is such a statement exhaustive in its content, so that "consequently ... a holder of preference shares had no rights other than those specifically so accorded him"?⁶ That is, should we follow the English courts in adhering to the maxim *expressio unius est exclusio alterius*?⁷ The English approach was first rejected in *Ex parte Betty*;⁸ which case was approved in *A-T Collieries Ltd v SA Mutual*⁹ and

⁴ J Hill: Preference Shares; in RP Austin and R Vann (eds): *The Law of Public Company Finance*; p146.

⁵ *ibid*; p141.

⁶ *Anglo-Transvaal Collieries v SA Mutual Life Assurance Society* 1977 (3) SA 631 (T); p638.

⁷ *ibid*; p638DE.

⁸ *Ex parte Betty: In re First Mutual Investment Trust Ltd (in liq)* 1974 (1) SA 127 (W).

⁹ *A-T Colliers v SA Mutual*; n.6.

SA Mutual v A-T Collieries Ltd (AD).¹⁰

This deviation from the English approach occurs in the South African cases because the statement as to preferent rights, while containing provisions granting specific rights to the shareholders, also includes a 'general provision'. For example, the rights of the shareholders in the *A-T Collieries* cases were stated thus:

"The preference shares shall confer on the holder thereof the following rights, viz.:

- (a) To receive a fixed cumulative preferential dividend of 6 per centum per annum on the accounts paid up thereon from time to time as and when declared in terms of the Company's articles of association (but not otherwise to participate in the profits of the Company);
- (b) in any winding up of the Company to rank in priority to the holders of the ordinary shares, both in regard to any arrears of dividend up to the date of winding up and in regard to return of capital.

Save as herein specially provided to the contrary, all shares in the Company shall rank *pari passu* in every manner."¹¹

Clauses (a) and (b) refer to specific rights of the preference shareholders; while a 'general provision' is contained in the last sentence; i.e. 'Save as herein specially provided to the contrary, all shares... shall rank *pari passu* in every manner.'

Galgut J in *Ex parte Betty*, in effect, favoured the English approach - but only "in the absence of some indication to the contrary"¹² - the indication to the contrary being the general provision. The general provision provided that "such

¹⁰ *SA Mutual Life Assurance Society v Anglo-Transvaal Collieries Ltd* 1977 (3) SA 642 (AD).

¹¹ *A-T Collieries v SA Mutual*; n.6; pp637H - 38A. The 'general provision' in *Ex parte Betty* (n.8) was to the effect that "such preference shares carry the same rights and privileges as to voting or otherwise as the ordinary shares in the company" (p128H).

¹² *Ex parte Betty*; n.8; p130AH.

preference shares carry the same rights and privileges as to voting or otherwise as the ordinary shares in the company."¹³ Thus, given that the preference shareholders' rights had not been expressly or specifically provided for with regard to surplus assets, any rights to surplus assets were regulated by the 'or otherwise' proviso (that is, the general provision) and consequently the preference shareholders, like the ordinary shareholders, were entitled to share in the surplus assets on a winding-up. Therefore, while the general rule is that upon a winding-up any surplus assets are only for distribution to the ordinary shareholders, such rule is circumvented given the presence of the general provision.

In *A-T Collieries v SA Mutual (T)* Colman J adopted a similar approach, arguing that "[i]n the absence of the general provision it *might* have been a proper *inference* that the draftsman intended the rights embodied in paras. (a) and (b) to replace completely the right of equal participation which exists, *prima facie*, at common law"¹⁴ (emphasis added). His concluding remarks being that:

"[the] election, in a general provision following immediately upon paras. (a) and (b), to assert the common law parity of rights in all respects not specially provided for was, in my judgment, an election to negative *the inference* that the common law right of equal participation had been excluded, and was not to operate at all"¹⁵ (emphasis added).

But Colman J does not seem to express a precise opinion on whether the absence of a general provision definitely results in the English exhaustive approach (i.e. *expressio unius est exclusio alterius*) being applicable. His use of the words 'might' and 'inference' in the above quotes are not words which convey certainty, although they do reflect a probability that

¹³ *ibid*; p128H and n.11.

¹⁴ *A-T Collieries v SA Mutual*; n.6; pp638H - 639. As to the contents of paras. (a) and (b) see p3 *supra*.

¹⁵ *ibid*; p639A.

in the absence of a general provision, the English approach is applicable.

When the case went to the Appellate Division, Kotzé JA agreed with Colman J's conclusion. But the ordinary shareholders tendered a new interpretation of the construction of preference shareholders' rights. An attempt was made to distinguish between financial or proprietary rights on the one hand and non-financial rights on the other: it was argued that because the specific rights conferred on the preference shareholders were financial rights, then, in terms of the English approach/presumption, such reference was exhaustive of the proprietary/financial rights, while the general provision referred to the general, non-financial rights.¹⁶ The court, via Kotzé JA, rejected this distinction for the following reasons:

"First, [the specific clause], as in the case of any document, must be read and considered as a whole in order to ascertain from the ordinary and grammatical sense of all the words used what the language means So read and considered its meaning is plain: all the shares of [the company], ordinary and preference, rank *pari passu* 'in every manner', i.e., in respect of all financial and non-financial rights, save as is 'specially' provided to the contrary in sub-clauses (a) and (b). The words 'in every manner' preclude the general provision from being confined merely to non-financial rights. 'Specially' too tends to reinforce that conclusion: it is only the rights that are specially provided ... that are excluded from the operation of the general provision, but no other rights. Also, the [English] presumption would only apply in the absence of any contrary indication in the clause conferring preference rights. The general provision here is such an indication, and a cogent one too."¹⁷

¹⁶ SA *Mutual v A-T Collieries (AD)*; n.10; p655EH. Examples of the general, non-financial rights are voting rights, attendance at meetings and the receiving of accounts (see *ibid* pp655H - 656).

¹⁷ *ibid*; p656AC (Emphasis added) The emphasised extract in the quote is an assertive statement as to the law and does not contain the indecision contained in Colman J's statements.

Therefore, the rule with regard to the rights attaching to preference shares is that "if the preference rights are expressly stated, that statement is presumed to be exhaustive"¹⁸ of such rights, subject to any contrary indication (e.g. a general provision). Hence, there has been a rejection of the maxim *expressio unius est exclusio alterius* - or rather the maxim is subject to the existence of a 'general provision'. And so, if one follows Pickering's identification of the three groups into which "legal rights ... are broadly classifiable"¹⁹: profit rights,²⁰ voting rights, and capital rights; then applying the approach of the South African courts the following feature is apparent: where the document grants a preferential right in at least one of these categories, then in the absence of any indication to the contrary, such right is exhaustive of the rights of the preference shareholder, and therefore the common law principle of equality is excluded.

VOTING RIGHTS

Although s 193 grants every member of a company the right to vote at meetings of the company, this right is made subject, *inter alia*, to s 194 which itself provides that the articles of association can stipulate that 'preference shares shall confer no right to vote at meetings of the company'. But s 194 also provides exceptions of when preference shares will carry a voting right despite the articles generally stating otherwise; therefore:

(a) during any period determined as provided in

¹⁸ *ibid*; p655F.

¹⁹ MA Pickering: The problem of the preference share; (1963) 26 *MLR* 499; p499.

²⁰ Pickering in fact uses the term 'income' and not 'profit'; however, I think that it is better to use the latter term as the courts tend to use such term.

- subsection (2)²¹ during which any dividend or any part of any dividend on such shares or any redemption payment thereon remains in arrear and unpaid; or
- (b) in regard to any resolution proposed which directly affects any of the rights attached to such shares or the interests of the holders thereof, including a resolution for the winding-up of the company or for the reduction of its capital²²
- then, the preference shareholder has a right to vote.

*Utopia Vakansie-Oorde v Du Plessis*²³ considered the interpretation of s 194. The majority judgment (delivered by Jansen JA)²⁴ agreed with the minority decision (delivered by Trollip JA)²⁵ on the meaning of the phrase 'in arrear and unpaid' in s 194(1)(a). Trollip JA held that "as die voorkeurdividend ... of nie verklaar word nie of verklaar word maar onbetaald bly",²⁶ then such shareholders had a right to vote. His more germane reasons for this conclusion being:

²¹ ss (2) states: The period referred to in ss (1)(a) shall be a period commencing on a day specified in the articles of the company concerned, not being more than six months after the due date of the dividend or redemption payment in question, or, where no due date is specified, after the end of the financial year of the company in respect of which such dividend accrued or such redemption payment became due.

Henochsberg analyses this provision as follows:
 "The effect of the subsection ... is that the period commences on the date, if any, specified in the articles provided such day is not more than six months after the date payment of the dividend or redemption in fact becomes due; and if no such day is specified in the articles, the period commences on the first day after the expiry of the six months from the end of the financial year in respect of which the dividend has in fact accrued or the redemption payment in fact became due" (*Henochsberg*; n.2; p303).

²² s 194(1)(a) and (b).

²³ *Utopia Vakansie-Oorde Bpk v Du Plessis* 1974 (3) SA 148 (AD).

²⁴ *ibid*; p163.

²⁵ *ibid*; pp174F-78D.

²⁶ *ibid*; p178D.

1. s 194(1)(a) could be easily avoided by not declaring any dividend - whether a company is capable of paying or desires not to pay.²⁷ This avoidance would render the sub-section ineffective, thus the only other conclusion is that ss (1)(a) applies to undeclared dividends and declared but unpaid dividends.²⁸
2. While the primary meaning of 'arrear' refers to an obligation which is declared and therefore is due, but unpaid; a wider interpretation refers to an obligation which is 'behind-hand' - namely, a condition which should have been adhered to but was not. Relying upon this wider interpretation, Trollip JA held that a preferent dividend which remains undeclared, therefore also is 'in arrear' under s 194(1)(a).²⁹
3. "As slegs die enge sin beoog is, sou, eerstens, die uitdrukking 'verskuldig en betaalbaar', in plek van 'agterstallig', gebruik gewees het ... en sou, tweedens, dit onnodig gewees het om 'en onbetaald' aan 'agterstallig'... te koppel, want 'agterstallig' in die enge sin beteken op sigself verskuldig, betaalbaar, en onbetaald. Trouens, die koppeling van 'en onbetaald' dien o.a. om die begrip van 'n onverklaarde en onbetaalde dividend volkome uit te druk."³⁰

But, Trollip JA cautioned that it would seem ss (1)(a) does not apply to non-cumulative dividends as such dividends cannot adhere to the requirements of the subsection. "Geen 'betaaldatum' van die dividend is bepaal of bepaalbaar nie, of, as die dividend nie verklaar word nie, kan dit nóg as agterstallig nóg as onbetaald beskou word."³¹

In s 194(1)(b) controversy surrounds the understanding of when a resolution will directly affect an interest of a

²⁷ *ibid*; p176AB.

²⁸ *ibid*.

²⁹ *ibid*; p178CE.

³⁰ *ibid*; p176G-177.

³¹ *ibid*; p178AB.

preference shareholder. Jansen JA acknowledged that the concept 'interests' encompassed a wider spectrum than that of 'rights'. Although it was impossible to define the content of such interests, he held that "die belange verband met die 'regte' moet hou, en dat daaronder sal val belange in die volle genot van die regte en hul beveiliging."³² Concerning the ambit of 'affect', Jansen JA opted for a wide interpretation³³ and said that "[o]m ... bewys van werklike of waarskynlike benadeling as gevolg van die voorgestelde besluit te verg, en nie slegs potensiële benadeling nie, sou hierdie bedoeling verydel."³⁴ Thus given the ambit of the meaning of 'interests' and 'affects', the preference shareholders were entitled to vote in respect of the following matters: election of directors,³⁵ proposed resolution approving a loan³⁶ and the manner of preparing the financial statements.³⁷ But finally, the decision as to what constitutes the rights and interests of the preferent shareholders always depends on the particular circumstances of the situation: for example, Jansen JA conceded that:

³² *ibid*; p163CD.

³³ *ibid*; p163DF. Jansen JA reasoned as follows: "Die woord 'raak' is ook minder duidelik. Dit dra dikwels die betekenis 'tref' (deur 'n hou of skoot) maar dit word ook algemeen in die sin van 'betref, aangaan, betrekking hê op, ... aanraak' ... gebruik. Die Engelse woord 'affect' dra moontlik gewoonlik 'n egter betekenis, maar dit is opvallend dat *The Concise Oxford Dictionary*, benewens betekenissoos 'attach' en 'produce (material) effect on', ook 'touch (in mind)' opgee Beide 'raak' en 'affect' kan 'n wye betekenis dra. Gesien dat hier 'n begunstigende bepaling op die spel is, dat die bedoeling is om in die voorgeskrewe omstandighede die voorkeuraandeelhouders geleentheid te gee om die reg om te stem 'ten volle' uit te oefen, wil dit my voorkom dat 'raak' hier in daardie wye betekenis gebruik word." (*ibid*)

³⁴ *ibid*; p163FG.

³⁵ *ibid*; p169A.

³⁶ *ibid*; pp168H-69.

³⁷ *ibid*; p171E.

"daar moet toegegee word dat in die geval van die gewone handelsmaatskappy, wat teen 'n wins besigheid doen, dit die voorkeuraandeelhouers weinig kan skeel wie die direkteure is"³⁸

However, Trollip JA (in the minority decision) came to a different conclusion:

"voorkeuraandeelhouers het die reg om te stem ten opsigte van enige voorgestelde besluit indien dit die besondere geldelike belange of voordele voortvloeiend uit die regte verbonde aan die aandele en behorende aan die houers daarvan as 'n groep, regstreeks en in 'n besigheidsin verander, verswak, benadeel, of andersins raak."³⁹

His reasoning being that preference shareholders, being motivated from an investment point of view, consequently, their 'interests' must be understood from such a perspective. And because the shares and their accompanying rights were bought for their investment and profit-making abilities, the 'interests' refer to monetary interests and benefits.⁴⁰ Fortunately Jansen JA correctly distinguished the importance of the relationship not having a purely business or monetary distinction - a factor which Trollip JA ignored. Otherwise, the inference from the majority's judgment is that, in the absence of contrary evidence, a purely 'monetary' relationship (i.e. an ordinary trading company) will not enable preferent shareholders such a wide variety of 'rights and interests'.

³⁸ *ibid*; p169AB. Similarly, the preferent shareholders had a right to vote concerning a proposed loan "aangesien [hulle] belange en regte veel verder strek as hoeveel hulle by likwidasië sou ontvang: daarin word ook behels die reg en genot van okkupasië vir 99 jaar (met 'n opsie om te verleng." (*ibid*; p165E)

³⁹ *ibid*; p182GH.

⁴⁰ *ibid*; p181GH. Consequently, the issues concerning the election of the directors (p184D), the loan (p188D) and the financial statements (p183G) were regarded as falling outside the rights and interests of the preferent shareholders.

DIVIDEND RIGHTS

The Companies Act makes no express reference to dividends; rather the Act prescribes which profits are distributable and which are to be retained as non-distributable reserves. Thus *Henochsberg* points out:

"The manner of declaration of a dividend is ordinarily regulated by the articles Their language may be such that a right to payment of a dividend accrues merely upon the establishment of the fact that there are divisible profits ...; but ordinarily the accrual of such right depends upon there being a declaration of a dividend (*Boyd v CIR 1951 (3) SA 525 (AD)* at 534; *Cohen v Segal 1970 (3) SA 702 (W)* at 705)." ⁴¹

Table A arts 84-90 contain provisions regarding dividends and reserves; however, no indication of the preference shareholders' rights appears in such provisions. The following factors, concerning payment of preferent shareholders' dividends, should be noted:

1. There must be adequate profits before a dividend can be declared and distributed. Declaration of a dividend must be in accordance with the procedure stated in the articles.
2. The right to claim a dividend exists only once the dividend has been declared. "Thus ... preference shareholders have no preference on liquidation of the company for arrear but undeclared dividends." ⁴²
3. Although profits exist, a company is not obliged to distribute them in the form of preferent dividends: "those profits, provided the articles allow it ... may be utilised to create or build up a reserve for future expenses, dividends or other authorised purposes;" ⁴³

⁴¹ *Henochsberg*; n.2; p830.

⁴² JL Sher: The rights of preference shareholders: a re-examination; (1983) 7 *SACLJ* 87; p88.

⁴³ *Utopia Vakansie-Oorde v Du Plessis*; n.23; p175.

4. Preferential treatment ahead of ordinary shareholders concerning the 'declaration and payment' of dividends, exists only if preference extends in respect of dividends.⁴⁴
5. Botha points out that "... where not expressly stated otherwise in the memorandum or articles or terms of issue, the dividend in the case of preference shareholders will *prima facie* be regarded as cumulative."⁴⁵

VARIATION OF (CLASS) RIGHTS

"It is a question of some importance to preference shareholders whether their rights can be varied by the company and, if so, by what means. The mere possibility of variation of rights might surprise many redeemable preference shareholders who will usually regard the transaction as being in essence a loan. In a loan agreement, ordinary contractual principles would preclude any unilateral variation. The position of a shareholder has, however, traditionally been more problematical in view of the special nature of the shareholder's contract with the company."⁴⁶

The examination of the variation of shareholders' rights will cogitate upon three features: (1) can rights be varied;

⁴⁴ *ibid.*

⁴⁵ DH Botha: Section 194 of the Companies Act and *Utopia Vakansie-Oord Bpk v Du Plessis*; (1978) 11 *De Jure* 63; p76. Botha makes this conclusion because "[n]o appeal was made against the finding of the court *a quo* [in the *Utopia Vakansie-Oorde v Du Plessis* case] on the question of cumulativity." (*ibid*)

⁴⁶ Hill; n.4; p165.

The reference to 'the special nature of the shareholder's contract with the company' alludes to the alteration of the memorandum and articles, at minimum, by a special resolution (e.g. see ss 56(1) and 62(1)). Consequently Gower notes that "the shareholder is making a contract on terms which are alterable by the other party by a special majority voting at a general meeting." (LCB Gower: *Gower's principles of modern company law*; 4th ed, 1979; p316.) In essence, this permits unilateral variation within a contractual context - hence, Hill refers to it as 'the special nature of the shareholder's contract with the company'.

if so, (2) by which means or procedure; and (3) how can unilateral variation by the company be overcome? These points will be considered from two angles - firstly, where 'special conditions' (i.e. s 53(a) read with s 56(1)) or 'special rights of any class of members' (i.e. s 56(5)) are contained in the memorandum; and secondly, where the rights are incorporated in the articles of association (i.e. s 62(1)).

RIGHTS CONTAINED IN THE MEMORANDUM

Section 56(5) offers conspicuous protection to the shareholder; however s 53 read with s 56(1) is capable also of being used to strengthen the shareholders' position against inimical action by a company.

Where a preference or right exists in a special condition 'which shall apply to the company', being stated in the memorandum, then alteration of the condition is by means of a special resolution, unless the special condition itself prohibits or prescribes another manner for its alteration.⁴⁷ This protection is further entrenched by s 55(1) which provides that 'a company may by special resolution make additions to or alter the provisions of its memorandum' but always subject to s 53(a). But, what must be remembered is that s 53(a) refers to a 'special condition' and not to a 'special right'.

Section 56(5) provides that:

'Nothing in this section shall authorise any alteration of a memorandum constituting a variation or abrogation of the *special rights* of any class of members, save and except that such rights may be altered or abrogated in the manner prescribed in the memorandum for such variation or abrogation.'
(emphasis added)

Three observations need to be made at the outset: (1) the subsection refers to *special rights* and not merely rights

⁴⁷ S 53(a) read with s 56(1). Also cf. *Henochsberg*; n.2; p86.

generally nor a special condition; (2) and the rights must belong to any class of members, hence where there is only one class of members then s 56(5) is not applicable, rather s 56(1) would be of assistance, provided that what was sought to be altered was a special condition;⁴⁸ and (3) the manner of alteration or abrogation must be prescribed, thus the memorandum must contain a variation clause, because in the absence of such a clause, there is no prescribed manner for the alteration and hence the special rights are incapable of alteration.

Henochsberg submits that the reference to the rights being altered 'in the manner prescribed in the memorandum' (s 65(1) and (5)) necessarily implies that the 'procedure for variation' must be stated in the memorandum only. There can be no reference in the memorandum to the articles or terms of issue as sources providing information as to the manner of alteration.⁴⁹ *Henochsberg* correctly refers to *Welsbach Incandescent* as a case where the court held that the memorandum could contain a statement that the 'manner prescribed' was to be found in the articles.⁵⁰ Such incorporation in the memorandum by reference to the articles is accepted by *Gower*⁵¹ and *Pennington*.⁵²

⁴⁸ S 56(1) provides that unless prohibited by the condition itself, a special condition contained in the memorandum may be altered by special resolution in the manner prescribed in any such special condition (emphasis added).

⁴⁹ *Henochsberg*; n.2; p89. But *Henochsberg* does refer to *In re Welsbach Incandescent Gas Light Co Ltd* [1904] 1 Ch 87 (CA) as providing an opposite approach.

⁵⁰ *ibid*; pp97-98.

⁵¹ *LCB Gower: Gower's Principles of Modern Company Law*; 4th ed, 1979; p563.

⁵² *RR Pennington: Pennington's Company Law*; 6th ed; p220.

CLASS RIGHTS CONFERRED BY THE ARTICLES

Section 62(1) provides that subject to the provisions of the Companies Act and to the conditions contained in a company's memorandum, a company may by special resolution alter or add to its articles. Thus, in the absence of a variation clause in the articles,⁵³ it would seem that variation of rights is by special resolution - unless the memorandum provides that all shares are to be equal, upon which occurrence no variation is possible. But Gower argued that if the articles lacked a variation clause the class rights contained in such articles could not be varied because if they were capable of variation then surely legislative protection⁵⁴ would have been extended to such shareholders. Instead, such protection is afforded only where a variation clause is contained in either the memorandum or the articles. Consequently, Gower, concludes:

"It makes little sense to give this [protection] when the variation has been pursuant to a variation of rights clause but to deny it when there is no provision for variation The legislature must surely have assumed that ... there could be no variation. And, since the power to alter the articles expressed by section 10 [now section 9 in the English Act; section 62 in the South African Act] is expressly 'subject to the provisions of this Act' it is subject to the implied limitations of

⁵³ See Table A art 7.

⁵⁴ By 'legislative protection' is meant (under South African Companies Act) s 102 - the English equivalent being s 72 of the 1948 Companies Act. S 102(1) states: 'If in the case of a company the share capital of which is divided into different classes of shares, provision is made by the memorandum or articles for authorising the variation of the rights attached to any class of shares of the company, subject to the consent of any specified proportion of the holders of the issued shares of that class or the sanction of a resolution passed at a separate meeting of the holders of those shares, and if in pursuance of the said provision the rights attached to any such class of share are at any time varied, the holder of a share of that class, being a person who did not consent to or vote in favour of the resolution for the variation, may apply to the Court for an order under section 252.'

section 72."⁵⁵

But, this approach no longer applies in England given the "combination of ss 125 and 127 of the 1985 Act."⁵⁶

However, the court in *Cumbrian Newspapers v Cumberland Herald*⁵⁷ rightly disputed the accuracy of Gower's interpretation. Scott J reasoned that:

"Section 72 [s 102, South African Companies Act] was enacted in order to provide a benefit to certain members of a company in certain circumstances. The reason why the benefit was not extended to cover certain other circumstances may well have been, as Professor Gower has suggested, that the legislature was proceeding on a mistaken assumption as to the law. But that would not, in my view, justify reading into the section a restriction on the power of a company to alter its articles in circumstances not covered by the section. As Viscount Simonds remarked in *Kirkness (Inspector of Taxes) v John Hudson & Co Ltd* [1955] 2 All ER 345 at 352: "... the beliefs or assumptions of those who frame Acts of Parliament cannot make the law."⁵⁸ [Emphasis added]

If a variation clause is present in the articles, is adherence to it mandatory? Hill refers to *Fischer v Easthaven Ltd* as authority for the view that adherence to the variation clause is not mandatory as the clause is merely 'facultative'; while *Crumpton v Morraine Hall* is authority for the mandatory

⁵⁵ Gower; n.50; p564.

⁵⁶ *Cumbrian Newspapers Group Ltd v Cumberland and Westmorland Herald Newspaper* [1986] 2 All ER 816; p828GH: "Rights attached to a class of shares' can, if contained in the articles, now be varied, even if no provision for variation is contained in the articles (see s 125(2)). A dissentient minority is given the same protection whether or not provision is made in the articles for the variation of the rights (see s 127(1))."

⁵⁷ *ibid.*

⁵⁸ *ibid*; pp828j-829b.

approach.⁵⁹ (Although s 125(3) of the Australian Companies Code now makes compliance with the procedure stated in the variation clause mandatory.)⁶⁰ Baxt prefers the decision of the latter case, i.e. *Crumpton v Morriner Hall*, which case, he states, follows the approach of Gower and Palmer.⁶¹ While in *Cumbrian Newspapers v Cumberland Herald* Scott J propounded that:

"... it is couched in an enabling form and not in a restrictive form. It enables class rights to be varied by the procedure prescribed. It is not expressed to restrict variation of class rights otherwise than by the procedure prescribed. It may, however, fairly be said to be implicit in art 4 of Table A [art 7 of Table A in the South African Companies Act] that rights attached to a class of shares cannot be varied, at least by the members themselves, otherwise than by the procedure there laid down."⁶²

The South African position seems as precarious as that experienced overseas. Table A art 7 is not assertive of the manner of variation of class rights. Art 7 states that 'the rights attached to any class... may be varied' with the written consent of three-fourths of the class of shareholders or with the sanction of a resolution passed at a separate meeting of such class of shareholders. (Emphasis added) If the phrase was expressed as 'shall be varied', then it would be mandatory and no problem of interpretation would exist.

RIGHTS ATTACHING TO A CLASS OF SHARES

"[A]re the [shareholder's] rights under [the] articles ... rights attached to a class of shares?"⁶³ Or, as Rice simply

⁵⁹ Hill; n.4; p165. *Fischer v Easthaven Ltd* [1964] NSW 261 and *Crumpton v Morriner Hall* [1965] NSW 240.

⁶⁰ *ibid*; p166.

⁶¹ R Baxt: The variation of class rights; (1968) 41 *Australian L.J.* 490; p493.

⁶² n.56; p828a.

⁶³ *ibid*; p825a.

phrases the question: "What is a class right?"⁶⁴ Rice's article was written in 1958, while *Cumbrian Newspapers v Cumberland Herald* was decided in 1986, and the shift in emphasis in both instances is rather interesting.

Rice concludes that:

"Rights enjoyed by a particular class will constitute class rights where either (a) they have been specifically conferred on that class, or (b) though not specifically conferred, they are fundamental to the character of the class. Moreover, it is immaterial that they are not peculiar to that class in question, but are enjoyed by the members at large. All other rights, however, cannot in any circumstances be considered class rights."⁶⁵ (emphasis added)

Rice lists four areas in which rights are 'fundamental':

- "(1) rights as to dividends;
- (2) rights on a winding-up;
- (3) voting rights; and
- (4) rights to the protection of class rights [ie. a variation clause]."⁶⁶

In *Cumbrian Newspapers v Cumberland Herald*, Scott J identified three categories:

"First, there are rights or benefits which are annexed to particular shares. Classic examples of rights of this character are dividend rights and rights to participate in surplus assets on a winding-up. If articles provide that particular shares carry particular rights not enjoyed by the holders of other shares, it is easy to conclude that the rights are attached to a class of shares.... A second category ... would cover rights or benefits

⁶⁴ DG Rice: Class Rights and their Variation in Company Law; 1958 *JBL* 29; p29.

⁶⁵ *ibid*; p32.

⁶⁶ *ibid*; p31. With regard to point (4) of the list, the English 1985 Companies Act s 125(7) deems a variation clause in the articles to itself confer a class right on that class of shareholders.

conferred on individuals not in the capacity of members or shareholders of the company but, for ulterior reasons, connected with the administration of the company's affairs or the conduct of its business It is, perhaps, obvious that rights or benefits in this category cannot be class rights

....
 [The third category] would cover rights or benefits that although not attached to any particular shares, were none the less conferred on the beneficiary in the capacity of member or shareholder of the company."⁶⁷

The court had to decide if the third category rights fell within the meaning of the phrase 'rights attached to a class of shares'. Possession of any shares would suffice to make the beneficiary of the right a member of the company.⁶⁸ The right does not attach to a particular share. Scott J concluded that:

"a company which, by its articles, confers special rights on one or more of its members in the capacity of member or shareholder thereby constitutes the shares for the time being held by that member or members a class of shares The rights are class rights."⁶⁹

However, a reading of equivalent sections in the South African Companies Act shows that matters are not so ambiguous. Section 102 and art 7 of Table A refer to a company 'the share capital of which is divided into different classes of shares'; consequently, it seems that only Scott J's first category, and not third category, rights are protected by s 102 and art 7. This leads to the following anomaly referred to by Scott J: third category rights contained in the memorandum would be protected as such rights fall under 'special rights of any class of members' i.e. s 65(5), South African Companies Act - and therefore cannot be altered or abrogated except in the manner prescribed in the memorandum for such

⁶⁷ n.56; pp825b-26c.

⁶⁸ *ibid*; p826j.

⁶⁹ *ibid*; p830cd. Also, see p829ej for the five considerations which led Scott J to this conclusion.

alteration/abrogation; while third category rights contained in the articles would be capable of alteration without requiring the specific class' consent (i.e. art 7 and s 102 do not offer such category of rights any protection) - and therefore, third category rights are more freely alterable if contained in the articles than in the memorandum. It was this anomaly which, in part, led Scott J to conclude that such third category rights constitute 'class rights'.⁷⁰ But, this irregularity does not prevent the beneficiary of the right from proceeding under s 252 (Member's remedy in case of oppressive or unfairly prejudicial conduct) for protection. As *Henochsberg* points out:

"where class rights are not varied ... but what is done adversely affects the interests of the holders of the shares, whether by reducing the shares' commercial value or otherwise, s 252 is in any event available to any such shareholder; s 102 does not apply at all in such a case."⁷¹

Having established that the right is a 'class right', the next step is to ascertain whether such right has been varied.⁷² Rice emphasises the distinction between legal and commercial variation.⁷³ He warns that "we [must be] careful to distinguish between -

- (1) a variation of the class right itself, and
 - (2) a variation of the enjoyment of the class right."⁷⁴
- Consequently he concludes that:

⁷⁰ *ibid.* See his fifth consideration at p829hj.

⁷¹ *Henochsberg*; n.2; p165. Note: in this instance the six weeks time limit, applicable to s 102 protection, does not apply: s 252(2).

⁷² Note: s 56(5) uses the words 'variation or abrogation'; while s 102(1) uses the term 'variation', although ss (2) states that "variation" in this section includes abrogation and the expression "varied" shall be construed accordingly.' And lastly, art 7 of Table A uses the term 'varied'.

⁷³ Rice; n.64; p32.

⁷⁴ *ibid.*

"when we have to consider what constitutes a variation of a class right, the difficulty lies not in understanding the meaning in law of the word 'variation',⁷⁵ but in appreciating precisely the scope of the class right alleged to have been varied".⁷⁶ (Emphasis added)

Pennington further distinguishes between substantial alteration and literal alteration; but here again, no alteration occurs merely because the shares are commercially adversely affected.⁷⁷

Concerning the distinction between the legal and commercial values, Lord Greene concluded in *Greenhalgh v Arderne Cinemas*⁷⁸ as follows:

"Instead of [the shareholder] finding himself in a position of control, he finds himself in a position where the control has gone, and to that extent the rights of the [class of] shareholders are affected, as a matter of business. As a matter of law, I am quite unable to hold that, as a result of the transaction, the results were varied; they remain what they always were - a right to have one vote per share"⁷⁹

(Romer LJ in *White v Bristol Aeroplane*⁸⁰ warns that no significance is to be attributed to Lord Greene's use of the expressions 'affected' and 'varied' with respect to the commercial and legal value respectively.⁸¹) The distinction made in *Greenhalgh v Arderne Cinemas* was carried through in

⁷⁵ Rice footnotes the following: "Its legal meaning does not differ from its commercial meaning." (ibid; p32n5)

⁷⁶ ibid; p32.

⁷⁷ Pennington; n.51; pp226-28.

⁷⁸ *Greenhalgh v Arderne Cinemas Ltd & Another* [1946] 1 All ER 512 (CA).

⁷⁹ ibid; p518A.

⁸⁰ *White v Bristol Aeroplane Co Ltd* [1953] 1 All ER 40.

⁸¹ ibid; p48AB.

later cases: for example, *White v Bristol Aeroplane*⁸² and *Tadcaster Brewery*.⁸³

One cannot overcome the distinction between the right commercially and the right legally by providing that "the rights or privileges attached to any class or shares ... may be affected, modified, varied, dealt with, or abrogated in any manner with the sanction of an extraordinary resolution passed at a separate meeting of the members of that class ..."⁸⁴ (Emphasis added) In *White v Bristol Aeroplane* and *Tadcaster Brewery* Evershed MR had to decide the ambit of the meaning of the expression 'affect ... in any way'. In *White v Bristol Aeroplane* he said that one must still approach the matter by asking: "Are the rights ... 'affected' by what is proposed?"⁸⁵ And he concluded that the rights:

"`remain exactly as they were before. Each one of the manifestations of the preference shareholders' privileges may be repeated without change whatever after, as before, the proposed distribution.' It is, no doubt, true that the enjoyment of, and the capacity to make effective, those rights are, in a measure, affected ..., but there is, to my mind, a sensible distinction between an affecting of the rights and an affecting of the enjoyment of the rights or the stockholders' capacity to turn them to account"⁸⁶

While in *Tadcaster Brewery* he accentuated the absurd results which would occur should one adopt the wide meaning of 'affect':

"Carried to its fullest extent, the argument must,

⁸² n.80.

⁸³ *In re John Smith's Tadcaster Brewery Co Ltd* [1953] 1 All ER 518.

⁸⁴ *White v Bristol Aeroplane*; n.80; p42H; also *Tadcaster Brewery*; n.83; p520GH.

⁸⁵ n.80; p44E.

⁸⁶ *ibid*; p44EG.

I think, mean that any activity on the part of the directors in pursuance of their powers which may in any way affect or touch the value of any of the privileges attached to the preference stock would be rendered ineffective save with the prior sanction of a special meeting of the preference stockholders. Such a conclusion obviously runs counter to the ordinary conception of the relationship between preference and ordinary stockholders in a company of this character. Even if some limit is put on the word 'affect', what follows? The most that can be said here is that the swelling of the number of ordinary shareholders affects the voting rights. It does not. As Jenkins LJ pointed out ..., if it is discovered that there are more adult persons in the country than you thought, the voter would not on this view be enabled to say that his voting rights were affected merely because a greater number of people had similar voting rights. That seems to me to be wrong."⁸⁷

Evershed MR acknowledged that he was "not persuaded that the conclusion which [he had] indicated involve[d] the result that no meaning, as distinct from variation, can be given to the word 'affected'."⁸⁸ To illustrate the possible distinction between 'affecting' and 'variation' he gives the following example:

"it might be, though I express no view on it, that a resolution aimed at increasing the voting power of the ordinary stockholders by doubling it, giving them twofold their present power, without otherwise altering any other of the privileges or rights attached to any class, might be said to be something so directly touching the position, and therefore, the rights, of the preference stockholders ... albeit that there was no variation of their own individual rights."⁸⁹

Pennington relies on this quote as supporting a 'substantial variation test'.⁹⁰ But, I think that Pennington's reliance is mistaken as Evershed MR is only using the example

⁸⁷ n.83; p522CE.

⁸⁸ *White v Bristol Aeroplane*; n.80; p46A.

⁸⁹ *ibid.*

⁹⁰ Pennington; n.51; p228.

to illustrate the meaning of the expression 'affecting' as being distinct from, or broader than, the term 'variation'; and therefore, he did not "[depart] from the line followed by the court in certain earlier cases, where it was held that rights of a class of shareholders are altered only if they are altered literally."⁹¹ In fact, Evershed MR points out that the case of a 'substantial variation' (as it were) was not before the court to consider.⁹²

The South African textbooks also seem to adopt a substantial variation test. For example, Cilliers and Benade state that: "Class rights are varied only if after the variation they differ in substance from what they have been before; there is no variation if the class rights still are the same in substance but commercially less valuable."⁹³ And in a footnote they refer to *Pennington's Company Law*, fifth edition, which reference discusses the substantial variation approach.⁹⁴ Although, they do continue and warn that "[a] fresh issue of shares or the creation of new shares does not constitute a variation of shareholders' class rights merely because it changes the balance of voting power of the different classes of shares."⁹⁵ Also *Henochsberg* states that "[f]or rights to be varied their substance must be changed (*Pennington* 200-203)."⁹⁶ The edition of *Pennington* referred to is the fourth edition and again, like the reference of Cilliers and Benade, the reference is to the section which discusses 'substantial variation'.

In concluding how shareholders as a class could protect

⁹¹ *ibid*; p228.

⁹² *White v Bristol Aeroplane*; n.80; p46A.

⁹³ HS Cilliers & ML Benade (eds): *Corporate Law*; DH Botha, MJ Oosthuizen & EM de la Rey (authors); 1987, Durban; Butterworths; p97.

⁹⁴ *ibid*; p97n3, referring to p245 of *Pennington's Company Law*.

⁹⁵ *ibid*.

⁹⁶ *Henochsberg*; n.2; p165.

their rights, it is worthwhile to refer to the following words of Gower:

"It seems, therefore, that if a clause is effectively to prevent class rights from being 'affected as a matter of business' - which one would have supposed is what business men would want - it is necessary to find a formula which will expressly operate in any event which affects any class of shareholders (as opposed to the rights attached to the shares) or the enjoyment of their rights (as opposed to the rights themselves). This seems less than satisfactory. The distinctions which the courts have drawn are over-subtle and unsuited to matters of practical business as opposed to abstract jurisprudence. In every case where the voting equilibrium is upset it is clear that class rights are 'affected as a matter of business', and it is strange to protect a class from having its votes halved while refusing to protect it when the votes of the other class are doubled; the practical effect is the same in both cases."⁹⁷ (Emphasis added)

Gower rightly exposes the folly of distinguishing between doubling of other votes and a halving of one's own votes: that is, Evershed MR's examples of an adult voter and an increased population⁹⁸ versus his attempt to distinguish between 'affecting' and 'variation' with an example of the doubling of ordinary shareholders' power.⁹⁹ Such distinctions *in substance*, are no different. And more importantly, the contentious clause referred to rights being affected or varied *in any manner*.¹⁰⁰ This phrase, 'in any manner', surely takes a shareholder into the realm of the enjoyment of his rights and the *commercial* affecting or variation of his rights; and this overcomes the distinction between "a variation of the class right itself"¹⁰¹ and "a variation of the enjoyment of the class

⁹⁷ Gower; n.50; p568.

⁹⁸ n.87 and accompanying text.

⁹⁹ n.89.

¹⁰⁰ n.84.

¹⁰¹ Rice; n.64; p32.

right"¹⁰²

But, was Evershed MR justified in comparing a constitutional voter to a company law voter? I think not, because there is a difference between (i) the constitutional vote as a personal right in a democracy, and (ii) the company law right as a (partial) right of ownership. That is, the constitutional vote is a right to expression about one's life and environment, while the company law vote is a type of property right. Consequently, the effective voting power is important: If, out of a total of 100 shares, shareholder A has 1 share, then his intrinsic value or ownership (expressed as a percentage) is 1/100 percent. If the total shares are doubled and the company now has 200 issued shares, then the effective voting power of shareholder A is 1/200 percent; thus the effectiveness of his right is affected - his right of ownership is altered. Hence the share's substance has been varied.

PROTECTION OF RIGHTS

Protection of the shareholder is possible via two channels. Firstly, a shareholder is given protection under s 252(1) where 'any particular act or omission of a company is unfairly prejudicial, unjust or inequitable, or the affairs of the company are being conducted in a manner unfairly prejudicial, unjust or inequitable to him or to some part of the members of the company'. To remedy the situation the Court may, with a view to bringing to an end the matters complained of, make such order as it thinks fit, whether for regulating the future conduct of the company's affairs or for the purchase of the shares of any members of the company by other members thereof or by the company...' (s 252(3)) And secondly, protection (specifically for preference shareholders) is available under s 194 - the rights or interests of the preferent shareholder are protected to the extent that the

¹⁰² *ibid.*

shareholder can at least vote in favour of what he regards as being in the best interests of his shareholding; thus, the protection exists in that the shareholder has a vote at the time that the resolution is taken. However, having already discussed s 194, I shall now be discussing s 252 (read with s 102 where applicable).

The three *Donaldson Investments v Anglo-Transvaal Collieries*¹⁰³ cases between themselves deal quite succinctly with the approach of the courts to an application under s 252. A number of general points needs to be alluded to at the outset:

- (1) the courts favour an interpretation which advances rather than limits the remedy available under s 252(3);¹⁰⁴
- (2) the onus of proof rests on the person seeking protection under the section to prove "not only that a particular act or omission is unfairly prejudicial, unjust or inequitable, but also to establish that it is just and equitable that the Court should make an order in terms of ss(3)"¹⁰⁵ - this second aspect of the 'proof process' is because of the insertion of the word 'and' in ss(3);¹⁰⁶
- (3) "the word 'unfairly' qualifies the word 'prejudicial' only It would be tautologous to speak of any act or omission as being unfairly unjust or unfairly inequitable";¹⁰⁷
- (4) "The onus is on the appellants to prove the factum probandum of s 252(2) on a balance of probabilities";¹⁰⁸

¹⁰³ *Donaldson Investments (Pty) Ltd & others v Anglo-Transvaal Collieries Ltd & others* 1979 (3) SA 713 (W); 1980 (4) SA 204 (T); 1983 (3) SA 96 (AD).

¹⁰⁴ *Donaldson Investments v A-T Collieries* 1979 (W); n.103; p719H.

¹⁰⁵ *ibid*; p719EF.

¹⁰⁶ *ibid*.

¹⁰⁷ *ibid*; p719E.

¹⁰⁸ *Donaldson Investments v A-T Collieries* 1980 (T); n.103; p210A.

and

- (5) the phrase 'considers it just and equitable' (in ss(3)) "seems to imply a degree of discretion to be judicially exercised 'to bring to an end the matters complained of'."¹⁰⁹

Bearing in mind that the courts will not freely interfere in the management of a company's affairs¹¹⁰ and that the courts generally accept that "a minority shareholder must defer to the wishes of the majority",¹¹¹ what, then, is the approach of the courts in interpreting the meaning of 'unfairly prejudicial, unjust or inequitable'? Of the three judgments, Preiss J devoted a lengthy discussion to answering this¹¹² and concluded that:

"It seems to me that the new wording of s 252 means, at least, what was set out in some of the cases dealing with the old s 111bis [s 252's predecessor], where the requirement was placed at the less stringent level. In my view, the applicants must establish a lack of probity or fair dealing, or a visible departure from the standards of fair dealing, or a violation of the conditions of fair play on which every shareholder is entitled to rely. Couched in another form, I agree that the applicants must establish that the majority shareholders are using their greater voting power in a manner which does not enable the minority to enjoy a fair participation in the affairs of a company. The emphasis is upon the fairness of the conduct complained of. It must be conduct which departs from the accepted standards of fair play, or which

¹⁰⁹ *ibid.*

¹¹⁰ *Donaldson Investments v A-T Collieries* 1979 (W); n.103; p720C; quoting *Levin v Feld & Tweeds Ltd* 1951 (2) SA 401 (A) at pp414-415.

¹¹¹ *Donaldson Investments v A-T Collieries* 1979 (W); n.103; p720C; quoting *Sammel & others v President Brand Gold Mining Co Ltd* 1969 (3) SA 629 (AD) at p678. Also see *Donaldson Investments v A-T Collieries* 1980 (T); p209G. Preiss J warned that, when considering if the variation was unfairly prejudicial, it would be fatal to rely on a healthy majority as an indicator negating prejudice. (*ibid*; p734A)

¹¹² *Donaldson Investments v A-T Collieries* 1979 (W); pp720D-722D.

amounts to an unfair discrimination against the minority."¹¹³

But ultimately "the circumstances of each case must be examined in order to decide whether it is such conduct, entitling the Court to intervene under s 252."¹¹⁴

In applying such an approach, as given above, Galgut AJA in the Appellate Division saw the court's function as being "to compare the rights attaching to the preference shares before and after the agreement and to consider what effect the change had on the value of the shares."¹¹⁵ And by 'value' Galgut AJA meant the price of the shares;¹¹⁶ although he also referred to the "theoretical future potential value"¹¹⁷ of the rights prior to the variation (or act complained of) "as opposed to the real and immediate benefits gained"¹¹⁸ pursuant to the variation - and the use of the word *benefits* seems to extend beyond some monetary valuation of the rights (which valuation is really a valuation of the shares). One has to admire his frank acknowledgement of the economic/monetary driving force behind a person being an investor.

Myburgh J in the court a quo also spoke of the value of the rights but it would seem that by 'value' he was referring to the benefits which the rights granted. I do not deny that one should never speak of value in terms of some quantity - for example, when one deals with a shareholder's right to

¹¹³ *ibid*; p722EG. See *Donaldson Investments v A-T Collieries 1980 (T)*; n.103; at p209H and the list of cases therein cited.

¹¹⁴ *Donaldson Investments v A-T Collieries 1979 (W)*; n.103; p722G.

¹¹⁵ *Donaldson Investments v A-T Collieries 1983 (AD)*; n.103; p111H.

¹¹⁶ *ibid*; p119AD; also see p116G.

¹¹⁷ *ibid*; p119AB (emphasis added).

¹¹⁸ *ibid*.

participate in profits being limited to 6 per centum,¹¹⁹ then a variation of the right by increasing it to 10 per centum is an increase in value. However, a voting right does not as such attach any value *per se*, rather it is a benefit and therefore I think one should be careful to align value with a monetary value or with the price of the shares. But I hasten to add that one must not be eager to disregard the fact that shares are a form of investment to their holders, and as such, their monetary value is a factor at stake.

SUMMARY

- . The maxim *expressio unius est exclusio alterius* applies if there is no indication to the contrary, e.g. a 'general provision'.
- . A preference shareholder has a voting right (1) where the dividend is undeclared and/or unpaid, and (2) where his rights and interests will be affected.
- . The right to receive a dividend is governed by the share agreement. It is best to contract that the dividend is to be cumulative.
- . 'Class of shares' refers to rights and benefits annexed to particular shares.
- . Variation of rights: Under the memorandum - in the absence of a variation clause, the preference rights cannot be varied. Under the articles - in the absence of a variation clause, the preference rights can be altered by a special resolution; in the presence of a variation clause, such clause must be of a mandatory nature. 'Affecting' versus 'variation': it is best that the share agreement defines the difference between and the ambit of these two words.
- . One must distinguish between the right and its enjoyment.
- . Protection of the right is via the establishment of the fairness of the conduct complained of and, possibly, how the value of the share has been changed - where 'value' has both a qualitative and quantitative dimension.

¹¹⁹ *Donaldson Investments v A-T Collieries 1980 (T)*; n.103; p213GH.

CHAPTER 3

MAINTENANCE OF CAPITAL AND REDEMPTION OF PREFERENCE SHARES

One must distinguish between a reduction of capital and a redemption of redeemable preference shares. It is the ordinary capital of a corporation to which the creditors look, during insolvency, to recoup their losses, while redeemable preference shares, having the quality of medium to long term loans, do not provide such a stable source of funds upon which to rely.

An analysis of the requirements for *maintenance of capital* must be two-sided: it must investigate the protection offered to the creditor and to the minority shareholder. As far as the creditors are concerned, an important question is whether a court may confirm a reduction of capital which leaves it at the discretion of the directors to decide when to make (periodic) reductions. While inevitably it is the minority shareholder with less than 25 percent of the voting power, who requires protection.

Finally, in the discussion of the *redemption of redeemable preference shares*, two questions stand out for consideration: firstly, who exercises the option to make the redeemable preference shares liable to be redeemed; and secondly, when does the event triggering redemption become so remote as to deny the redeemable preference shares their quality of redemption?

ORDINARY SHARES AND MAINTENANCE OF CAPITAL

*Trevor v Whitworth*¹ is authority for the rule of maintenance of capital; however ss 83 - 90 (inclusive) of the

¹ (1887) 12 AC 409.

Companies Act 61 of 1973 provide the statutory means whereby a company may reduce its capital. Because s 98(3) provides that any redemption of preference shares does not constitute a reduction of capital, ss 83 - 90 apply to ordinary shares.²

There are two interest groups which occupy a volatile position should a reduction of capital be contemplated. Firstly, and more importantly, the creditors of the company considering a reduction; because of the "theoretical concept that the issued capital of the company constitutes a guarantee fund for creditors, which must be maintained for their benefit"³ And secondly, the ordinary shareholders whose shares are being reduced.

The two methods of effecting a reduction of capital are via s 83 and s 84 - the latter involving the court's confirmation but not the former. Under a s 83 reduction both creditors and shareholders (the latter more subtly so) are protected. The written consent⁴ of all the company's creditors⁵ is required; while minority shareholders are safeguarded as the reduction must affect all the shares or a class of shares proportionately.⁶ A s 84 reduction protects shareholders and creditors by allowing them to state their objections concerning the reduction to the Court before such

² Although with regard to other capital - the capital redemption reserve fund and the share premium account - the provisions relating to reduction of capital apply.

³ HS Cilliers and ML Benade (eds): *Corporate Law*; DH Botha, MJ Oosthuizen and EM de la Rey (authors); 1987, Durban, Butterworths; p108.

⁴ s 83(2).

⁵ s 83(1)(b). If there are no creditors then the company can proceed, *ceteris paribus*, under this section.

⁶ That is, there will be no question of oppression or fraud on a minority of shareholders.

Court decides to accept or reject such reduction.⁷ Lastly, shareholders are protected when voting upon the issue of reduction, as both s 83 and s 84 require a special resolution to be passed.

PROTECTION OF SHAREHOLDERS

The protection offered to shareholders via the court's confirmation prompted O'Rourke to refer to the following passage in *British and American Trustee v Couper*⁸: "The interests of the dissenting minority of shareholders (if there be such) are properly safeguarded by this: that the decision of the majority can only prevail if it be confirmed by the court".⁹ But in considering the safeguards offered to shareholders, it is apposite to repeat the warning of de Wet J in *Consolidated Textile Mills Ltd*:¹⁰

"The provision of the Act that a reduction of capital shall have the sanction of the court was not placed there for the purpose of protecting a party from what is considered to be a bad bargain. In the first place it is to protect the creditors, and in the second place minority shareholders who might be forced, against their will, to accept an alteration in regard to their rights in the company which might work to their detriment. A shareholder cannot be heard to say that it is inequitable when he is being held to his bargain."¹¹

⁷ ss 85 and 86. A creditor who objects to the reduction and whose consent is dispensed with, has to have his claim secured (s85(3)). Where the reduction 'involves the payment to any shareholder of any paid-up share capital', the Court has to issue a rule nisi calling on all persons to state their objections (s 86(1)).

⁸ *British and American Trustee and Finance Corp. Ltd and Reduced v Couper* [1894] AC 399 (HL).

⁹ B O'Rourke: *Reduction of Share Capital - The Reassertion of Discretionary Power*; (1970) 87 SALJ 161; p163.

¹⁰ *In re Consolidated Textile Mills Ltd* 1952 (2) SA 188 (N).

¹¹ *ibid*; p193DF.

Section 83(1)(a) and s 84(1) require that a company's articles authorize the reduction of capital. In the absence of a stipulation concerning the method and procedure of a reduction, de Wet J in *Consolidated Textile* held that when the court confirms a reduction of capital, "the reduction shall be effected in the first instance by payment of capital which is entitled to priority in a winding-up".¹² And in a winding-up preference shares are paid prior to ordinary shares. But with the introduction of redeemable preference shares, one would envisage this question would not arise frequently. With regard to dividends, Centlivres CJ in *Levin v Felt and Tweeds Ltd*¹³ extended this principle of Lord Greene and held that, similar to a winding-up when preferent shareholders are entitled to arrear dividends on their shares, so with a reduction of capital "there is ... nothing unfair or inequitable"¹⁴ in such shareholders receiving their dividends. However, this analogy of a reduction of capital to a winding-up of a company is a fruitless exercise. The motivations spurring a reduction of capital are unrelated to a winding-up situation.

Where a company reduces its capital by extinguishing some of the shares within a particular class, leaving the remaining shares of such class intact, then *Hahlo's Company Law*¹⁵ refers to the case of *British and American Trustee*¹⁶ where the court, in confirming such a reduction, held that "if there is nothing unfair or inequitable in the transaction, I cannot see that there is any objection to allowing a company limited by shares to extinguish some of its shares without dealing in the same

¹² *ibid*; de Wet J accepted the remarks of Lord Greene in *Re Chatterley-Whitfield Collieries* [1948] 2 A.E.R. 593. The relevant passage of Lord Greene's remarks are at p190A, while de Wet J's acceptance of such principles are at p191C.

¹³ 1951 (2) 401 (AD).

¹⁴ *ibid*; p411E.

¹⁵ *Hahlo's South African Company Law through the cases*; JT Pretorius (gen. ed.); 5th ed, Juta and Co Ltd.

¹⁶ n.8.

manner with all other shares of the same class."¹⁷ But, Lord Herschell warned that such a scheme would be "most narrowly scrutinized by the court".¹⁸

Concerning the onus of proof with regard to 'fairness' *Henochsberg* says that:

"Where there is only one class of shareholders the onus of proving that the reduction is unfair is on the minority opposing its confirmation. Where there are different classes of shareholders, and the reduction is contrary to the rights of a class, the onus of proving that the reduction is unfair is on those opposing its confirmation if it has been approved by a separate resolution of that class validly adopted under the articles; but if it has not been so approved, the onus of proving that it is fair is on the company (*Carruth v Imperial Chemical Industries Ltd* [1937] AC 707 (HL) at 769-770; [1937] 2 All ER 422 at 462, *Re Holders Investment Trust Ltd* [1971] 2 All ER 289 (Ch) at 291)."¹⁹

PROTECTION OF CREDITORS

Section 85(1) enables a creditor (1) where the reduction involves 'payment to any shareholder of any paid-up share capital' or (2) 'in any other case' if the court so directs, to object to a reduction. Any claim of a creditor must be such that if it were the case of a winding-up of the company, the claim would be admissible as proof against the company.

Despite objections being expressed by creditors, the court has a discretion to dispense with such objections where the company secures payment of the claim by appropriation.²⁰ *New*

¹⁷ *Hahlo's Company Law*; n.15; pp178-179.

¹⁸ *ibid*; p178. See also p183.

¹⁹ *Henochsberg on the Companies Act*; PM Meskin (ed); 4th ed, 1985, Butterworths; p139.

²⁰ s 85(3).

*Modderfontein Mining*²¹ considered the question of securing the indebtedness and concluded that:

"In view of the very strong financial position of this company ... I think it is unnecessary to order payment into Court or even the deposit and keeping of the money in a separate banking account. Nothing more is needed in the circumstances of this case than an order that the company appropriate the sum ... in its books as due, actually or contingently, to several creditors."²² (emphasis added)

Presumably where opposite facts are present - i.e. the company is not in a financially strong position - then payment into court or the depositing of the money in a separate banking account will be necessary so as to secure a creditor. Protection of creditors via their consent or securing of their debt is entrenched by s 86(2) which prevents a court from making an order confirming the reduction or the rule *nisi*, unless the court is satisfied that every creditor has consented or that his debt has been secured.

At a time when it seemed that the courts were unduly exercising their discretion in favour of companies seeking reductions, there was the case of *Vlakfontein Gold Mining*.²³ The court summarized its function when confirming a reduction as being:

- "(a) to ensure that the relevant formalities and provisions of the Companies Act have been duly complied with ...
- (b) to consider whether the proposed reduction is fair and equitable as between the shareholders and particularly as between different classes of shareholders; ...
- (c) to safeguard the interests of existing

²¹ *Ex parte New Modderfontein Gold Mining Co Ltd* 1950 (1) SA 581 (W).

²² *ibid*; p583.

²³ *Ex parte Vlakfontein Gold Mining Co Ltd* 1970 (2) SA 180 (T).

creditors; ...

- (d) *to safeguard the interests of the general public, that is to say, persons who may in the future have dealings with the company or may be minded to invest in its securities, or who may in some manner become creditors in the future*"²⁴

[Emphasis added]

While there is nothing novel in the identification of these duties - the court finding support from *Levin v Felt and Tweeds*²⁵ and *Sammel v President Brand Mining*^{26,27} - one's appreciation of the case rests upon the court's exercise of its *discretion* regarding these points,²⁸ and also point (d).

Galgut J, refusing to confirm the reduction, held that while the "paper formalities" of point (a) had been complied with, "if the court confirmed the present resolution the directors would be given the power to decide how much is to be repaid to shareholders and when such repayments are to be made."²⁹ Such power "may well be detrimental to the then creditors and, even though unlikely, it might be that by withholding repayment they may be prejudicing shareholders."³⁰ Secondly, by granting directors such open-ended authority, point (d) would also be adversely affected - especially as "a reduction of capital ... in the main is purely dependant on the future activities and profit-making ability of the company."³¹

²⁴ *ibid*; p183DG.

²⁵ n.13.

²⁶ *Sammel and others v President Brand Gold Mining Co Ltd* 1969 (3) SA 629 (AD).

²⁷ n.23; p183DG.

²⁸ For example, see O'Rourke; n.9.

²⁹ *ibid*; p164.

³⁰ n.23; p184B.

³¹ *ibid*; p185A. O'Rourke agrees with such reasoning: "it is submitted that the decision of the Court was clearly correct, for a confirmation of the reduction

Briefly, other protections offered to the relevant parties are: (1) the court should be given the reasons for the reduction to enable it properly to exercise its discretion,³² and (2) the circular (about the proposed reduction) must not contain statements which are untrue in material respects.^{33,34}

PREFERENCE SHARES AND THEIR REDEMPTION

Redeemable preference shares are an exception to the maintenance of capital rule. Section 98(3) provides that 'the redemption of redeemable preference shares shall not constitute a reduction of a company's authorised share capital'.

'A company ..., if so authorized by its articles, may issue preference shares which are, or at the option of the company are liable, to be redeemed' (s 98(1)). But, s 98(1)(d) provides that the *terms and manner of the redemption* must be provided by the articles of the company. Can such terms preclude the issuing company from the option of redeeming the

in the form sought would in effect be allowing the directors to decide when to make a payment in reduction of capital - without considering future creditors. Future contractual creditors may possibly be adversely affected by such an inopportune decision and payment, and future creditors whose rights flow from damage suffered as a result of some negligent act could certainly be adversely affected." (n.9; p165).

However, point (d) would seem to be overcome by issuing debentures - see *In re Durban North Estates Ltd* 1947 (4) SA 568 (D).

³² *Ex parte National Industrial Credit Corp Ltd*; 1950 (2) SA 10 (W).

³³ *Levin v Felt and Tweeds*; n.13.

³⁴ *Ex parte Rhodesian Pulp and Paper Industries Ltd*; 1959 (2) SA 735 (SR).

preference shares? In *AA Mutual v Century*³⁵ the Appellate Division had to decide this question. The court, concluding that such a clause was enforceable, reasoned that:

"there is nothing in that paragraph which is incompatible with [s 98], or with [art 3 of Table A] The effect of that paragraph is merely that [the issuing company] renounces *pro tanto* the right to redeem which it has. Such a renunciation is unobjectionable.

Subject to certain exceptions, every person can renounce a right conferred by law solely for his own benefit. One of the exceptions is that no one can renounce a right contrary to law"³⁶

"Nor can the rights of any person other than the company be affected if the company enters into an agreement by which it renounces *pro tanto* its rights to redeem any particular shares. There is nothing in [s 98], or in [art 3] of the articles, or in the first special resolution, or in the common law, which obliges the company to redeem or which prohibits an agreement not to exercise the right of redemption, unless, possibly, the effect of the agreement is to deprive the shares concerned of their character of redeemable preference shares, eg by providing that they are under no circumstances to be redeemed."³⁷ [Emphasis added]

There is no necessity to base the argument on the company renouncing its right to redeem. The wording of s 98(1) itself extends a choice: it refers to preference shares which are to be redeemed or preference share which at the option of the company are liable to be redeemed. But, the court was wise to highlight the fact that a term, which permanently deprives the shares of their redeemable characteristic, would be dealt with differently. But, where the occurrence of the shareholder relinquishing his title becomes so remote, then surely the event triggering the option to redeem is so remote that, in

³⁵ *AA Mutual Insurance Assoc. v Century Insurance Co.* 1986(4) SA 93 (AD). The terms of redemption provided that "the undertaking not to redeem operates only while [the shareholder] (or an approved transferee from [the shareholder] holds the shares." [p101H]

³⁶ *ibid*; pp100J -101B.

³⁷ *ibid*; p101FH.

reality, there is no characteristic of redeemability.

There are two modes of redemption: (1) out of profits of the company which would otherwise be available for dividends or (2) out of proceeds of a fresh issue of shares made for the purpose of redemption.³⁸ Where the former path is taken, a sum equal to the nominal amount of the shares redeemed or the shares' book value must be transferred to the capital redemption reserve fund.³⁹ Where the latter path is chosen, the company, by special resolution, can issue shares other than redeemable preference shares. The company must issue shares up to the nominal amount or book value of the shares redeemed, and the share capital will not be deemed to have been increased (for the purposes of s 75(3)). But, a proviso to this 'non-increasing' effect is that if new shares are issued before the redemption of the preference shares, then, within thirty days after the new share issue, the redeemable preference shares must be redeemed otherwise the new issue shall not, for the purposes of any law relating to stamp duty, be deemed to have been issued in pursuance of the subsection.⁴⁰ But, no redemption can occur until such time as any premium payable has been provided for out of profits or the share premium account.⁴¹ From a balance sheet and income statement point of view, it would be better to finance the premium out of the share premium account.

Once the company has then redeemed the share, it must give notice to the Registrar within one month thereafter.⁴² Notice must be in the prescribed form specifying the shares so

³⁸ S 98(1)(a).

³⁹ S 98(1)(b). This reserve is then treated as if it were share capital of the company; and the provisions of the Companies Act relating to the reduction of share capital except as provided in s 98) shall apply to the reserve.

⁴⁰ s 98(2).

⁴¹ s 98(1)(c).

⁴² Form CM 19: Schedule 2; Administrative Regulations.

redeemed. Failure to give notice constitutes an offence.⁴³

SUMMARY

- . A shareholder will not be protected from a bad bargain. A shareholder is protected to the extent that the decision of the majority can only prevail if it be confirmed by the court.
- . The placing of the onus of establishing fairness, with respect to the shareholders, depends on a number of factors.
- . The creditor's consent can be dispensed with, by securing his claim.
- . The court will not confirm a reduction where ultimately the directors themselves, independently of the court's knowledge, can reduce capital at their own discretion.
- . A right to redeem must exist. It must not be a remote right.
- . The option to redeem is at the instance of the company or any other party.

⁴³ In terms of s 441(1)(n) the offence is punishable by a fine not exceeding ten rand for each day during which the contravention continues.

CHAPTER 4

FINANCIAL ASSISTANCE

The prohibition against a company granting financial assistance for the purchase of its shares exists so as to protect the company, its creditors and minority shareholders. As Beuthin explains:

"If the speculation fails, the company may suffer a loss, for it will often not have received an adequate *quid pro quo* when parting with its funds. But even if success attends the venture, so that actual loss is avoided, the interests of creditors and minority shareholders will nevertheless have been subjected to an illegitimate risk."¹

Thus, s 38(1) of the Companies Act provides that 'no company shall give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance *for the purpose of or in connection with* a purchase or subscription made or to be made by any person of or for any shares of the company, or where the company is a subsidiary company, of its holding company.' [Emphasis added]

The financial assistance prohibition "comprises two main elements; one is the giving of financial assistance, the other is the purpose for which it is given (or the 'in connection with' provision). The two elements are linked to form a single prohibition, but although so linked they are vitally different in concept."² Apart from considering these two elements, other

¹ RC Beuthin: Section 86(bis)(2) - A new test for 'financial assistance'?; (1973) 90 SALJ 211; p214.

² *Lipschitz v UDC Bank Ltd* 1979 (1) SA 789 (AD); p799DE. But Schreiner JA in *Gradwell (Pty) Ltd v Rostra Printers Ltd* 1959 (4) SA 419 (AD) notes that "[u]nless what was to be done would amount to giving of financial assistance within the meaning of the subsection the purpose and the connection would not be important" (p425FG).

matters of consequence which will be discussed are: the effect of contravention of s 38 on the agreement between the parties themselves or between one of the parties and an outside, third party; the severability of the financial assistance provision from the rest of the share purchase agreement; and finally, against whom one can institute proceedings.

CRITERIA FOR 'GIVING OF FINANCIAL ASSISTANCE'

"The words 'financial assistance', however, have not been comprehensively defined in the section or elsewhere in the Act and, inevitably, problems sometimes arise as to whether what a company has done in a given case constitutes the giving of financial assistance within the meaning of those words as used in the section. In their endeavour to facilitate the solution of such problems, the Courts have from time to time formulated certain 'tests' to guide them to a proper answer."³

What follows is an exegesis of such tests.

IMPOVERISHMENT TEST

Miller JA in *Lipschitz v UDC Bank* explains this test as postulating the following question: "has the company, in consequence of what it did for the purpose of or in connection with the purchase of its shares, become the poorer?"⁴ A negative answer to this question would indicate that s 38 has not been contravened.

The origin of this so-called impoverishment test is *Gradwell v Rostra Printers*.⁵ The statement of Schreiner JA in *Gradwell v Rostra Printers*, which subsequent courts have relied upon as advocating this test, is the following:

"The [company's] assets and liabilities are put into

³ *Lipschitz v UDC Bank*; n.2; p798BC.

⁴ *ibid*; p798CD.

⁵ n.2.

a different form but the balance is unchanged Here the company would have no more and no less after the completion of the transaction than before Its financial position would be unchanged - only its investment would be smaller."⁶

This approach was adopted in *S v Hepker and Another*;⁷ *Bay Loan Investment (Pty) Ltd v Bay View (Pty) Ltd*;⁸ and *Lomcord Agencies (Pty) Ltd v Amalgamated Construction Co (Pty) Ltd*.⁹ While *Jacobson v Liquidator of M Bulkin & Co Ltd*¹⁰ seems to follow an impoverishment test, because although the judge in *Evrard v Ross*¹¹ was correct when he observed that le Grange J, in *Jacobson v Liquidator : Bulkin*, rejected such test as the true or sole approach;¹² in fact, le Grange J concluded that there had been an impoverishment of the company in the circumstances of the case.¹³

⁶ *ibid*; p426AB.

⁷ 1973 (1) SA 472 (W); p479H.

⁸ 1972 (2) SA 313 (C); p317AC - see the cases therein referred.

⁹ 1976 (3) SA 86 (D); p89GH.

¹⁰ 1976 (3) SA 781(T).

¹¹ 1977 (2) SA 311 (D).

¹² *Jacobson v Liquidator : Bulkin*; n.10; p788E; and *Evrard v Ross*; n.11; p317EF. In this latter case Leon J, despite noting the criticisms against the impoverishment test, accepted the test - he said that "the weight of authority would seem to favour the view that this will usually determine whether there has been a contravention of the section" (p322H).

¹³ *Jacobson v Liquidator : Bulkin*; *ibid*; p788F. The court rightly rejected an approach "which makes the operation of the prohibition dependent upon the financial position of the borrower of the money at the time when the loan is made or at the time when repayment of the loan is desired." (*ibid*; p788H-89) As le Grange J emphasises, if one follows this approach then s 38 is not contravened if the borrower is a millionaire; while if he is a pauper, it is contravened - at p789A. Another problem with this approach is that if one chooses the borrower's financial position at the time when the loan is granted, one is then faced with the problem that his financial position could deteriorate in the intervening time until when repayment of the loan is required.

In *Evrard v Ross* Leon J held that:

"if due weight is given to the word 'financial' in the section I do not think that it would be correct to hold that the company's pecuniary resources have been employed where its true financial position has remained unchanged [L]ooking to the company's money to 'see what has become of it' is entirely consistent with this view. I emphasise that the section in no way prevents the company from rendering assistance other than financial assistance."¹⁴ (emphasis added)

Leon J's identification of money or pecuniary resources with financial assistance ignores the fact that s 38 also refers to 'a guarantee or the provision of security'. Miller JA is correct when he states, in *Lipschitz v UDC Bank*, that "[s]uch an interpretation unduly narrows and restricts the terms of the section."¹⁵ Miller JA rejected the exclusive use of the impoverishment test; rather, this test can be relied upon as a pointer or guide in the appropriate circumstances. He correctly observes that:

"the purpose of the Legislature in specifically including the giving of a guarantee and the provision of security in the concept of 'financial assistance' was to guard also against a company's merely exposing its funds to possible risk (as distinct from actually employing or depleting its funds) for the purpose of or in connection with the purchase of its shares."¹⁶

SECONDARY TESTS

Other secondary or complementary tests (or, as Hiemstra J expresses it, other "qualifications"¹⁷) have been developed.

¹⁴ *Evrard v Ross*; n.11; p323AB. In *Karnovsky v Hyams* 1961 (2) SA 368 (W) Claassen J speaks of a reduction of capital of the company - at p370AB.

¹⁵ n.2; pp800G-801C. Also see (1973) 90 SALJ 211; p214.

¹⁶ *ibid*; p801BC.

¹⁷ *S v Hepker*; n.7; p479F.

For example, in *Karnovsky v Hyams Claassen J* developed the 'sound business method' approach:

"If a transaction is real and not fictitious and in the ordinary course of sound business methods, the Court would, in my view, be slow to condemn such a transaction on the basis of [s 38], unless the Court, when in possession of the full facts, could say that on a balance of probabilities the transaction if carried out would constitute a criminal offence."¹⁸ (emphasis added)

There is no definition of a sound business method; rather, the concept depends upon the facts of each particular case. *Claassen J* applied the circumstances of the case to this test in the following manner:

"... the sellers of the shares are stepping completely out of the company and are giving up any control they may have had through the board of directors. While they still had control they may have been satisfied to leave the debts owing to them by the company unsecured but when they step out completely and control passes into other hands, it seems to me that, while not demanding payment, they are acting normally and in business-like manner in stipulating that their loan accounts be secured by mortgage bond over the fixed assets of the company. In doing that there is nothing immoral or contrary to sound business methods."¹⁹

This 'sound business method/practice' approach, together with the fact that there must be a real contract, were accepted

¹⁸ *Karnovsky v Hyams*; n.14; p370BC. However, by relying upon the 'sound business practice', there is the possibility that a court would be interfering in the management or business affairs of a company by adhering to this requirement.

¹⁹ *ibid*; p370GH; similar reasoning was followed in *Bay Loan Investment v Bay View*; n.8; p317DG. McLennan regards the court's acceptance of such agreements as "sensible". [JS McLennan: Financial assistance to acquire shares - s 38; (1983) 100 SALJ 430-38; p433.]

in *S v Hepker*;²⁰ *Beuthin*;²¹ *Evrard v Ross*;²² *Bay Loan Investment v Bay View*;²³ and *Gray v Thesing Vastgoed BV*.²⁴ While in *Lipschitz v UDC Bank* the Appellate Division expanded upon the element of authenticity of the transaction, saying that it is permissible for the parties involved to conclude an agreement so as to avoid the financial assistance prohibition, but the agreement must not be "disguised in order to conceal the true agreement."²⁵ This remark goes to the heart of the matter. One must be careful to distinguish between extraneous agreements surrounding the actual share-sale agreement. Clearly, a contract concerning the seller's loans to the company must be kept distinct from the contract for the sale of the shares. Consequently, the question to ask is: "to what extent is the 'extraneous contract' severable from the share-sale agreement?"

However, this 'sound business method' approach will not protect the parties where "the Court, when in possession of the full facts, could say that on a balance of probabilities the transaction if carried out would constitute a criminal offence."²⁶ By including this proviso - which is the essence of s 38 - this secondary test or qualification of 'sound business practice' ultimately is not relevant. Even if the agreement is in accordance with sound business practice, one still must question whether an offence of financial assistance has been committed. Thus, one is left in the dark as to the precise meaning or content of the giving of financial assistance.

²⁰ n.7; p479FH.

²¹ *Beuthin*; n.1; p215.

²² n.11; p323CD.

²³ n.8; p317EF.

²⁴ 1987 (1) SA 744 (A).

²⁵ *Lipschitz v UDC Bank*; n.2; p806FG.

²⁶ *Karnovsky v Hyams*; n.14; p370BC.

Another secondary qualification referred to by the courts is the 'quid pro quo' approach: the company may part with something in terms of the share-sale agreement, if simultaneously it receives some benefit by way of this agreement. An illustration of this approach is *Karnovsky v Hyams*: the share-sale agreement required the company to pass a bond over its assets to secure the company's indebtedness with respect to the loans to the sellers of the shares. Claassen J concluded that the benefit received by the company was that it no longer had to repay the loans immediately; it was granted an extension of time within which to make such repayments.²⁷ Thus, no 'impoverishment' (as it were) of the company occurred, because the company was simultaneously receiving a benefit. This *quid pro quo* approach was earlier followed in *Karoo Auctions (Pty) Ltd v Hersman*,²⁸ and more recently in the case of *Gray v Thesing Vastgoed*.²⁹ But one also can view such agreements as being subject to the sound business method test. Hence, one is not provided with a better understanding of the concept of 'the giving of financial assistance'.

A third qualification, found in *Gradwell v Rostra Printers*, concerns the distinction between a *direct* and an *ultimate object*.³⁰ Beuthin explains this approach as follows: "The ultimate object of financially assisting the purchaser of shares will be unobjectionable ... as long as the direct and immediate object is to perform a perfectly normal transaction according to sound honest business methods."³¹ To establish

²⁷ *ibid*; p371A.

²⁸ 1951 (2) SA 33 (E); p39AC.

²⁹ n.24; p755CD.

³⁰ n.2; p426DE.

³¹ Beuthin; n.1; p216. Schreiner JA stated it thus in *Gradwell v Rostra Printers*:

"I do not agree ... that the partial discharge of the loan indebtedness was merely incidental to the transaction in any relevant sense. It is true that it was not the *ultimate goal* of the transaction.

these objects, he notes that one may refer to the "intentions and motives of directors."³² However, Schreiner JA contradicts himself because he also warns that "[u]nless what was to be done would amount to the giving of financial assistance within the meaning of the subsection, the *purpose* and the connection would not be important" (emphasis added).³³

Miller JA understands this 'direct - ultimate object' approach as being the 'ultimate finding' of the court in *Gradwell v Rostra Printers* and thus rejects the cases which rely on the latter case as advocating the impoverishment test.³⁴

FOR THE PURPOSE OF / IN CONNECTION WITH

The source of difficulty concerns the meaning of the phrase 'in connection with'. In *S v Hepker Hiemstra J* concluded as follows:

"If that is not financial assistance, albeit indirectly, for the clear purpose of paying for its own shares, then I would like to know what it is. Clearly it is at least financial assistance 'in connection with' the purchase of the shares. The phrase certainly has a wider connotation than 'for

But it was the *direct object* of the parties to pay off part of the loan account so as to leave a smaller account to be purchased. The way the *ultimate object* was to be achieved was by carrying out a step, the partial discharge of the indebtedness, which, though it was more convenient to [the purchaser] and possibly also to [the seller], was not the giving of financial assistance" (p426DE). [Emphasis added]

³² Beuthin; *ibid*.

³³ *Gradwell v Rostra Printers*; n.2; p425G. Miller JA in *Lipschitz v UDC Bank* (n.2) refers to this anomaly at p800A of his judgment. Miller JA agrees that the 'intention' only becomes important once it is established that there has been the giving of financial assistance.

³⁴ *Lipschitz v UDC Bank*; *ibid*.

the purpose of'."³⁵

But Miller JA in *Lipschitz v UDC Bank* rejected any literal interpretation of this phrase, 'in connection with':

"The 'in connection with' provision is an alternative to 'for the purpose of' and in the context of the section its connotation cannot be otherwise than profoundly affected by the concept to which it is an alternative. The words 'in connection with' appear to have been inserted in order to cover a situation where, although the actual purpose of the company in giving financial assistance might not have been established, its conduct nevertheless stood in such close relationship to the purchase of its shares that, substantially if not precisely, its conduct was similar to that of a company which gave the forbidden assistance with the purpose described in the section. In short, the alternative was inserted merely to close possible loopholes; it was not intended by such insertion to create a different type of offence, or a lesser offence, or to prohibit conduct which was not substantially similar to the conduct prohibited by the main provision characterized by the words 'for the purpose of'."³⁶

In *Zentland Holdings (Pty) Ltd v Saambou Nasionale Bouvereniging*³⁷ Van Winsen J does acknowledge that "the difference [between the two phrases] does not readily lend itself to exact definition."³⁸

SEVERABILITY

When considering severability one must distinguish between the agreement to give financial assistance and the actual agreement of the sale of the shares,³⁹ because where the

³⁵ n.7; p479AB.

³⁶ n.2; p804FH.

³⁷ 1979 (4) SA 574 (C).

³⁸ *ibid*; p580FG.

³⁹ *Vernon v Schoeman* 1979 (2) SA 305 (D); p307FG.

granting of financial assistance is a provision within the 'larger contract', "the whole agreement is not necessarily void and ... the enforceability of its other provisions depends on whether they are severable from the unenforceable one."⁴⁰

Beuthin advocated that the South African courts would follow the English case of *South Western Mineral Water Co Ltd v Ashmore*⁴¹ - namely, that one looks to the intention of the parties and thereby establishes if they themselves would forgo the financial assistance provisions.⁴² Hefer J in *Vernon v Schoeman* seems to have adopted, in part, such an approach as he stated that "the parties themselves have separated the invalid provision from the rest of the agreement"⁴³ - this fact seemed to influence Hefer J. But, the note to *The South African Company Law Journal* (1978) entitled "Financial assistance in share sale - severability" rejects such an approach; and argues that:

"the test of severability is surely an *objective* one independent of the question whether, as against the company, which was not a party to the proceedings, an attempt would or would not be made to enforce the [financial assistance agreement]. If there is a *subjective* element it arises only at the contracting stage when the intention of the parties is relevant to the question of whether or not the offending provision was severable from the basic share-sale."⁴⁴

Miller JA in *Lipschitz v UDC Bank* stated his approach as follows:

"The primary question whenever a Court is asked to uphold the good while rejecting the bad part of a contract is whether the contract is divisible in

⁴⁰ *ibid*; pp307H-08 and p309CE.

⁴¹ [1967] 2 All ER 953.

⁴² RC Beuthin: Act in haste - repent at leisure; (1968) 85 SALJ 194; p196.

⁴³ n.39; p309CE.

⁴⁴ (1978) SACLJ F₁ - F₅; pF₁.

that respect."⁴⁵

CONSEQUENCE OF CONTRAVENTION OF s 38

Any distinction between the contract of financial assistance and the act of giving such assistance has been rejected by the courts: *Karoo Auctions v Hersman*;⁴⁶ *Albert v Papenfus*;⁴⁷ *Bay Loan Investment v Bay View*;⁴⁸ *Goss v Goss*;⁴⁹ *Saambou v Ligatex*;⁵⁰ and *Lipschitz v UDC Bank*.⁵¹ The cases support the view that the contract is *void ab initio* - although, as Miller JA observes in *Lipschitz v UDC Bank*, the prohibition "*prima facie* envisages the actual giving of such assistance".⁵² Even where the contract exists but no performance has been rendered, Miller JA argues that the contract would be "invalid and unenforceable".⁵³

Where there are numerous contracts in the circumstances of the case, but the financial assistance contract cannot be severed from the other contracts, then the other contracts are

⁴⁵ n.2; p807G.

⁴⁶ n.28; pp39D-40.

⁴⁷ 1964 (2) SA 713 (E); p721DH.

⁴⁸ n.8; p316EF.

⁴⁹ *Goss v EC Goss & Co (Pty) Ltd & Others* 1970 (1) SA 602 (D); p608AD. Shearer J describes the financial assistance agreement as being *ultra vires* the powers of the company; therefore, "the company had no power to enter into the agreement and the form of agreement gone through was inoperative to create any right in or against the [company]." (p608BD)

⁵⁰ *Saambou Nasionale Bouvereniging v Ligatex (Pty) Ltd* 1976 (1) SA 868 (ECD); p871GH.

⁵¹ n.2; pp802B-03B.

⁵² *ibid*; p802H.

⁵³ *ibid*; pp802H-803B.

invalid and unenforceable.⁵⁴ Where the other contract is independent of the financial assistance contract, such independent contract is enforceable.⁵⁵

Section 38(3) creates the criminal offence.⁵⁶ But, what is the position where there is an agreement for financial assistance but no performance has occurred? Miller JA, without reaching any conclusion on the matter, said that "[i]t might be ... that an agreement of that kind, not carried out, would not constitute the criminal offence created by the section."⁵⁷

While one understands the motivation behind imposing criminal liability upon the company's directors, it seems harsh to impose liability also upon the company. Consequently, McLennan remarks that "if it is safe to assume that the purpose of the section is to protect a company's funds, then to make the *company itself* guilty of an offence is quite ludicrous."⁵⁸

RECOVERY AND LIABILITY

The only case to devote attention to the problem of 'whom to sue' is *Jacobson v Liquidator : Bulkin*. The liquidator did

⁵⁴ *Saambou v Ligatex*; n.50; p873 and *Goss v Goss*; n.49; p608EH.

⁵⁵ *ibid*; p872BD.

⁵⁶ The section provides as follows:

- (a) Any company which contravenes the provisions of this section, and every director or officer of such company, shall be guilty of an offence.
- (b) For the purpose of this subsection 'director', in relation to a company, includes any person who at the time of the alleged contravention was a director of the company.
- (c) It shall be a defence in any proceedings under this section against any director or officer of a company if it is proved that the accused was not a party to the contravention.'

⁵⁷ *Lipschitz v UDC Bank*; n.2; p802H.

⁵⁸ McLennan; n.19; p432.

not bring an action against Bulkin to whom the 'illegal loan' had been given, because it would have been "futile".⁵⁹ Rather, the liquidator brought an action against the directors of the company (in which the shares were being bought) who collectively had contrived the scheme. But, counsel for the directors:

"contended that, unless the Court extended relief to the [company] on ... equitable principles,⁶⁰ Bulkin would be enriched at the expense of the company which had lent him the money to pay for the shares, and that Bulkin could be sued for the [amount]."⁶¹

The court rejected this submission, arguing that:

"[p]erformance by all parties had been made in accordance with the terms of the agreement Bulkin got what he bargained for and the company got what it bargained for Bulkin and the company are *in pari delicto* The Court has no discretion to grant relief where the purpose of the action is not restoration but the enforcement of an illegal obligation"⁶²

But McLennan rejects the submission that the company was *in pari delicto*: the company is at the mercy of the directors and therefore, it is the directors themselves who are at fault and guilty of "misapplying the company's funds ... [consequently] the directors are liable to reimburse the company."⁶³

Le Grange J agreed with *Wallersteiner v Moir*⁶⁴ that the

⁵⁹ *Jacobson v Liquidator : Bulkin*; n.10; p787C.

⁶⁰ See *Jajbhay v Cassim* 1939 SA 537 (AD) for such equitable principles.

⁶¹ *Jacobson v Liquidator : Bulkin*; n.10.

⁶² *ibid*; p789FH.

⁶³ JS McLennan: Financial assistance to acquire shares; (1977) 94 SALJ 145; p147.

⁶⁴ [1974] 3 All ER 217 (CA).

financial assistance prohibition exists to protect not only the creditors but also the company's funds. The latter category is protected against loss "by way of action for damages against the defaulting directors."⁶⁵ But McLennan argues that, precisely because the financial assistance prohibition is for the protection of a company's funds,

"the proper approach in these cases is not to limit the company's remedies but rather to look for means of assisting the company to recover its funds. Why in the circumstances of the present case, and particularly in view of the fact that it had performed all its 'obligations' under the agreement, should the company be debarred from suing [Bulkin] for the full amount of the loan? To allow this claim would not be tantamount to giving effect to an illegal transaction; on the contrary, to permit the company to recover the loan from [Bulkin] would not only discourage this form of illegality but also, it is submitted, would help to give effect to the real purpose of the section. The transaction was not *ex facie* illegal: loan by companies to directors are lawful in certain circumstances (see s 226); it was the purpose of the loan that was prohibited by the section. The borrower [Bulkin], a director of the company, was the person primarily responsible for the whole transaction. It would be highly anomalous if he were entitled to defeat an action for the recovery of the loan by pleading that he and his colleagues used the moneys for an unlawful purpose. It is submitted, therefore, that, in relation to the company, the victim of the transaction, the cause is, in these circumstances, not *turpis*."⁶⁶

SOME REMARKS

There are a few outstanding remarks which I would like to make. As there is no coherency between these observations, I shall list them in point form:

1. In *Gradwell v Rostra Printers* Schreiner JA noted that "[t]he words 'made or to be made' ... seem to cover assistance provided even after the purchase or

⁶⁵ *Jacobson v Liquidator : Bulkin*; n.10; p790EF.

⁶⁶ McLennan; n.63; p146.

subscription."⁶⁷

2. Onus of proof: rests upon the person alleging contravention of s 38 and the standard of proof is on a balance of probabilities. The cases referring to the question of onus are: *Evrard v Ross*⁶⁸ and *Miller v Muller*.⁶⁹ In *Karnovsky v Hyams Claassen J* remarked that "[i]n terms of sec [38](3), where criminal conduct is alleged in a civil case, the standard of proof is still a balance of probabilities. But in such a case the reasonable mind is not so easily convinced as is indicated in the case of *Gates v Gates 1939 AD 150*".⁷⁰

3. Declaration of a dividend: Colman J in *Novick & Another v Comair Holdings Ltd & Others*⁷¹ refers to the New Zealand case *Re Wellington Publishing Co Ltd*⁷² as "authority for the proposition that there would have been no legality in the use of [a] dividend towards payment of the purchase price."⁷³ But the case of *Novick v Comair Holdings* does not seem to make any finding on this point with regard to South African law.

4. The liability of the company's directors usually can be based on an action for breach of their fiduciary duties - that is, the common law. This covers instances such as (1) when a company renders financial assistance but receives no *quid pro quo* - such breach is "a misuse of

⁶⁷ *Gradwell v Rostra Printers*; n.2; p424E.

⁶⁸ n.11; p316GH and p323BC.

⁶⁹ 1965 (4) SA 458 (C); p466H.

⁷⁰ n.14; p370C. See also *Zentland Holdings v Saambou*; n.37; p579A.

⁷¹ 1979 (2) SA 116 (W).

⁷² (1973) 1 NZLR 133.

⁷³ *Novick v Comair Holdings*; n.71; p136GH.

[the company's] assets and therefore is detrimental to its interests"⁷⁴ - and (2) when a company purchases an asset either at an inflated price or an asset which it does not need - this is "another instance of a misapplication of funds."⁷⁵ Hence, McLennan concludes: "I

am unaware of a case where a contravention of the section took place but which did not also involve a breach of fiduciary duty and the consequent misapplication of funds."⁷⁶

EXCEPTIONS TO FINANCIAL ASSISTANCE PROHIBITION

To complete the discussion of s 38, it is necessary to reproduce subsection (2) which refers to instances when assistance will not be regarded as contravening s 38(1):

Section 38(2) The provisions of subsection(1) shall not be construed as prohibiting:

- (a) the lending of money in the ordinary course of its business by a company whose main business is the lending of money; or
- (b) the provision by a company, in accordance with any scheme for the time being in force, of money for the subscription for or purchase of shares of the company or its holding company by trustees to be held by or for the benefit of employees of the company, including any director holding a salaried employment or office in the company; or
- (c) the making by a company of loans to person, other than directors, *bona fide* in the employment of the company with a view to enabling those persons to purchase or subscribe for shares of the company or its holding company to be held by themselves as owners.

⁷⁴ McLennan; n.19; p434.

⁷⁵ *ibid*; p437.

⁷⁶ *ibid*.

SUMMARY

- . Various tests, e.g. impoverishment test, 'sound business method' test, 'quid pro quo' test, are used to establish the 'giving of financial assistance'. The courts tend to seek some tangible loss.
- . The principles of the law of contract determine whether the financial assistance provision can be severed from the actual share-sale contract.
- . The company itself, and its directors are guilty of an offence. While this is unfortunate for the company, because it is the company which one seeks to protect, the company can sue the directors for recovery of damages - hence, its resources will not be depleted.

PART III

DEBT FINANCING

CHAPTER 5

DIRECTORS' DUTIES TO BONDHOLDERS AND OTHER CREDITORS^{*1}

The consideration of creditor protection outside the bounds of contract law might seem unusual since corporate law and principles of fiduciary duty traditionally exist for the protection of stockholders. However, contract law provides no protection against unanticipated wealth expropriations from bondholders and creditors to stockholders; instead, such protection may be achieved using the principles of fiduciary duty.

Part I analyses recent literature to emanate from America. Such literature wisely interprets corporate law as interacting with economics; thus, any legal theories advocated are based on principles of economic and business efficiency. In striving to attain such efficiency, one sees two trends developing: efficiency attained through a contractual duty of good faith versus its attainment through the corporate law principles of fiduciary duty. The Commonwealth case-law, the content of part II, considers creditor protection from a purely legal stance - namely, whether the phrase "interests of the company" can be extended to include creditors' interests.

VIEWS FROM AMERICA

GOOD FAITH DUTY

The duty of good faith is a "neoclassically expanded

^{1*}The title to this chapter may seem misleading because one does not refer to a director's duty to shareholders, rather the duty is to the company. However, I have chosen to phrase the chapter in this manner as one finds similar phraseology in the literature.

contract interpretation."¹ The duty "permits, but does not compel, creation of a common law of bondholder protection for cases where the bond contract fails clearly to allocate all risks."² Bratton and Oliver³ favour such a duty - but, only for the protection of convertible bondholders as this "hybrid security ... reduce[s] conflict between stockholders and bondholders by creating a class of securityholders whose interests go to both sides of the debt-equity line."⁴

The basis of Bratton's approach is that residual risk exists which is detrimental to the bondholder - irrespective of whether the bondholder is unaware or well-informed. While it may be argued that it is the bondholder himself who should gather his own information so as to prevail upon such risk, Bratton submits that commensurable fault may be placed at the instance of the issuer. He acknowledges the difficulty in ascertaining which party is more at fault, and finally places the duty upon the bond issuer:

"Bondholder expectations persistently outpace

¹ WW Bratton: The economics and jurisprudence of convertible bonds; 1984 *Wis. L. Rev.* 667; p691. [Emphasis added] The distinction between classical and neoclassical contract interpretation is explained by Bratton as follows:

"Classical contract doctrine tends to confine the court to linguistic, structural, and textual analysis bounded by the 'four corners of the document.' Neoclassical analysis, based on the insight that texts do not have immutable meanings, is more expansive. It bids the court to consider the entire circumstances of the relationship to assure selection of the meaning most consonant with the parties' expectations. Through freely interpolated good faith duties, neoclassical interpretation also brings ethical restraints to bear on self-interested conduct damaging to the interests of other parties to the contract." (*ibid*; p692)

² *ibid*; pp698-99.

³ NT Oliver: Fiduciary obligations to holders of convertible debentures: *Simons v Cogan*, 549 A.2d 300 (Del. 1988); (1989) 58 *Univ. Cincin. L.Rev.* 751.

⁴ Bratton; n.1; p669 and Oliver; n.3; p769.

contract protections and are frustrated by remote risks. We can ascribe to the issuer knowledge of this, since it has a direct role in the drafting process. The issuer thus can be faulted for failing to correct these mistaken expectations with a bond contract that is crystal clear.... If we accept ... that convertible bond prices are insensitive to residual risks, it turns out that the bondholders have not been compensated by lower bond prices for bearing the residual risks. Thus, protecting bondholders against the residual risks could be justified on the grounds that they are entitled to the benefit of their bargain."⁵

Bratton admits that the well informed convertible bondholders, when protected under the neoclassical contract interpretation, will effect a wealth transfer from stockholders to bondholders;⁶ however, he argues that it is "a matter of selecting a fair and workable approach falling somewhat short of the ideal result",⁷ because ultimately "efficiency requires judicial consistency and clarity more than judicial results perfectly according with actual market expectations."⁸ Hence, Bratton chooses the good faith doctrine,⁹ "so long as the risk of the issuer conduct has not clearly been allocated to the bondholders by the bond contract."¹⁰

The mechanics underlying the good faith doctrine are that:

"... [it] place[s] the drafting burden on the

⁵ Bratton; n.1; pp703-04.

⁶ *ibid*; p708ff.

⁷ *ibid*; p710. Where the result of the application of the good faith doctrine greatly deviates from actual market expectations, then Bratton argues that such results will be "promptly and explicitly ... overridden in subsequent bond contracts" [*ibid*; p718]. Bratton does not deny that such changes will be costly. A problem with Bratton's approach is that existing debentures will continue to provide a problem should they be the subject of interpretation in the future.

⁸ *ibid*; p719.

⁹ *ibid*; p715.

¹⁰ *ibid*; p672.

convertible bond issuer where its actions benefit the stockholders by diminishing the value of the conversion privilege At best, the courts tell us that the good faith duty protects the parties' expectations in the fruits of the contract, and the issuer action in question deprives the bondholders of those fruits."¹¹

Thus, Bratton refers to the case of *Harff v Kerkorian*¹² as being an instance where judicial intervention could have occurred to protect the convertible bondholders. In this case the convertible bondholders questioned the validity of the distribution of a cash dividend. The bondholders unsuccessfully based their argument on a breach of fiduciary duty, but Bratton argues that an alternative approach would have been to rely upon neoclassically expanded contract interpretation. He calls attention to the fact one is dealing with an 'omitted term' case, consequently, "no doctrinal barrier prevented the *Harff* court from filling the gap with a term protecting the bondholders."¹³

Oliver adopts a slightly varied approach from Bratton. She argues that:

"corporate management should be compelled, by an implied duty of good faith and fair dealing arising from the indenture, to protect the reasonable expectations of the convertible debenture holders that were induced by promises made by the corporation in the indenture."¹⁴

These 'promises made by the corporation in the indenture' are the "complex arrangement of contractual provisions that protects the conversion option creating the expectation in the security holder that the option will be available to him when

¹¹ *ibid*; p698.

¹² 324 A.2d 215 (Del. Ch. 1974), *rev'd*, 347 A.2d 133 (Del. 1975).

¹³ Bratton; n.1; pp695-96.

¹⁴ Oliver; n.3; p768.

it becomes economically attractive."¹⁵ Consequently, maximization of convertible bondholder interests is limited to "that required by the spirit of the express provisions of the trust indenture."¹⁶ And whenever management's action "does not comply with the clearly expressed intent of the parties to the indenture",¹⁷ the implied good faith duty has been breached.

Oliver's approach attributes intentions to the parties involved in the agreement. Thus, she approves of the case *Katz v Oak Industries Inc*¹⁸ where the court stated that:

"the duty was breached if the express provisions of the contract clearly indicates that *the parties would have agreed to proscribe the act complained of had they thought to negotiate with respect to that matter.*"¹⁹

Although both Bratton and Oliver speak of a good faith duty, they appear to have different understandings of such a duty. Underlying Bratton's approach is a strong endorsement of the classical interpretation of contracts - consequently, it can be said to exist so as to fill any lacuna's and "it comes into play only when the contract *fails to allocate a risk* and yields to an explicit contract provision providing for a different result."²⁰ But Oliver emphasizes the spirit or intent of the covenants contained in the indenture, and breach of the duty occurs where the corporation's management, "although technically complying with the letter of the

¹⁵ *ibid*; p774.

¹⁶ *ibid*; p776.

¹⁷ *ibid*. Oliver refers to *Simons v Cogan* [n.3] where the court formulated the test for breach of duty: "the duty [is] breached if the express provisions of the contract clearly indicates that the parties would have agreed to proscribe the act complained of had they thought to negotiate with respect to that matter" [*ibid*; p775].

¹⁸ 508 A.2d 873 (Del. Ch. 1986). See Oliver; *ibid*; p774.

¹⁹ Oliver; *ibid*; p775. Emphasis added.

²⁰ Bratton; n.1; p718. Emphasis added

indenture, does not comply with the clearly expressed intent of the parties to the indenture."²¹ Consequently, Bratton's approach results in a greater degree of certainty than that of Oliver.

FIDUCIARY OBLIGATIONS

Diverse premises underlie the recommendation that corporate management has a *fiduciary obligation* to protect all bondholders. For example, McDaniel relies on the market value of a firm: in terms of this formula the market value of a firm equals the market value of its bonds plus the market value of its shares.²² A director fulfills his fiduciary obligation when he maximizes the value of the firm according to this formula. Those who argue that maximizing the value of shares results in maximizing the value of the firm, do not realize the full significance of the concept of maximization of firm value. However, provided bondholders receive compensation for their losses,²³ then only is it possible to maximize firm value and simultaneously maximize stockholder wealth. It is a logical consequence of the equation that once the bondholder is protected and shielded from injurious decisions of management,

²¹ Oliver; n.3; p776.

²² MW McDaniel: Bondholders and corporate governance; (1986) 41 *Bus. Law.* 413; p418.

²³ Three conditions must be satisfied if bondholders are to be compensated: "(1) it is easy to identify the winners and the losers; (2) it is easy to determine the amount of their gains and losses; and (3) the cost of actually paying compensation is low. Those three conditions frequently will be satisfied in the case of leveraged takeovers and recapitalizations of companies with publicly-traded securities" [MW McDaniel: Bondholders and Stockholders; 1988 *J. of Corp. Law* 205; pp251-52]. The amount of compensation required can be gauged from the price variations in the share and bond markets. And instead of a cash compensation, McDaniel suggests increasing the interest paid on a bond "so that the bonds continue to trade at or above the [ex ante] price" [ibid; p252].

the only consequence is for management to maximize firm value.²⁴ But, this latter maximization is subject to the following qualification: management must not prevent a corresponding increase from accruing to the bond's market value.²⁵ And thus the rule can be stated that "[p]rima facie evidence of a breach of [a fiduciary] duty is a decision that causes stock prices to rise and bond prices to fall."²⁶

McDaniel argues that this fiduciary duty will attain Pareto efficiency as it "can dramatically reduce the average agency costs of debt for all corporations and sharply reduce the systematic risk of expropriation loss, which in turn will lower average borrowing costs for all corporate borrowers."²⁷ Another advantage is that "it measures compensation on a situation-specific basis."²⁸

While the premise upon which McDaniel bases his fiduciary duty is the economic 'reality' that "stockholders and bondholders are all securityholders with differing claims on

²⁴ This formulation refers to Pareto efficiency and is a form of 'equitable justice' - a term used by McDaniel; n.23.

²⁵ McDaniel; n.22; p448. This qualification refers to 'distributional justice'. [McDaniel; n.23; p252.] The attainment of distributional justice is more difficult as it involves formulating apportionment principles. McDaniel argues that "[a] 'rationally related' sharing rule should apply at all times ... to enable bondholders to receive a fair share of the gain from a transaction" [McDaniel; n.23; p258]. He explains the term 'rationally related' as follows:

"The division of gain between bondholders and stockholders will have a rational relationship if the division depends on the size of an investor's stake in the firm and the risk class of his investment. An equal division of gains between bondholders and stockholders per dollar invested would lack a relational basis because a firm's stock is relatively more risky than its bonds" [McDaniel; n.23; p257].

²⁶ McDaniel; n.22; p449.

²⁷ McDaniel; n.23; p245.

²⁸ *ibid.*

the assets and cash flow of an enterprise";²⁹ Barkey formulates his "new fiduciary articulation"³⁰ upon the financial theory rule of corporate current-market-value maximization³¹ and the Black-Scholes conception of the corporation.³²

Barkey's explanation for extending directors' fiduciary duties to debt security holders is based on the Black-Scholes scientific conception of the corporation which postulates that the bondholders own the assets and cash flow of a corporation, while the stockholders have a call option on such assets and cash flow. The 'model' of the corporation results in "a dynamic mathematical 'distribution of ownership between the stockholders and bondholders'."³³ Barkey expatiates upon this theory so as to provide the basis of his 'new fiduciary articulation':

"Because, in general, bondholders and stockholders have first and residual claims respectively on the corporation's assets and cash flow, they are correspondingly the first and residual equitable owners of the corporation's assets and cash flow. Because corporate officers and directors owe fiduciary duties to the equitable owners of the corporation's assets and because, in general, bondholders are the first equitable owners of the corporation's assets under the Black-Scholes [model], corporate [management] owe[s] fiduciary duties to bondholders which correspond to those owed to stockholders."³⁴

²⁹ McDaniel; n.22; p416 and n.23; p246.

³⁰ AH Barkey: The financial articulation of a fiduciary duty to bondholders with fiduciary duties to stockholders of the corporation; (1986) 20 Creighton L. Rev. 47; p74.

³¹ *ibid*; p50.

³² *ibid*; p51.

³³ *ibid*; p52. Barkey says that "[this] ... conception of the corporation might be thought of as stockholders owning the corporate form (call option on the corporate substance) and bondholders owning the corporate substance (assets and cash flow)" [*ibid*; p56].

³⁴ *ibid*; pp68-69.

Barkey, to explain the mechanics of his 'new fiduciary articulation', has recourse to the current-market-value maximization rule which provides that in the presence of perfect capital markets, the attainment of 'optimal operating decisions' is achieved by maximizing the market value of securities before such operating decision is undertaken.³⁵ However, "[t]he generalised anomaly in [this] rule ... defines the new fiduciary articulation because it specifies what is to be rectified".³⁶ The efficient use of corporate assets, while maximizing the current market value of the firm, might not simultaneously maximize the market value of all the securities; thus, what is required, is that such risky debt must receive side payments.³⁷ Consequently, this fiduciary duty demands corporate management to fulfil two requirements:

"(1) maximize the present value of the returns, evaluated with respect to all eventualities, on corporate assets, and (2) make corporate side payments so all classes of the corporation's securityholders receive more or less as much wealth as such classes would otherwise attain through alternative nonexpropriating corporate decisions."³⁸

Content and enforcement of the fiduciary duty

McDaniel states that the fiduciary duty consists of the duty of loyalty and the duty of care.³⁹ He defines the duty of loyalty as a "duty to refrain from self-dealing at bondholder expense, a duty to deal fairly with bondholders, and a duty to make full disclosure to bondholders".⁴⁰ McDaniel defines the duty of care as including a duty not to mismanage the

³⁵ *ibid*; p50. Barkey argues that this rule solves the corporation's fundamental problem of having "no way of directly constructing managerial objectives from the diverse preferences of the corporation's securityholders." [*ibid*; p50]

³⁶ *ibid*; p74.

³⁷ *ibid*; p50.

³⁸ *ibid*; p74.

³⁹ McDaniel; n.23; p266 and n.22; p449.

⁴⁰ *ibid*; n.23; p266.

corporation⁴¹ and the duties of "fidelity, good faith and prudence".⁴²

To enforce these fiduciary obligations bondholders must be able to bring a derivative suit,⁴³ although a direct suit is also possible:

"If bondholders cannot bring derivative suits, they may have to pursue less than optimal remedies. For example, in some cases a bondholder derivative suit against directors or stockholders to recover an improper dividend may be preferable to a direct suit by bondholders to recover damages for capital losses. The distinction between direct suits and derivative suits are so esoteric that bondholders need to be able to bring both. The court can decide which is appropriate. In some cases both will be appropriate because of overlap."⁴⁴

And in specifying against whom the bondholders may bring such suits, McDaniel articulates it thus: they can bring direct suits against the corporation or against the corporate management, alternatively they can sue the corporate management under a derivative action brought on behalf of the corporation. Bondholders may seek relief as individuals or a class; while the relief sought, may be in the form of "monetary damages, an injunction, or declaratory relief."⁴⁵ McDaniel argues that

⁴¹ *ibid*; p268.

⁴² *ibid*; p269 - the duty of care is also referred to as the 'business judgment rule'.

⁴³ McDaniel; n.22; p450ff.

⁴⁴ *ibid*; p451.

⁴⁵ McDaniel; n.23; p309. McDaniel has the following opinion about bondholder action:

"In general, bondholders are more likely to succeed in a suit against directors and officers if the suit is a direct suit brought by bondholders as a class for injunctive or equitable relief. Bondholders are more likely to succeed in a suit for monetary damages if the suit is a class action against the corporation. If the suit is against the corporation, bondholders can assert that the corporation owes fiduciary duties to bondholders, or

when bringing an action against the corporate management, the bondholders as a class should bring a direct claim "for injunctive or equitable relief".⁴⁶ But to obtain monetary damages, then bondholders as a class should sue the corporation.⁴⁷

Barkey also identifies his new fiduciary articulation with the duties of care and loyalty.⁴⁸ He argues that the very essence of his approach results in a derivative suit being brought for breaches of the "duty of care with the business judgment rule"⁴⁹ "because the corporation is the legal owner of its assets",⁵⁰ and in a direct suit being brought for breaches of the "duty of loyalty with the entire-fairness careful-scrutiny rule"⁵¹ "because side payments are an inherent incident of corporate security ownership under it".⁵² An individual suit takes preference over a derivative suit because where a derivative suit exists, an individual claim for side payment will also exist; but the availability of an individual suit for side payment may be present without a derivative suit being at one's disposal.⁵³

that the corporation owes bondholders an implied contractual duty of good faith and fair dealing" [ibid. p312].

⁴⁶ ibid; p312.

⁴⁷ ibid.

⁴⁸ Barkey; n.30; pp76-77.

⁴⁹ ibid; p76. He refers to this duty as "an operationally advisory fiduciary duty" [ibid].

⁵⁰ ibid; p77.

⁵¹ ibid; p76. He refers to this duty as "an operationally compulsory fiduciary duty" [ibid].

⁵² ibid; p77.

⁵³ ibid; pp77-78. Stated differently, the entire-fairness careful-scrutiny rule, i.e. duty of loyalty, overrides the business judgment rule, i.e. duty of care, [ibid; p81]. And Barkey gives the following example:

"there cannot be a derivative claim regarding a non synergistic merger per se because the

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"Directors are under a general law duty to exercise their powers for the purposes for which they were conferred and bona fide for the benefit of the company as a whole."⁵⁴

It is the above concept of which the English, Australian and New Zealand courts have availed themselves to extend directors' fiduciary duties to include a consideration of creditors' interests. A fiduciary duty is a consequence of an agency relationship between the parties concerned. However, it will be seen that in some instances the formulation of this extended fiduciary duty involves a negative duty upon the directors not to adversely affect creditors' interests, rather than a positive duty.

EXISTENCE OF FIDUCIARY DUTY

Those advocating a fiduciary duty to consider the interests of creditors while the company is solvent, do so on the basis that creditors' interests "may be prejudiced ... in the event that the compan[y] become[s] insolvent."⁵⁵ Mason J

corporation's assets (market value) are not damaged, but there can be an individual claim for side payment regarding an unanticipated wealth expropriation in such a merger" [ibid; p78].

⁵⁴ R Sappideen: Fiduciary obligations to corporate creditors; 1991 *J. of Bus. L.* 365; p386.

⁵⁵ *Walker v Wimborne* (1976) 137 CLR 1; p7. Emphasis added. The fact that the company in *Walker v Wimborne* was insolvent at the pertinent time is irrelevant as this fact was not relied upon by Mason J in establishing that directors have a fiduciary obligation to account for creditors' interests. [ibid] Also see R Barrett: Directors' duties to creditors; (1977) 40 *MLR* 226; p229; and J Hill: Recent cases: Companies - duties of directors towards creditors - whether there are such duties when company is solvent; (1986) 60 *ALJ* 525; p527. But, Dawson infers that insolvency was the determining factor in deciding whether a breach of duty had occurred. He refers to

in *Walker v Wimborne* was the first to assert this⁵⁶ and was later followed by Jacobs J in *Grove v Flavel*.⁵⁷

Barrett articulates the premise upon which this full-time duty is based as being that "the theoretical possibility of future insolvency is sufficient to require directors to give continuing attention to creditors' interests".⁵⁸ Such a possibility always exists during a company's solvency, therefore a duty exists during solvency. Barrett indicates that this approach is possibly a result of "the statutory scheme of creditor protection"⁵⁹ - "insolvency and impending liquidation ... emphasise the statutory protection afforded to creditors".⁶⁰ However, it is upon such emphasis that Barrett himself relies to argue that it is only during times of insolvency or 'impending liquidation' that a duty to creditors

the fact that while three transactions occurred during insolvency and were found by the court to constitute a breach of duty, the fourth transaction, the payment of pensions, occurred during solvency and the court held this payment not to constitute a breach of duty [F Dawson: Acting in the best interests of the company - for whom are directors' 'trustees'?; (1984) 11 NZULR 68; p70]. Dawson ignores the fact that such payment was found by Mason J to be "reasonably incidental to the carrying on of the business of a company" [p13], and that Mason J, in agreeing with the trial judge, stated that "[i]t is implicit in his Honour's findings that the payments were made bona fide and with a view to advancing the interests of [the company]" [ibid].

⁵⁶ *ibid*. It should be noted that Mason J "rejected the approach ... that the directors could take into account the interests of the other companies within a 'group of companies', [but Baxt] believe[s] that such a rejection can be restricted to the facts of [this] ... case. There have been other cases in which the courts have taken the view that the directors should bear in mind the interests of other companies within the group" [R Baxt: Note: Company Law; (1983) 1 C&SLJ 167; p167]. Baxt refers to *Charterbridge Corp. Ltd. v Lloyds Bank Ltd.* [1970] 1 Ch 62 as such a case where the 'group interests' were recognised [ibid; p168].

⁵⁷ *Grove v Flavel* (1986) 11 ACLR 161; p167.

⁵⁸ Barrett; n.55.

⁵⁹ *ibid*; p230.

⁶⁰ *ibid*; p231.

exists. At all other times there will be conflict of interests between shareholders and creditors and consequently, at these times there is no extended duty.⁶¹

What did Mason J mean when he spoke of the event of insolvency? If he intended a link between the action during solvency and the resultant insolvency, it seems that directors, during solvency, do not have a direct duty but rather an indirect duty to creditors. Consequently, if "a contemplated payment or other course of action would jeopardise [the company's] solvency",⁶² only then does the director's duty to creditors arise; and then the duty seems to be to isolate the creditors from the effect of the insolvency. Lord Templeman in *Winkworth v Edward Baron Development* provides the best example of the mechanism of this indirect duty:

"The company is not bound to pay off every debt as soon as it is incurred and the company is not obliged to avoid all ventures which involve an element of risk, but the company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts."⁶³

But this indirect aspect of the duty is highlighted when he confesses that "[t]hese breaches of duty would not have mattered if [the directors] had been able to maintain the solvency of the company and to see that all its creditors were paid in full."⁶⁴ However, Hawke calls attention to the policy 'axis' represented by the need for relative freedom to operate through the limited liability company on the one hand, and the risk that must be accepted by the creditor in dealing with that

⁶¹ *ibid*; pp230-31.

⁶² *Nicholson v Permakraft (NZ) Ltd. (in liq.)* [1985] 1 NZLR 242; p249.

⁶³ *Winkworth v Edward Baron Development Co* [1987] 1 All ER 114; p118d.

⁶⁴ *ibid*; p118f.

company."⁶⁵

Where doubtful solvency exists, courts have held that "the interests of the company are in reality the interests of [the] creditors alone".⁶⁶ Such an approach has been supported by Templeman LJ in *In re Horsley & Weight*,⁶⁷ Cooke J in *Nicholson v Permakraft*⁶⁸ and Nourse LJ in *Brady v Brady*.⁶⁹ However, Richardson J and Somers J in *Nicholson v Permakraft* question whether directors' duties arise when the company is doubtfully solvent.⁷⁰ But, Richardson J did state that when a company is insolvent "the creditors have an interest in the company and the directors *might* be said to have a duty to them for creditors' money is then at stake".⁷¹ But Street CJ in *Kinsela v Russell Kinsela* was more assertive in his opinion, stating that the duty arises when the company is insolvent;⁷² and Dillon LJ in *West Mercia Safetywear v Dodd* approved of this formulation.⁷³ The underlying premise for allowing a fiduciary duty was aptly stated by Street CJ:

"But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to

⁶⁵ N Hawke: Creditors' interests in solvent and insolvent companies; 1989 *J. of Bus. L.* 54; p57.

⁶⁶ *Brady v Brady* [1988] BCLC 20; p40h.

⁶⁷ *In re Horsley & Weight Ltd* [1982] Ch 442; p455CD.

⁶⁸ n.62; p249.

⁶⁹ n.66; p40gh.

⁷⁰ n.62; p254 and p255 respectively.

⁷¹ *ibid*; p254. Emphasis added. It should be noted that Richardson J speaks of a duty to the creditors; but I think that he uses this reference loosely as referring to a duty to take account of creditors' interests (and not a direct duty) - see p23 *infra*.

⁷² *Kinsela v Russell Kinsela Pty Ltd (in liq.)* (1986) 10 ACLR 395; p401.

⁷³ *West Mercia Safetywear Ltd (in liq.) v Dodd & another* [1988] BCLC 250; pp252-53.

displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration."⁷⁴

The two cases devoting attention to explaining the circumstances of insolvency or doubtful solvency are *Nicholson v Permakraft* - the judgment of Cooke J⁷⁵ - and *Kinsela v Russell Kinsela* - specifically Street CJ.⁷⁶ Cooke J acknowledged that while the existence of a balance sheet solvency - total assets exceeding total liabilities - or the maintenance of subscribed capital - after payment of shareholder dividends - are relevant indicators in establishing solvency/insolvency; more importantly "directors [must] consider ... whether what they do will prejudice the company's practical ability to discharge promptly debts owed"⁷⁷

Street CJ was hesitant to expand upon "a general test of the degree of financial instability"⁷⁸ But in relating financial instability with risk, he said that:

"... to some extent the degree of financial instability and the degree of risk to creditors are interrelated [T]he plainer it is that it is the creditors' money that is at risk, the lower may be the risk to which the directors, regardless of the unanimous support of all of the shareholders, can justifiably expose the company."⁷⁹

⁷⁴ n.72; p401.

⁷⁵ n.62; p249.

⁷⁶ n.72; p404.

⁷⁷ n.62; p249.

⁷⁸ n.72; p404.

⁷⁹ *ibid*, emphasis added because Street CJ warned that: "Wholly differing value considerations might enter into an adjudication upon the justification for a particular decision by a speculative mining company of doubtful stability on the one hand, and, on the

In contrast to these two cases, Nourse LJ in *Brady v Brady* took a different approach which did not concentrate on the company's insolvency:

"What is accepted here is that [the company] remained solvent after the dispositions had taken place and also that they were made in good faith But there is no evidence which shows that the interests of creditors were ever considered. The directors never asked themselves whether *half* the assets would *in all eventualities* be sufficient to discharge *all* the existing debt."⁸⁰

The above cases still do not explain exactly when the duty arises. As Street CJ emphasised, different types of industries incur degrees of risk which are normal for one type of industry, but abnormal (and therefore a greater risk) for other industries.⁸¹ Secondly, one must realise that the word 'insolvency' refers either to balance sheet insolvency - "assets are insufficient for the payment of [a company's] debts and other liabilities and the expenses of winding up"⁸² - or to 'liquidity insolvency' - "a company's inability to pay its debts on time."⁸³ Riley's proposal is that either form of insolvency is acceptable - "[creditors] will at best run the risk of being paid late, and at worst may receive nothing of the debt due to them."⁸⁴ Categorizing the cases into either of

other hand, by a company engaged in a more conservative business in a state of comparable financial instability" [ibid]. Jacobs J in *Grove v Flavel* states that "a real risk of insolvency" should also give rise to a duty; adding that the existence of such risk "depend[s] on the facts of a particular case" [n.57; p170].

⁸⁰ *Brady v Brady* [1988] BCLC 20; p40. On appeal, the court found that creditors' interests had been considered [*Brady v Brady* (1988) 2 All ER 617].

⁸¹ n.79.

⁸² CA Riley: Directors' duties and the interests of creditors; (1989) 10 Co. Law. 87; p88.

⁸³ ibid.

⁸⁴ ibid; p89.

these two instances of insolvency, the following is apparent: *Winkworth v Edward Baron* favours the insolvent liquidity test;⁸⁵ *Brady v Brady* favours a balance sheet approach;⁸⁶ Cooke J in *Nicholson v Permakraft* advocates a liquidity test as more important than a balance sheet test;⁸⁷ while it is unclear which approach was favoured in *Kinsela v Russell Kinsela*.⁸⁸

Views from the writers

Sealy is against allowing the fact of insolvency such a pivotal role because, during the existence of a company, its financial status may fluctuate between solvency and insolvency.⁸⁹ He expresses his opinion as follows:

"The question ... is whether the directors are behaving responsibly or irresponsibly within the limits of business judgment; the directors can only

⁸⁵ n.63 plus accompanying texts.

⁸⁶ n.80; p40.

⁸⁷ n.62; esp. n.77 and accompanying text.

⁸⁸ n.72; esp. n.79 and accompanying text.

⁸⁹ LS Sealy: Directors' 'wider' responsibilities - problems conceptual, practical and procedural; (1987) 13 *M.U.L.R.* 164; p186. Grantham acknowledges that "there are perhaps no complete answers to [Sealy's] criticisms [but] two points can be made in favour" of using insolvency as a catalyst for allowing creditors' interests to dominate:

"First, this means of establishing priorities within the company does not rely upon insolvency *per se*. Rather, it is merely that insolvency is the most obvious indication that the residual risk is no longer borne by the shareholders. Thus the question posed by the court is not simply whether the company is insolvent, but that given the distribution of risk does it continue to be appropriate to regard the interest of shareholders as exclusively reflecting the corporate interest. Secondly, and perhaps more by way of mitigation, it is also a solution that has recently found favour with the courts in the United States, in determining when and to what extent a board may engage in takeover defense tactics" [R Grantham: The judicial extension of directors' duties to creditors; 1991 *J.of Bus. L.* 1; p15].

look at the matter broadly, even intuitively, and so should the court.... Directors' decisions are taken with reference to the company as an ongoing business concern and should be judged by that broad standard, not by technicalities and (perhaps fortuitous) coincidences of [insolvency].

There is, however, a price to be paid, if [we] ... are to [have] ... a more elaborate formulation [T]he courts have no option but to acknowledge that they must sit in review of business decisions."⁹⁰

Riley argues that the duty to consider the interests of creditors "[a]t the very least, ... arises in a situation where the company has become insolvent."⁹¹ He argues that it is better to consider creditors' interests when insolvency arises than during a company's solvency, because in the latter instance

"the emphasis is moved from the effectiveness of the enforcement mechanism [which occurs if the duty arises at the company's insolvency], to the *discretion* granted to directors by the inclusion of creditors' interests within the interest of the company."⁹²

Grantham also relies on insolvency as creating an obligation to consider creditors' interest: "the onset of insolvency sufficiently alters the motivation of the company and the relative gains of externalising the cost of debt to create uncompensated risks for the creditor."⁹³ However, Grantham does not equate exclusively the interest of creditors with the interests of the company; rather,

"such interests must be viewed as being merely the dominant concern. A dominance that will normally see that interest reflected as the corporate interest, yet admitting the possibility that in some circumstances the combined weight of other

⁹⁰ Sealy; *ibid.*

⁹¹ Riley; n.82; p93.

⁹² *ibid.*; p89 and p93.

⁹³ Grantham; n.89; p3.

interested groups may prevail."⁹⁴

RATIFICATION BY SHAREHOLDERS

Templeman LJ in *In re Horsley & Weight* was against allowing shareholders to ratify directors' misfeasance where such misfeasance had caused detrimental consequences for the company's creditors.⁹⁵ Cooke J in *Nicholson v Permakraft* agreed, remarking that:

"[t]he situation is really one where those conducting the affairs of the company owe a duty to creditors. Concurrence by the shareholders prevents any complaint by them, but compounds rather than excuses the breach as against the creditors."⁹⁶

Similarly, Street CJ in *Kinsela v Russell Kinsela* said that he saw "no reason in law or in logic to recognize that the shareholders can authorize the breach [of duty to take account of creditors' interests]."⁹⁷

Sealy argues that shareholders "are the only residual organ that the company has"⁹⁸ to enable the company to act competently; however, shareholder decisions should be open for review by the courts: "there must be room for an inquiry whether it was proper for them to [consent to a decision] in the interests of [the] new conception of the company."⁹⁹ But

⁹⁴ *ibid*; p15.

⁹⁵ n.67; p456.

⁹⁶ n.62; p250. Although Cooke J speaks of a 'duty to creditors', this phrase is more as an emphasis against allowing ratification, than saying that directors owe a fiduciary duty 'to the creditors' instead of 'to the company'.

⁹⁷ n.72; p404.

⁹⁸ Sealy; n.89; p181.

⁹⁹ *ibid*; ppl81-82.

Grantham is against allowing shareholders the capacity to ratify directors' breach of duty to consider creditors' interests:

"The new conception [of the company] however, reflecting a community of interests, will in some circumstances displace the shareholders as 'owners' and thus render it inappropriate, in those circumstances, for shareholders to forgive the breach."¹⁰⁰

CATEGORIZATION OF CREDITORS

Distinctions have been made between existing, continuing, contingent, and future creditors. Cooke J in *Nicholson v Permakraft* argued that "current and likely continuing trade creditors"¹⁰¹ were to be protected; however, 'future new creditors' do not require protection as they must take the company as they find it and secondly, such creditors themselves must protect their own interests. But, the example of a 'continuing trade creditor' is different: although, in respect of such a creditor, one can still distinguish between current and future debts, Cooke J was of the opinion that such a distinction was unnecessary because such a creditor "may continue to give credit in ignorance of a change damaging to their prospects of payment."¹⁰² Therefore such a creditor required protection.

Sealy is against categorization of creditors - even the description of a class as 'existing creditors', because "[w]hen the liquidator ... in the fullness of time recovers the sum ..., it is unlikely that these creditors will reap the benefit: many 'existing' creditors will have been paid off and replaced by 'future' creditors"¹⁰³ Instead, the extended notion of

¹⁰⁰ Grantham; n.89; p17.

¹⁰¹ n.62; p249.

¹⁰² *ibid*; p250.

¹⁰³ Sealy; n.89; p177.

a fiduciary duty "should reflect the fundamental principle of insolvency law that (statutory exceptions apart) it is a class action for the benefit of creditors generally."¹⁰⁴ But Grantham disagrees:

"[A] distinction is necessitated by the rationale for intervention [I]ntervention is justified only where the creditors' risk has been unilaterally increased, so the interest rate is no longer adequate protection. Thus it may be said that all the creditor requires is the restoration of the level of risk upon which the interest rate was calculated. On this basis it makes sense to distinguish between creditors making loans before the improper conduct and those making loans after such conduct with full knowledge of the increased risk."¹⁰⁵

In *Jeffree v NCSC*¹⁰⁶ Wallace J and Brinsden J agreed that both present and future creditors require protection.¹⁰⁷ While in *Brady v Brady* Nourse J stated that "the interests of the company are in reality the interests of existing creditors alone."¹⁰⁸ It would seem therefore, that while existing creditors fall under fiduciary protection, the position of future, contingent and continuing trade suppliers is less certain.

TO WHOM IS THE DUTY OWED?

A dispute has arisen concerning to whom the duty is owed : to the company or the creditors? Where the interests of the company refers to the interests of shareholders, there is no doubt that the duty is owed to the company. However, in the cases concerning creditors, some judges have stated that

¹⁰⁴ *ibid*; p185.

¹⁰⁵ Grantham; n.89; p7.

¹⁰⁶ *Jeffree v NCSC* (1989) 15 ACLR 217.

¹⁰⁷ *ibid*; p221 and p228 respectively.

¹⁰⁸ n.66; p40h.

directors owe a duty to the creditors.¹⁰⁹ I do not think too much notice should be given to such phraseology as it seems that judges are using this reference of 'a duty to creditors' as an abbreviation for saying that there is a duty to take into account the interests of creditors. For example, Cooke J in *Nicholson v Permakraft* referred to a duty owed to the company¹¹⁰ and then, later in his judgement, to a duty to creditors.¹¹¹

DIRECT DUTY TO CREDITORS?

Dawson opposes extending the interests of a company to include the interests of creditors. He argues that creditors, unlike shareholders, do not confer authority upon directors, and consequently there is "no relation of trust".¹¹² The relationship is one of contract and creditors can obtain protection through the law of tort: they can sue for negligence, in which case the duty is owed to the creditor, therefore the creditor can sue directly.¹¹³

Sealy disagrees with using "the neighbour principle of tort."¹¹⁴ He objects for the following reasons: Firstly, directors' functions are to take risks, not to exercise care.¹¹⁵ Secondly, in terms of *Prudential Assurance v Newman Industries*¹¹⁶ "directors have no liability to shareholders for

¹⁰⁹ For example, n.63; n.106; p221 and p227; and n.62; p250.

¹¹⁰ n.62; *ibid.*

¹¹¹ *ibid.*; p250.

¹¹² Dawson; n.55; p79.

¹¹³ *ibid.*; p80. Dawson notes that "it is no longer possible to argue that the mere fact that the only damages that have been suffered are economic necessarily precludes an action in negligence" [*ibid.*].

¹¹⁴ Sealy; n.89; p176.

¹¹⁵ *ibid.*

¹¹⁶ *Prudential Assurance Co Ltd v Newman Industries Ltd* (No. 2) [1982] Ch 204.

the negligent ... dissipation of corporation assets which indirectly cause them loss"¹¹⁷ - one can apply this conclusion to creditors, who themselves have a relationship with directors somewhat comparable to the director-shareholder relationship.¹¹⁸ Thirdly, categorization of creditors will occur with some creditors receiving preference to others¹¹⁹ - a result which conflicts with the fundamental principle of insolvency law "that it is a class action for the benefit of creditors generally."¹²⁰

Riley also considered the advantages and disadvantages of allowing creditors a direct action; but he considered this in the context of the fiduciary duty - that is, "whether the duty ought to be owed to creditors, and enforceable by them."¹²¹ He identified two advantages: Firstly, efficiency, in enforcement of the duty, would result because enforcement now would be placed at the disposal of those with an interest in the matter, in contrast with the directors, who obviously would be reluctant to bring a suit against themselves. Secondly, a successful claim would have the consequence of placing the proceeds with the actual creditor who suffered a loss as a result of the breach.¹²² But, Riley rejects allowing a direct duty to creditors because not only would it probably result in multiplicity of actions, and therefore incur considerable time and expense, but also the rule as to priorities of debt in a winding-up would be circumvented in the situation of insolvency.¹²³ Grantham also opposes a direct duty to creditors because, firstly, it "prohibits the board from fulfilling their

¹¹⁷ Sealy; n.89; pp176-177.

¹¹⁸ *ibid*; p177.

¹¹⁹ *ibid*; p177 and p178.

¹²⁰ *ibid*; p185 and p188.

¹²¹ Riley; n.82; p91.

¹²² *ibid*.

¹²³ *ibid*; p92.

duty of maximizing shareholder utility",¹²⁴ and secondly, it "does not sit easily alongside the boards' existing fiduciary duties"¹²⁵ - namely, "the pursuit of the corporate interest."¹²⁶

The general tenet amongst the Commonwealth writers is that creditors should not be able to bring direct suits against the directors. However, it will be remembered that the American writers are more flexible, allowing both direct and derivative actions to be brought so as to facilitate recovery.¹²⁷

SUMMARY

- . Good faith duty: Oliver states that in the absence of express terms indicating otherwise, the reasonable expectations induced by promises, must be protected. Alternatively, Bratton advocates that the directors must give equal consideration to the bondholders' interests, and where efficiency dictates that the bondholders' benefit outweighs any costs to the party placed under such a duty, then, the director/company incurs a duty.
- . Fiduciary obligations: McDaniel advocates both equitable and distributional justice, because the market value of the firm is equal to the market value of its bonds plus the market value of its shares.
- . New fiduciary articulation: Barkey argues his duty based on the theory that bondholders and stockholders have, respectively, first and residual claims on the corporations assets and cash flow.
- . Commonwealth: the majority argue that one can equate the 'interests of the company' with the 'interests of its creditors' when the company is of dubious solvency or is

¹²⁴ Grantham; n.89; p12.

¹²⁵ *ibid*; p13.

¹²⁶ *ibid*.

¹²⁷ *Supra*.

insolvent.

- . There is a general consensus that shareholders cannot ratify the director's breach of duty where it is a breach against the creditors.
- . The Americans favour both direct and derivative suits - whichever provides the better results. The Commonwealth writers are against direct suits - whether brought under the fiduciary duty or based upon negligence and the law of tort.

CHAPTER 6

RESTRICTIVE COVENANTS AND DEFAULT RISK

"The risk that worries me most is the risk of default

We need to be aware of the steps that will actually be followed in practice in the event of default. We need to understand what exactly are the undertakings that have been given, by whom and to whom? ... When exactly do the undertakings become effective? When do they cease?"¹

The analysis of the various and most important restrictive covenants will be directed toward answering these questions.

DEBT SUBORDINATION

"Subordination is a transaction whereby one creditor (the subordinated or junior creditor) agrees not to be paid by a borrower or other debtor until another creditor of the common debtor (the senior creditor) has been paid."²

"[T]he basic concept of a subordination agreement is ... the subordination of the right to receive payment of certain indebtedness (the subordinated debt) to the prior payment of certain other indebtedness (the senior debt) of the same debtor."³

Thus, the attractiveness of debt subordination covenants lies in the consequence that the subordinated debt "furnish[es] an equity base upon which may properly rest a commensurate increase in the [debtor] corporation's ability to obtain

¹ D Mitchell: Optimising your financial structure with minimum risk; Conference paper.

² PR Wood : *The law of subordinated debt*; 1990, London, Sweet and Maxwell; pl.

³ DM Calligar : Subordination agreements; (1961) 70 *Yale LJ* 376; p376.

[future] financing."⁴

The two primary approaches to subordinating debt are contractual and turnover agreements. They may be defined as follows:

"In ... a turnover subordination, on the insolvency of the debtor the junior creditor agrees to turn over to the senior creditor all recoveries received by the junior creditor in respect of the junior debt."⁵

While Farrar regards subordination trusts as a third method of achieving debt subordination,⁶ Wood's approach is to categorize such trusts as turnover subordinations.⁷ Wood also includes debtor-creditor turnover subordinations as turnover agreements.⁸

⁴ *ibid.* The belief that subordinated debt has the ability to broaden the debtor's equity base is evidenced, for example, in a newspaper article discussing Investec Merchant Bank's acquisition of Allied Trust Bank. The following was reported:
 "Investec had undertaken to provide ten million pounds of subordinated debt through its existing overseas structure, which would raise the shareholders funds of Allied Trust to thirty one million pounds." [Cape Times; Monday 7 September 1992; p12]

⁵ Wood; n.2; p9.

⁶ JH Farrar : Negative pledges, debt defeasance and subordination of debt; in *Contemporary issues in Company Law*; Farrar (ed); New Zealand Commerce Clearing House, 1987; pp145-146.

⁷ Wood; n.2; pp9-10. Wood describes the mechanism of subordination trusts as follows:

"the junior creditor agrees to hold dividends, proceeds and other payments on the junior debt received by the junior creditor on trust for the senior creditor as property of the senior creditor for application towards the senior debt until the senior debt is paid in full." (*ibid*; p9)

⁸ *Ibid*, pp10-11:

"Under this (somewhat unusual) form, the junior creditor agrees to claim or prove for the junior debt on the insolvency of the debtor and to pay an amount equal to dividends or other payments received

The second method of subordination, contractual subordination, is expounded by Wood as follows:

"The junior creditor agrees with the debtor that, so long as the senior debt is outstanding, the junior debt is not payable *unless and until the senior debt has been paid in full*. If the debtor becomes subject to insolvency or dissolution proceedings, the liquidator is directed to pay the senior debt first."⁹

Irrespective of the type of subordination one uses, it is gainful to heed the warning sounded by Ryan:

"The phrase 'subordination of debt' has no meaning. A provision that a specified junior debt is 'subordinated to' a specified senior debt of the common debtor would be so ambiguous or uncertain as not to be enforceable. The terms of subordination must state *how* - that is, in what circumstances, to what extent, and for how long - the junior debt is subordinated to the senior debt."¹⁰

Each method of subordination provides its own particular obstacles with respect to liquidation of the debtor and the junior creditor. However, probably the greatest challenge for South African law, concerns contractual subordination. A similar challenge is faced in England, Australia and New Zealand. The intricacy inherent in contractual debt subordination is that the principle of *pari passu* sharing amongst concurrent creditors is altered to the extent of the junior creditor deferring his right to receive a dividend or payment of his claim. Consequently, the courts are challenged into deciding whether the statutory order of payment to an insolvent's creditors can be altered by a subordination agreement.

by him to the senior creditor."

⁹ *ibid*; p11; also cf Farrar; n.6; pp145-146.

¹⁰ RH Ryan, Jr: The subordinated world of junk bonds; (1988) 105 *Banking LJ* 4; pp4-5.

SOUTH AFRICAN CASE-LAW

In *Lind v Lefdal's Pianos Ltd (in liq) and Others*¹¹ Feetham J refused to recognise an agreement conferring priority amongst concurrent creditors, "because I think that the distribution of the assets of the [debtor] company on liquidation is governed by the provisions of the law, and no agreement which is in conflict with those provisions can be given effect to by the liquidators."¹² However, the concurrent creditors could enter into an agreement amongst themselves,¹³ in which case an applicant senior creditor would bring an interdict against the other creditors to force them to comply with their agreement.¹⁴

Further opinion expressed by the courts has been in the

¹¹ 1929 TPD 241.

¹² *ibid*; p247. Cf: pp248-9 for the policy reasons underlying this conclusion. The court summarized the agreement as follows:

"Then there is a clause in the agreement, clause 4, which is the important clause for the purpose of this application. This clause provides that the funds of the company from time to time available shall be applied, devoted and paid out in a certain order of priority; and that this order of priority "shall also prevail and be of the fullest force and effect, and binding upon the parties hereto upon the liquidation of the company." Then follows clauses (a), (b), (c), (d) and (e), dealing with this question of priority. Clauses (a), (b) deal with the payment of the salary of Lefdal, the managing director, and the payment of the salaries of other servants or employees of the company, and of the rents and general expenses of the company. These are the debt which are recognised by this agreement as being entitled to priority; first Lefdal's salary; secondly the other salaries and expenses. Then the third clause refers to th[e] debt to Lefdal Then follows (d) and (e), which deal with payments owing by the company to the suppliers" [*ibid*; pp242-43]

¹³ *ibid*; p248 and p249.

¹⁴ *ibid*; p249 and cf. p250 where an interdict was granted against the one company.

context of s 311 compromises under the Companies Act; accordingly, one must be careful to distinguish between a rejection of the *suitability* of a subordination contract under s 311 compromises, and a rejection of the *actual* subordination. Stegmann J in *Ex parte Lebowa Development Corp Ltd*¹⁵ rejected the s 311 compromise containing a contractual subordination, because the "proposed subordination of existing to future claims is *purely contractual*. *It effects no permanent change* in the statutory ranking of claims."¹⁶ However, he did not reject the substance of a contractual debt subordination. He acknowledged that the right to *pari passu* treatment can be waived in favour of the remaining creditors.¹⁷ But, Stegmann J remarked that the waiver of this statutory right must be bilateral.¹⁸ He was prepared to assume that the junior/subordinated creditor and the judicial manager and the debtor company were party to the contract. Thereafter, future creditors would have the benefit of accepting, the subordination.¹⁹

Stegmann J, therefore, was amenable to the existence of subordination contracts and thus, to the variation or deferment of a creditor's statutory ranking. A necessary corollary to this is that, provided the subordination agreement is a bilateral contract and its benefit has been accepted by future creditors, the debtor's liquidator is bound to adhere to the subordination. However, before Stegmann J could affirm this, he hastily warned that variation and cancellation of the subordination agreement could occur so easily and "[t]he

¹⁵ 1989 (3) SA 71 (T).

¹⁶ *ibid*; p94I. Emphasis added. He provides the following reasons for his supposition:

"It can be undone by contract. It may simply be overtaken by events and disappear (as where those who may be expected to uphold it cease to be)." (*ibid*).

¹⁷ *ibid*; p93E.

¹⁸ *ibid*; p93F.

¹⁹ *ibid*; pp93I-94A.

attempt to set up a different ranking will have been foiled";²⁰ consequently, the subordination contract was not suitable to the s 311 compromise.²¹

In *Ex parte de Villiers and Another NNO : In re Carbon Developments*²² Stegmann J adopted the opposite view concerning a concurrent creditor's waiver of his statutory right to receive a *pro rata* share of a debtor's assets:

"The only safe approach is to acknowledge that the decision in *Lind v Lefdal's Pianos Ltd* reaffirms the permanence of the statutory ranking of the claims of creditors ...; and that all attempts to vary such statutory ranking of claims by contract are of questionable validity"²³

Stegmann J's two judgments, therefore, are at variance with each other.

In re Carbon Developments went on appeal to the Appellate Division where the concept of debt subordination was accepted by the full court.²⁴ Goldstone JA premised his decision on the understanding that the consequence of a subordination is that:

"the [subordinated] creditor has no claim unless other creditors receive payment in full. There is

²⁰ *ibid*; p94FI.

²¹ Although his second reason for disliking such agreements was that they do not enlarge the debtor's equity base. [*ibid*; pp94J-95A]

²² 1992 (2) SA 95 (WLD).

²³ *ibid*; p122AB. Stegmann J reaffirmed his approach when he stated the following:

"In South Africa, having regard to the decision in *Lind v Lefdal's Pianos...*, the position would appear to be [that] ... [t]he liquidator of an insolvent company remains bound by the statutory ranking of claims and has no power to give effect to contracts purporting to vary it." (*ibid*; p122FG).

²⁴ *Ex parte de Villiers and another NNO: in re Carbon Developments (Pty) Ltd (in liquidation)* 1992 November 2, 27; pp1-15; unreported.

no question of a rearrangement of the claims of the creditors who are to be paid out of the unencumbered assets of the company. The position would be no different in principle from the case of a [creditor] who, for whatever reason, decided not to prove a claim with the liquidator That can hardly be categorized as interfering with the *pari passu* payment of creditors by the liquidator."²⁵

Thus, because the subordinated creditor has a claim of which the "enforceability is made subject to the fulfilment of a condition",²⁶ the end result is not a rearrangement of the order in which creditors are to be paid - as was the instance in *Lind v Lefdal's Pianos*²⁷ - consequently, the *pari passu* rule is not infringed. Goldstone JA correctly describes the effect of a subordination as being that:

"the debt comes into existence or continues to exist (as the case may be), but its enforceability is made subject to the fulfilment of a condition. Usually the condition is that the debt may be enforced by the creditor only if and when the value of the debtor's assets exceeds his liabilities, excluding the subordinated debt

In the event of the insolvency of the debtor, sequestration would normally mean that the condition upon which the enforceability of the debt depends will have become incapable of fulfilment. The legal result of this would be that the debt dies a natural death"²⁸

Having accepted the ability to subordinate debt, the next obstacle concerns the form which such a contract must assume. Goldstone JA argued that the form may be bilateral or multilateral, or may be via a *stipulatio alteri* or it may be

²⁵ *ibid*; p10.

²⁶ *ibid*; p9.

²⁷ *ibid*; p10 - this is the basis upon which Goldstone JA correctly relies to dismiss the use of *Lind v Lefdal's Pianos*.

²⁸ *ibid*; p9.

included as a term in a loan contract.²⁹ In contrast, one will recall that initially Stegmann J held that the subordination agreement must be bilateral in form and thereafter it had the effect of a *stipulatio alteri* and hence future creditors had the benefit of accepting (or rejecting) the subordination.³⁰

Other cases have considered contractual debt subordinations within the restraints of s 311 compromises; however, their views concerning the subordination agreement have converged upon the question whether such agreements "furnish an equity base upon which may properly rest a commensurate increase in the corporation's ability to obtain"³¹ solvency. That is, their focal point has been upon the suitability of the agreements to s 311 compromises. In *Ex parte Spendiff NO : In re Central Plumbing Works (Natal) (Pty) Ltd*; *Ex parte Spendiff NO : In re Candida Footwear Manufacturers (Pty) Ltd*; *Ex parte Spendriff NO : In re Jerseytex (Pty) Ltd*³² and *Cooper v A & G Fashions (Pty) Ltd*; *Ex parte Millman NO*³³ the courts, in principle, were prepared to accept a subordination agreement; but in *Singer NO v MJ Greeff Electrical Contractors (Pty) Ltd*³⁴ and *Ex parte de Villiers NO: In re MSL Publications (Pty) Ltd*³⁵ the courts were opposed to

²⁹ *ibid*. Goldstone JA expressed himself as follows: "Subordination agreements may take many forms. They may be bilateral, i.e. between the debtor and the creditor. They may be multilateral and include other creditors as parties. They may be in the form of a *stipulatio alteri*, i.e. for the benefit of other and future creditors and open to acceptance by them. The subordination agreement may be a term of the loan or it may be a collateral agreement entered into some time after the making of the loan." [*ibid*]

³⁰ *Supra*; n.18 and n.19, and accompanying text.

³¹ *Cape Times*; n.4.

³² 1988 (1) SA 616 (D&CLD).

³³ 1991 (4) SA 204 (CPD).

³⁴ 1990 (1) SA 530 (WLD).

³⁵ 1990 (4) SA 59 (WLD).

their use.

WAIVER OF A STATUTORY RIGHT

Although *In re Carbon Developments (AD)* has displaced reliance upon a subordination agreement constituting a waiver of the *pari passu* principle, I have decided to discuss the possibility of waiving a statutory right, as the conclusions reached disprove Stegmann J's theory that a statutory right cannot be waived.

Section 342(1) of the Companies Act states that 'in every winding-up of a company the assets shall be applied in payment of ..., subject to the provisions of section 435(1)(6), the claims of creditors as nearly as possible as they would be applied in payment of ... the claims of creditors under the law relating to insolvency ...'. The relevant insolvency law is contained in s 103(1)(a) Insolvency Act 24 of 1936: 'Any balance of the free residue after making provision for the expenditure mentioned in sections *ninety-six to one hundred and two inclusive* [i.e. preferent claims], shall be applied - (a) in the payment of the unsecured or otherwise non-preferent claims proved against the estate in question in proportion to the amount of each such claim'.

Christie provides an affirmative answer as to whether a statutory right can be waived.³⁶ He refers to *Bezuidenhout v AA Mutual Insurance Assoc Ltd.*,³⁷ where Kotze JA held that:

"Even a peremptory statutory provision may be renounced by a person for whose benefit it has been introduced. The scope of the rule is stated as follows by Craies on *Statute Law*, 7th ed, p269:
 'If the object of a statute is not one of general policy, or if the thing which is being done will benefit only a particular person or class of persons, then the conditions prescribed by the

³⁶ RH Christie: *The law of contract in South Africa*; 2nd ed., 1991; Butterworths, Durban; p533.

³⁷ 1978 (1) SA 703 (A).

statute are not considered as being indispensable. This rule is expressed by the maxim of law, *quilibet potest renuntiare juri pro se introducto*'.

In *Ritch and Bhyat v Union Government*, 1912 AD 719 at pp734-5, Innes ACJ points out that the rule of our common law is to the same effect [But] while everyone is entitled to renounce a right introduced for his benefit, that right ceases when a law prohibits the renunciation, especially when the prohibition is based not only on the debtor's right but also on public interest; for the agreements of private individuals cannot derogate from public laws."³⁸

But, Lubbe and Murray refer to *Vrystaatse Lewendehawe Koöperasie Bpk v Pretorius*³⁹ for the suggestion that the waiver of a statutory right is possibly illegal.⁴⁰ However, I disagree with their reliance upon this case: Flemming AJ stated the consideration before the court as follows:

"Die vraag is gevolglik daarna of die wetgewende voorskrifte ... in die kategorie val van regte wat uitsluitlik ten voordele van die [mens] geskep is en waarby beletsels uit hoofde van wyer belange ontbreek sodat die betrokke afstanddoening geldiglik gemaak kon word vir sover dit daardie gevolge aangaan."⁴¹

And Flemming AJ's conclusion was that the statutory right was not for the exclusive benefit of the party waiving such right, but also for the protection of other parties;⁴² consequently, such waiver was not possible:

"Wat nie moontlik is nie, is dat die afstanddoeningsbeginsel ingeroep word om ... andersluidende reelings meë to bring as wat die Wetgewer voorgeskryf het. Bepaaldelik is die

³⁸ *ibid*; p710AD.

³⁹ 1978 (1) SA 651 (O).

⁴⁰ *Farlam and Hathaway: Contract cases, material and commentary*; G Lubbe and C Murray, (eds): 3rd ed., 1988; Juta and Co Ltd, Cape Town; p729.

⁴¹ n.39; p654CD.

⁴² *ibid*; pp656H-657.

[statutêre regte/verwikkellinge] nie geskep in belang enkel van die applikant nie, maar is daar ook ander belange op die spel."⁴³

Consequently, it appears that the statutory *pari passu* right in the insolvency law can be waived if to do so is not contrary to public policy or the right waived does not grant benefits to third parties. That is, waiver of a right depends on the 'purpose' of such right; not on whether such right is mandatory or directory.⁴⁴

The *pari passu* rule exists to protect the concurrent creditor, and exists for his sole benefit. The subordination of this right does not adversely affect other concurrent creditors; consequently, I see no reason why a contractual subordination should not be allowed. No general public policy is overridden and no detrimental consequences are experienced by any class of persons.

Wood, correctly, states that:

"the object of the *pari passu* rule is to ensure that a creditor is not paid ahead of the general body of creditors rather than that one creditor agrees to be deferred. No policy of the insolvency law is offended [where a creditor defers his right to receive payment]."⁴⁵ [Emphasis added]

This concept of 'deferment' is the important factor. Perhaps it is better to refer to contractual subordination as the deferment of being treated as a concurrent creditor and not as the waiver of *pari passu* rights.

⁴³ *ibid*; p658F.

⁴⁴ RB Grantham: Legal imperialism and debt subordination: (1989) *NZLJ* 224; p225.

⁴⁵ Wood; n.2; p23.

FOREIGN JURISDICTIONS

In *Horne v Chester and Fein Property Developments Pty Ltd*⁴⁶ the court's policy was that provided the subordination did not "adversely affect the rights of strangers to the contract",⁴⁷ a liquidator must distribute in terms of such contract. While in *Re Walker Construction Co Ltd (in liq)*⁴⁸ the court argued that the statutory *pari passu* right is a private right and not a public right - although, as Farrar rightly observes, the special circumstances of the case do not permit one to rely upon it as authority.⁴⁹

The decision in *British Eagle International Airlines Ltd v Compagnie Nationale Air France*⁵⁰ has been the focus of attention. Farrar construes the decision as affirming that "the distribution rules applicable in bankruptcy and insolvent winding up must be observed and that it is against public policy to allow contracting out. They are not simply matters of private right which can be varied by agreement."⁵¹ This

⁴⁶ [1987] 5 ACLR 245. Referred to in Wood; n.2; pp23-24; and B Johnston : Contractual debt subordination and legislative reform; 1991 *J of Bus. L.* 225.

⁴⁷ Johnston; *ibid*; p230.

⁴⁸ [1960] NZLR 523. Referred to in Wood; n.2; p24 and Farrar; n.6; pp147-149.

⁴⁹ Farrar; *ibid*; p149.

⁵⁰ [1975] 2 All ER 390. Referred in Wood; n.2; p25; Farrar; n.6; p146 and p149; Grantham; n.44; and New hope for debt subordination; [1991] NZLJ 39.

⁵¹ Farrar; n.6; p149. Farrar proceeds to say that: "There seem to be two aspects of public policy involved here. One is that the legislation lays down a mandatory code of procedure to be administered in a proper and orderly way, and this is a matter in which the commercial community generally has an interest. The second is that to allow contracting out would be unfair and possibly a fraud on the general body of ordinary creditors. It is submitted that the latter will not always be the case If all the creditors are parties to the arrangement then the second point has no

'wide' interpretation is followed in *Carreras Rothmans Ltd v Freemans Matthews Treasure Ltd*.⁵² However, others have extracted a 'narrower' proposition from *British Eagle*: for example, Wood interprets the case as being "a decision on post-petition disposals, not *pari passu* payment of debts";⁵³ *Horne v Chester and Fein Property Developments*⁵⁴ regarded the case as stating "that in insolvency law, the whole of the debtor's estate should be available for distribution to all creditors, and no one creditor or group of creditors can lawfully contract in such a manner as to defeat other creditors not parties to the contract ...";⁵⁵ and lastly, Johnston, favouring a wide interpretation,⁵⁶ explains the contrast between these two approaches as follows: While debt subordination involves the senior creditor having 'priority' over the subordinated junior creditor, this is distinct from divestiture of the debtor company's property. It is the latter action which is prohibited under the narrow view of *British Eagle*.⁵⁷ Stegmann J in *Carbon Developments*⁵⁸ regrettably interpreted *British Eagle* as propounding the 'wide' interpretation.⁵⁹

*A-G v McMillan & Lockwood Ltd (In Rec, In liq)*⁶⁰ gave a different exposition of *British Eagle*. Their interpretation

validity." (ibid)

⁵² [1985] 1 All ER 155. Referred to in Johnston; n.46; p229.

⁵³ Wood; n.2; p25: "All that the case decided was the routine proposition that a creditor cannot, after insolvency, walk into the insolvent's house and help himself to the furniture"

⁵⁴ n.46. Referred to by Johnston; n.46; p230.

⁵⁵ The case was quoted in Johnston; ibid.

⁵⁶ ibid; pp231-32.

⁵⁷ ibid; p231.

⁵⁸ n.22.

⁵⁹ ibid; p120C.

⁶⁰ [1990] BLC 1508. Referred to in Grantham (1991); n.50.

was that the right to share equally may be waived in a debt subordination agreement made between the creditors. And they understood *British Eagle* as merely providing public policy concerns as to why such an agreement cannot be made with the company.⁶¹ However, under this interpretation, enforcement of the agreement is only between the creditors and does not involve the liquidator of the insolvent company. Thus, the liquidator would pay the junior creditor upon which occurrence there arises an obligation upon the latter to transfer the dividend to the senior creditor. This is really an example of a turnover subordination.

CONCLUSION

Fortunately, the future of contractual debt subordination agreements in South Africa is no longer dependent upon (1) *Lind v Lefdal's Pianos*' refusal to recognise an agreement governing priorities amongst creditors;⁶² and (2) waiver of the statutory *pari passu* right.

Reliance upon *Lind v Lefdal's Pianos* should be discouraged as the specific agreement was not of the nature of a subordination agreement. It attempted to provide an order of payment upon the insolvency of the company which was contrary to the spirit of the Insolvency Act.⁶³ However, a subordination agreement does not attempt such a feat - instead, the junior creditor merely agrees to defer his right to *pari passu* payment. Fortunately, the Appellate Division in *In re Carbon Development (AD)* recognised the different circumstances which existed in *Lind v Lefdal's Pianos* thereby distinguishing it from a debt subordination contract.

Can an individual defer a statutory right? The answer is dependent upon two elements: (1) public policy; and (2) third

⁶¹ Grantham; *ibid*; p41. Emphasis added.

⁶² n.11.

⁶³ See n.4 for a summary of the agreement.

parties. There exists no public policy which underlies the *pari passu* rule; the rule exists for the benefit of each concurrent creditor. Also, no third parties are adversely affected by the deferral of the creditors' right. One might be tempted to argue, as a last resort, that acknowledgement of a subordination agreement infringes upon the liquidator's work of distributing the assets; but Wood convincingly dismisses this agreement:

"The only policy which might be involved in preventing subordinations is that the liquidator should not be concerned with the extra work of reflecting priority agreements or be concerned with arrangements between creditors The answer to this is that the liquidator takes the insolvent as he finds him and that there is nothing new in the duty to pay claims in hierarchy or to value contingent debt."⁶⁴

Therefore, there is no reason why contractual debt subordinations should not be recognised.

POSTSCRIPT

1. Variation and cancellation of the subordination agreement:

This question has posed problems for the South African courts when deciding upon s 311 compromises: for example, *Ex parte Lebowa Development Corp*;⁶⁵ *Ex parte de Villiers : in re MSL Publications (Pty) Ltd*,⁶⁶ and *Carbon Developments*.⁶⁷ These cases take it for granted that that which has 'gone' (namely, the *pari passu* right) can be returned by cancellation of the subordination. However, Lubbe and Murray refer to the result of a waiver as being

⁶⁴ Wood; n.2; p25.

⁶⁵ n.15; p94IJ.

⁶⁶ 1990 (4) SA 59; p85FG.

⁶⁷ n.22; pp118D-119.

that the "legal consequences are ... extinguished."⁶⁸ Consequently, no right of the subordinated creditor to receive *pari passu* payment exists once he has waived his right. Hence, cancellation of the subordination agreement does not 'bring back' the right - the right has 'gone' forever.

But, if one views the contractual subordination as a deferral of a right to the *pari passu* rule, it is possible that one is dealing with a *pactum de non petendo*. A *pactum de non petendo* "suspends the capacity to enforce [the right], usually for a specified period or until the occurrence of some contingency"⁶⁹ and "does not extinguish the legal consequences of a transaction".⁷⁰ Consequently, variation of the subordination agreement is possible.

2. Uni- or bilateral waiver?

In *Ex parte Lebowa Development Corp* Stegmann J indicated that, at minimum, the waiver must be bilateral.⁷¹ However, the matter is uncertain. In *Impala Distributors v Taunus Chemical Manufacturing*⁷² the court stated that where a right is for the exclusive benefit of a party, he can unilaterally waive such right. In contract, *Union Free State Mining and Finance Corporation Ltd v Union Free State Gold and Diamond Mining Corporation Ltd*⁷³ adopted the contractual approach.

However, if one regards the subordination as a *stipulatio alteri*, which by its very nature requires an acceptance by

⁶⁸ *Farlam and Hathaway*; n.40; p730; RH Christie: *The law of contract in South Africa*; 1st ed, 1981; pp438-39.

⁶⁹ *Farlam and Hathaway*; *ibid.*

⁷⁰ *ibid.*

⁷¹ n.15; p93EJ-94A.

⁷² 1975 (3) SA 273 (T).

⁷³ 1960 (4) SA 547 (W).

the party in whose benefit the right is waived or deferred, the dispute as to whether bi- or unilateral waiver is required, surely no longer arises.

3. Acceptance of the *stipulatio alteri*.

Must this be at the time when the potential 'senior' creditor extends credit to the debtor, or at the time of the debtor's liquidation? It seems unfair to argue that acceptance must be at the time when the senior creditor extends credit to the company, because the unsuspecting creditor is disadvantaged. The ignorant creditor relies upon the company's existence as an indication that the company has some form of an equity base. Consequently, could one not argue that there is an implied acceptance?

CONTINGENT AND TURNOVER SUBORDINATION

Under turnover subordinations - both a subordination trust or a debtor-creditor turnover subordination - the statutory *pari passu* right is not infringed as the junior creditor claims his full amount (ie *pari passu* and then 'turns over' any difference necessary to the senior creditor). As Wood points out: "The turnover obligation, which achieves the subordination, is purely a relationship between the junior creditor and the senior creditor."⁷⁴

The advantage of the trust over the ordinary turnover is that under the trust agreement the senior creditor acquires "a proprietary claim against the junior creditor for recoveries on the junior debt".⁷⁵ The senior creditor under the debtor-creditor turnover lacks such a proprietary claim and is dependant upon the junior creditor's prolonged solvency.⁷⁶

⁷⁴ Wood; n.2; p26.

⁷⁵ *ibid*; pp9-10.

⁷⁶ *ibid*; pp10-11.

The mechanics behind a contingent debt subordination is as follows:

"the junior debt is contingent or conditional on the debtor being able to pay the senior creditor in full. If the debtor is insolvent, the senior creditor will not be paid in full. The junior creditor in effect renounces his junior debt in that event. If the debtor would be solvent if the junior debt were shared down but not wholly wiped out, then the junior debt is diminished accordingly. If the debtor would still be insolvent even if the junior debt were completely wiped out, the junior debt is cancelled."⁷⁷

Therefore, the mechanics of a contingent subordination are precisely the same as Goldstone JA's interpretation of a contractual subordination. The contractual subordination is a contingent subordination; consequently,

"because the junior debt is inherently contingent and is hence provable only in its contingent amount If the debtor is insolvent and the junior debt is conditional on solvency, the provable amount will usually be nil."⁷⁸

To avoid any difficulties surrounding the *pari passu* principle, it is best to use a subordination trust.

The South African context certainly has been biased by the fact that the courts were considering subordinations within the broader sphere of s 311 compromises and the future solvency or insolvency of the debtor company. Unfortunately, therefore, a more in-depth analysis of subordination agreements has not developed; and there is a corresponding lack of law concerning the actual 'substance' of such agreements.⁷⁹

⁷⁷ *ibid*; p11. Wood warns that regrettably "the drafting of the contingency can never be entirely satisfactory". [*ibid*]

⁷⁸ *ibid*; p26.

⁷⁹ For a greater analysis of the actual 'substance' of subordination agreements and what the American courts, especially in California, have laid down, see the very interesting article by HB Lambe: *Enforceability of subordination agreements*; (1984) 19 *Real Property, Probate and*

NEGATIVE PLEDGE COVENANTS

"The purpose of the original negative pledge covenants was simply to prevent the diversion of assets of the borrower to subsequent secured creditors. It also served to maintain equality of treatment between creditors of the same class, and to act as a deterrent on further excessive borrowing by the borrower."⁸⁰

This limit on 'subsequent secured credit' has been used in the context of the protection of secured and unsecured loans. The negative pledge protecting secured loans generally provides that "the debtor company ... will not, without the prior written consent of the debenture holder, grant any subsequent security ranking in priority to or *pari passu* with the floating charge."⁸¹ However, the trend in corporate finance today is to use a negative pledge within the context of unsecured lending. In this instance "[t]he objective is ... to ensure that if the debtor [company] does [give security] then the prior (unsecured) lender will either have equal and rateable security⁸² over the same asset or be given security over other assets of the debtor to at least the same value."⁸³ It is the negative pledge in the unsecured loan to which I shall limit my discussion.

Trust J. 631.

⁸⁰ DE Allan: Negative pledge lending - dead or alive? How to re-invent the mortgage; (1990) 5 *J.I.B.L.* 330; p330.

⁸¹ RM Goode: *Legal problems of credit and security*; 2nd ed., 1988; Sweet and Maxwell, London; p18. See also Farrar; n.6; pp137-138.

⁸² 'equal and rateable security': McDaniel makes the following observation concerning the meaning to be ascribed to this phrase: the understanding to be attributed to 'equal' is that the security will be "on a parity with the bonds"; while 'rateable' means that security will be "on a proportionate basis". (MW McDaniel: Are negative pledge clauses in public debt issues obsolete?; (1983) 38 *Bus. Law.* 867; p867.) McDaniel footnotes the following:

"It has been suggested that 'equal and ratably' is self-contradictory because 'equally' means in equal shares. In view of the purpose of the negative pledge clause, 'equally' must mean equal in rank." (ibid, n4.)

⁸³ Goode; n.81.

The unsecured lender (i.e. the prior/original lender) can attain 'securitization' under a negative pledge by means of either an affirmative or a negative covenant. In the former instance the borrower agrees that if it secures another creditor, it will grant equal and ratable security to the original lender; while the negative form states that the borrower will not give security to a subsequent creditor, without giving equal and ratable security to the original lender.⁸⁴ The significance of the distinction between affirmative and negative covenants is stated as follows by Goode:

"In its purely negative form the covenant does not involve a promise by the borrower to give equal and rateable security (or security of equal value); the provision of such security is simply a *condition* of the borrower's licence to encumber the asset. By contrast the affirmative covenant *obliges* the borrower to give security to the first financier upon the occurrence of the designated contingency, i.e. grant of security to the second financier."⁸⁵

How does the above distinction influence default?

"in [its] negative form ... the furnishing of security is merely a non-promissory condition of the debtor's right to incumber the asset. Accordingly the first creditor is not entitled to security, even if the covenant is broken, as he has not bargained for it. The position is otherwise in the case of an affirmative covenant The occurrence of the stipulated event triggers the debtor's promise to give security [A]t the very least [the first creditor] has a personal

⁸⁴ For examples of a drafted affirmative and negative covenants/forms, cf FW Jacobs: The effect of provision for ratable protection of debenture holders in case of subsequent mortgage; (1938) 52 *Harv. L. Rev.* 77; p127.

⁸⁵ Goode; n.81; pp18-19 (emphasis added). See also: Negative Pledge Clauses; (1965) 79 *Harv. L. Rev.* 263-266, pp264-65 and JB Stone: The 'affirmative' negative pledge; (1991) 6 *J.I.B.L.* 364; p369, where Stone refers to Gabriel as submitting "that the clause does not have the effect of causing a promise to grant a security (which would be specifically enforceable...) to come to life."

right to call for [security]."⁸⁶

However, whether the negative pledge is drafted in the affirmative or negative form, problems of enforcement continue to exist, except that an affirmative covenant/form has fewer disadvantages. The event of breach or default with respect to the negative pledge is very real and has prompted the following remark:

"One of the greatest fears of a lender under a negative pledge is that a borrower will do something dishonest. But since the negative pledge covenant is not a publicly binding document, there is little to stop a corporate securing funds outside the agreement."⁸⁷

REMEDIES AND ENFORCEMENT AGAINST THE BORROWER

In selecting the appropriate route the objective must be to "preserv[e] sufficient assets to satisfy the claim of the negative pledge lender".⁸⁸ Default in the negative pledge - i.e. the provision of security to the future lender - may be elucidatory of a borrower's pivotal financial credit worthiness.⁸⁹ Therefore the negative pledge lender is in danger of not being fully repaid - at least for the present moment. Consequently, it is wiser to adopt a course of action conducive to the preservation of the borrower's assets thereby making concessions for future repayment.

Allan notes that it is customary to include breach of the negative pledge as an event of default, "which then affords the original lender the right to accelerate repayment of his loan, either immediately or on demand. The lender is then, on

⁸⁶ Goode; n.81; pp19-20.

⁸⁷ Negative pledge lending: negative pledges on the hook; *Australia's capital markets*; p8; Supplement to (1989) No 60 *Corp. Finance*.

⁸⁸ Allan; n.80; p331.

⁸⁹ *ibid.*

default in repayment, free to enforce repayment by whatever means may be appropriate."⁹⁰ The inclusion of this breach as an event of default is especially relevant where the negative pledge is in the form of a negative covenant. However, where the breach of a negative pledge in the negative form is anticipated, the original lender would fare better by bringing an interdict against the borrower restraining him from so breaching the negative pledge. In contrast, the negative pledge lender under an affirmative covenant can sue for specific performance as "the affirmative covenant *obliges* the borrower to give security to the first financier upon the occurrence of the designated contingency".⁹¹ Alternatively, the original lender can have a power of attorney so that he himself can register the security once the borrower has breached the negative pledge. But, the negative pledge lender will rank after the subsequent lender as the timing of the registration of his security is subsequent to the second lender.⁹² If the borrower is in financial difficulties, the better route for the negative pledge lender under the affirmative covenant, is that of specific performance, rather than suing for acceleration of repayment upon default.

A remedy accessible to the original lender (under both covenants) is to sue for damages: "liquidated damages [for] recovery of the debt ... or ... unliquidated damages for breaches other than defaults in payment."⁹³ Stone argues that given a borrower's solvency, "generally common law damages will

⁹⁰ *ibid.*

⁹¹ Goode; n.81; pp18-19 (emphasis added). But suing for specific performance within the six month period under voidable preferences (s 29 of the Insolvency Act 24 of 1936) does provide an obstacle - however, see heading on "Insolvency of the borrower".

⁹² Hence, within the South African context, it is better to require that one be given security over *other* assets of the debtor. Otherwise, where one has such subsequent registration in respect of the same asset, the excess remaining to be repaid ranks as a concurrent credit.

⁹³ Allan; n.80; p331 and Stone; n.85; p369.

be an adequate remedy for breach of the negative pledge"⁹⁴ and he even refers to "expectation loss":⁹⁵

"the negative pledge lender ... bargains for something more than the mere contractual right to have his debt repaid. In extracting the negative covenant from the debtor, he gains a further legal right against the debtor which gives him greater control over the debtor's assets and undertaking than he would otherwise have. The debtor is restricted in his freedom to charge his assets and thus the carrying on of his business.

While this advantage that the negative pledge lender has over ordinary unsecured creditors may be 'no substitute for good old-fashioned security', it is nevertheless something that he has bargained for and is entitled to be compensated for if lost."⁹⁶

The equivalent position in South African law is *lucrum cessans*.⁹⁷ However, Allan warns that suing for damages is time consuming and therefore to be avoided.⁹⁸ Of course, once the borrower is insolvent, suing for damages is useless.

If negative pledge lending is to be used as a source of financing, then, from the lender's standpoint, an affirmative covenant should be used - but one should remember the premonitory remark of Goode:

"It is, of course, a question of construction whether the covenant is negative or affirmative. A covenant which appears at first sight to be negative may, when the instrument is construed as a whole, be read as importing a promise, not simply stating a condition."⁹⁹

However, two areas provide problems when the remedy of

⁹⁴ J Stone: Will a court appoint a receiver at the request of a negative pledge lender? (1991) 6 *J.I.B.L.* 405; p409.

⁹⁵ *ibid.*

⁹⁶ *ibid.*; pp408-09.

⁹⁷ *Farlam and Hathaway*; n.40; pp606-07, Note 8; and pp633-38.

⁹⁸ Allan; n.80; p331.

⁹⁹ Goode; n.81; p19.

specific performance is enforced: firstly, timing of the registration of the original lender's security; and secondly, enforcement of the security when the borrower is insolvent.

1. Timing of Registration of Security: Once specific performance is sought, the implication is that the subsequent lender has already obtained security and is the first to be registered. Where the negative pledge lender is to be secured under the same asset as the subsequent lender, the negative pledge lender, upon specific performance will rank after the subsequent lender, because the rule in the South African law states that 'first in time, is first in law' - *qui prior est tempore potior est iure*.¹⁰⁰ To overcome this problem, it is better therefore, to require the borrower to grant security over other assets to at least the same value.

2. Insolvency of the borrower: Where specific performance is sought within the six month period referred to in s 29 of the Insolvency Act 24 of 1936 (i.e. voidable preferences), the negative pledge lender's security may constitute a voidable preference. However, the negative pledge lender under an affirmative covenant has a right to security given the breach of the negative pledge, and as Smith states, concerning the object behind voidable preferences: "a person ... should not be permitted to select for payment out of a number of creditors, one who has no right to such selection."¹⁰¹ Breach of the affirmative covenant results in the original lender having a right to security, consequently, the insolvent should be permitted to secure him.

The onus is upon the negative pledge lender to prove that the security is in the ordinary course of business.

¹⁰⁰ For general comments on secured rights, cf. Joubert: *LAWSA: Mortgage and Pledge*; Vol. 17; para's 435 and 440.

¹⁰¹ C Smith: *The law of insolvency*; 3rd ed; 1988; Butterworths, Durban; p125.

However, it has been held that "it is not in the ordinary course of business for a bond to be passed for a past consideration."¹⁰² Given the development of negative pledges, surely it is in the ordinary course of business to grant security over a past consideration?

REMEDIES AGAINST SUBSEQUENT LENDER

The temptation might be to distinguish between the presence or absence of knowledge/notice of the negative pledge on the part of the subsequent lender; thereby arguing that against the lender without notice, the negative pledge lender has no remedy; and against the lender with notice, such subsequent lender "does not take clear of the [original lender's] rights, whatever they may be".¹⁰³ However, this comparison is relevant only where the negative pledge requires 'securitization' over the same asset as is secured for the subsequent lender, but the subsequent lender with notice of the negative pledge, insists on prohibiting subsequent mortgages. In such an instance the subsequent lender indeed has taken in "fraud"¹⁰⁴ of the original lender. Accordingly, the negative pledge lender can sue for an order setting aside the security.¹⁰⁵ Such an order does seem dependent upon the negative pledge being in an affirmative form thereby conferring a right upon the lender (whereas in the negative form, the securing of the loan is a condition).

Alternatively, because the 'fraud' extends only to the

¹⁰² *Mars: The law of insolvency in South Africa*; E de la Rey, ed.; 8th ed, 1988; Juta and Co Ltd, Cape Town; pp220-21 and p221n156 where the following cases are cited as reference: *Estate Sperryn and Dommissie v National Bank* 1923 TPD 166 and *Erlank's Trustee v Erlank* 1910 TPD 342.

¹⁰³ Jacobs; n.84; p118.

¹⁰⁴ *Cohen v Shires, McHattie and King* (1882)1 SAZ 41; p46.

¹⁰⁵ *ibid*; and *Coaton v Alexander* 1879 Buch. 17 and *Cato v Alion and Helps* (1922) 43 NLR 469; p471.

prohibition against subsequent mortgages, the original lender can seek to have such prohibition set aside¹⁰⁶ and to be included in the security coverage. Although, in terms of this alternative route the original lender will not rank *pari passu* as his registration ranks subsequent to the second lender. But, the original lender has an action for damages in delict against the subsequent lender for the excess remaining which the estate is unable to repay.

In all other instances the onus is upon the borrower to ensure the negative pledge lender is secured.

OTHER CLAUSES INCLUDED IN NEGATIVE PLEDGE COVENANTS

There are two other clauses which also form part of a negative pledge, and they concern the following areas:

- (1) "all financial ratios are within the norms for the sector of industry in which the company operates";¹⁰⁷
- (2) "the financial reporting of the company has to be full, accurate and timely."¹⁰⁸

However, such clauses are not exclusive to negative pledges; indeed, one could categorize them as standard clauses used in loan contracts generally.¹⁰⁹

CONCLUSION

While negative pledge lending might seem a suicidal form of financing when viewed from the original lender's perspective,

¹⁰⁶ In *Coaton v Alexander* (ibid; p21) is an example where the court found there to be 'fraud' with respect to part of the entire transaction.

¹⁰⁷ Farrar; n.6; p139.

¹⁰⁸ *ibid*.

¹⁰⁹ See the discussion headed, 'Standard contractual clauses', for a further discussion of these two clauses.

it is important to remember that it should only be to a particular type of borrower that it is extended. Thus, it has been opined that negative pledge lending should not be extended

"beyond prime credits. 'If you are getting to the stage where you have to get your hands on a security, you are obviously dealing with a client that was not good enough for negative pledge lending in the first place'".¹¹⁰

Similarly, Stock makes the following comment:

"The negative pledge deed is a statement by the company, on which lenders are depending, that the company will operate its business within certain financial ratios and criteria that will give lenders adequate protection. In many respects the deed is relying on the 'name' of the borrower and not on security. If the borrower has sufficient standing within the financial markets to create credibility for its future ability to finance borrowings, and if it can provide adequate financial data to support its projections and historically has shown that these projections are supportable, then it is probably in a reasonable position to contemplate a negative pledge deed."¹¹¹

Notwithstanding this optimistic outlook, the balance of probabilities is that, while negative pledges were created to overcome the situation that, in their absence, the "assets of the borrower which [were] encumbered by security interests in favour of specified lenders [would] obviously not be available to satisfy the claims of other (unsecured) creditors",¹¹² today a trend in South Africa towards negative pledge financing might not place the unsecured creditor in any better a position. The negative pledge lender has the opportunity of being placed in an equal position with a subsequent secured lender only if the

¹¹⁰ n.87; p8.

¹¹¹ D Stock: New forms of debt financing; in Farrar (ed.); n.6; p127.

¹¹² LC Buchheit: Negative pledge clauses: the games people play; (1990) 9 *Int. Finan. L. Rev.* 10; p10.

negative pledge requires security in another asset and such requirement is the subject of a right, that is, the negative pledge itself is in an affirmative form.

POSTSCRIPT I: "FIVE BASIC EXCEPTIONS"¹¹³

McDaniel refers to the following exceptions when the borrower can secure another lender without also securing the original lender:

1. "[M]ortgages on property to finance the purchase or construction thereof The mortgage financing must be committed for or closed within a reasonable time after the property is acquired (eg, one year). The increase in debt is offset by the asset acquired. Asset coverage remains unchanged and may increase to the extent the issuer has some equity in the mortgage property. Some issuers have enlarged this exception to permit mortgages on an existing property to finance the cost of its repair, alteration or improvement."¹¹⁴
2. "[E]xisting mortgages on property acquired by the issuer This exception is much like the first. It makes little difference whether the issuer puts a mortgage on an asset in order to purchase it or purchases an asset that already has a mortgage on it."¹¹⁵
3. "[M]ortgages existing at the date of the indenture are excepted because a buyer of a new debenture issue presumably has taken those mortgages into account when he makes his investment decision."¹¹⁶
4. "[M]ortgages that renew or replace permitted mortgages Since permitted mortgages may have any maturity, it does not matter if an issuer extends their maturity. Also, it does not matter if an issuer replaces a mortgage with another one for

¹¹³ McDaniel; n.82; pp869-70.

¹¹⁴ *ibid.*

¹¹⁵ *ibid.*

¹¹⁶ *ibid.*

the same amount because asset coverage remains unchanged."¹¹⁷

5. "[A]ll other mortgages which together do not secure debt that exceeds [X] per cent¹¹⁸ ... of consolidated net tangible assets (or stockholders equity) are excepted Unlike the [above] exceptions, which depend on the character of the mortgage ..., [this] ... clause exception limits the quantity of mortgage debt."¹¹⁹

POSTSCRIPT II: SALE-LEASEBACK COVENANTS

The negative pledge on its own does not prevent the issuer from entering into a sale-leaseback transaction and thereby achieving the same end as a mortgage transaction. Consequently, McDaniel observes that the negative pledge should also include a covenant restricting sale-leaseback covenants:

"because the transaction has substantially the same effect on unsecured [negative pledge holders] as a mortgage of the same asset. The asset becomes the property of the lessor and is no longer available to satisfy claims of unsecured creditors. Moreover, the rent often approximates the fixed charges on a mortgage loan. A sale-leaseback covenant is a backstop to the negative pledge clause and may be considered an extension of it."¹²⁰

¹¹⁷ *ibid.*

¹¹⁸ The actual percentage used by McDaniel is five percent, although he concedes that occasionally it is ten percent. (*ibid.*)

¹¹⁹ *ibid.*

¹²⁰ *ibid.*; pp867-68. McDaniel makes the following remarks about this covenant:

"Sales-leaseback covenants cover the same assets and have the same exceptions plus a few others. One exception is that an issuer may do a sale-leaseback of property if the issuer could have mortgaged it. Thus, all the exceptions of the negative pledge clause are imported into the sale-leaseback covenant. In addition, sale-leasebacks for as long as three years are excepted. Sale-leasebacks may be excepted if the sale proceeds are used to pay down long-term debt. The loss of an asset is offset by a reduction in debt. Sale-leasebacks may be

OTHER STANDARD COVENANTS

Fisher identifies the following covenants as being salient considerations in drafting bank loans:

- ".Cross default
- .Non-disposal of assets
- .Borrowing limits
- .Other financial ratios
- .Change of business
- .Material adverse change."¹²¹

To this list I would like to add a further two covenants:

- .Access to financial information
- .Change of control.

In selecting the optimum combination of covenants not only with respect to the particular transaction but also in regard to past and future contracts, the corporate borrower has to take into account, amongst other things, that it does "not want the unnecessary burden of monitoring different borrowing obligations that have different covenants attached."¹²² While it can be argued that "corporates are looking for consistency across the board for their covenants",¹²³ a warning has been sounded that "covenants may well have evolved in different circumstances and in the light of trading considerations they

excepted if the sale proceeds are used to acquire another principal property, such as a major plant. The loss of one asset is offset by the acquisition of another." (ibid; p870).

¹²¹ M Fisher: When covenants become a bind; (1992) No. 86 *Corp. Finance* 37; p37.

¹²² *ibid*; p38.

¹²³ *ibid*.

may no longer be appropriate.'"¹²⁴

The lender's emphasis, when constructing covenants, is epitomized in the definition of 'credit risk' - namely, "the risk of a change in the nature of the borrower or its business, which has, or may have, an adverse effect on the borrower's ability either to service or to repay its debt."¹²⁵ In their article on covenants, Beaumont and Crosthwaith expostulate that the content of such credit risk has diversified:

"the attention of lenders was mainly directed towards matters of credit over which borrowers, to a greater or lesser extent, had effective control."¹²⁶

"The new departure is to be found in those covenants which are designed to protect investors against risks which are normally outside the control of the issuer, or at least where factors outside its control are decisive."¹²⁷

¹²⁴ *ibid.*

¹²⁵ R Beaumont and J Crosthwait: Credit risk covenants; (1990) 12 *The Treasurer* 56; p56.

¹²⁶ *ibid.* They identify the following covenants as being subsumed within this category:

"the level of overall borrowings expressed as a proportion of the borrower's net worth, fundamental changes in the nature of the borrower's business (a lender might be happy to lend to a brewer with a good record of running its brewery; less happy if the brewer were to decide to become a casino operator), and disposals of substantial assets or parts of the business (the existence of which was influential on the decision to lend) and reinvestment of the proceeds in different types of asset." (*ibid.*; pp56-58)

¹²⁷ *ibid.*; p58.

"[T]he event which has claimed the interest of most commentators, including investors and issuers, is the take-over bid [I]nvestors have to calculate that their issuers may be 'at risk' from a bid in the course of the life of a loan Modern take-over techniques include the use of the target's assets to finance the bid ... or the stripping of assets or profits out of the target Investors also have a residual but real concern that change of ownership in an issuer could

.CROSS DEFAULT

Example: 'If any material indebtedness or obligation for any loans, constituting indebtedness of the borrower become due and payable, prior to its specified maturity, by reason of default, or are not paid when due',¹²⁸

then such occurrence shall constitute an 'event of demand/default' in the present loan.

The relevance of a cross default covenant would seem to lie on the following aspects: Prior payment (by reason of default) will result in an outflow of cash from the borrower and allows the other lender (to whom such prior payment is due), in effect, to have priority over remaining lenders. By using a cross default covenant, other lenders also are able to achieve a degree of 'preference'. Of course, the danger of using cross default covenants is that they can prematurely force the borrower into liquidation as capital sums (and not merely interest payments) are forced to be paid. However, the reason for the inclusion of a cross default clause when a 'material indebtedness or obligation for any loans ... are not paid when due', is linked to the possibility that non-payment of a sum when due, is an indication that the borrower is facing financial instability; consequently, such cross default allows the lender to call up the loan before maturity and so ensure his safety instead of being paid out in insolvent conditions.

A disadvantage of the cross default covenant is the

lead to ... intangible loss [such as] to good-will, to management quality, or to perceived financial standing because of the issuer's new-found association with a group which does not enjoy the long-term confidence of the market. Increasingly, therefore, [lenders] have sought to impose a 'change of control' [covenant as an 'event of default']."
(ibid; p58)

The 'change of control' can also be referred to as an event risk clause. (Fisher; n.121; p40) This quote provides an example of the 'new departure'.

¹²⁸ This covenant appeared in a bank loan agreement.

difficulty of monitoring the events to which it refers.

.NON-DISPOSAL OF ASSETS

Example: 'If ... the Borrower disposes of a material portion of its undertakings or assets or changes its asset structure, except in the normal course of business or the value of the Borrower's assets is materially reduced',¹²⁹ then, such occurrence constitutes an event of default.

A flaw with the above covenant is that the phrase 'material portion' is not defined. Rather, the restriction should be "in proportion to the asset value of the company, unless proceeds are reinvested in cash generating assets to maintain the corporate business as a going concern."¹³⁰ An alternative approach is to specify which assets cannot be disposed of - however, not only is this a rather cumbersome procedure, but it does not take into consideration the acquisition of future assets and therefore its scope becomes confined.

The restriction on the disposal of assets provides greater protection for a lender if the concept of disposal is elaborated upon to include the following actions: "the borrower 'shall not sell, lease, assign, transfer or otherwise dispose of (whether in one transaction or a series of related

¹²⁹ *ibid.*

¹³⁰ T Quinn and R Rees: Ten years in the corporate bond market; 1989 *The Treasurer : Commemorative Issue* 50; p52. Simpson makes the following remark concerning the 'percentage' restriction:

"the borrower should be permitted to 'net' out such assets against any liabilities of borrower which the purchaser is assuming in connection with the transfer, or to which he will take subject, and should be allowed to make the sale provided that the 'net' book value of such assets, as so determined, does not exceed the permitted amount." (DB Simpson: *The drafting of loan agreements: a borrower's viewpoint*; (1973) 28 *Bus. Law.* 1161; p1194).

transactions) any of its assets"¹³¹

Smith and Warner consider the following to be a disadvantage of such a covenant:

"One cost associated with flat prohibitions on the sale of particular assets rises from the fact that the firm is not permitted to divest itself of those assets whose value to others is greater than the value to itself. Thus the restriction which permits asset sale if the proceeds are applied to the purchase of new fixed asset lowers this opportunity cost."¹³²

.BORROWING LIMITS AND OTHER FINANCIAL RATIOS

The value of a lender's loan is impaired by every subsequent liability incurred by the borrower; consequently borrowing limits and other financial ratios are incorporated into loan agreements so as to minimize such a threat.

There are a variety of combinations of components which can constitute the ratios.¹³³ The definition of such components is important. For example, where the borrowing limit "is calculated as a ratio of the borrowing base, which is usually shareholders equity",¹³⁴ "it is important to define exactly what comprises borrowing for this purpose, and what the share capital and reserve figure is made up of."¹³⁵ Therefore, shareholders' equity should include "an acquisition or issue of share capital halfway through the year."¹³⁶ Similarly, as

¹³¹ RS Simmons: *Drafting of commercial bank loan agreements*; (1972) 28 *Bus. Law.* 179; p195.

¹³² CW Smith and JB Warner: *On financial contracting: an analysis of bond covenants*; (1979) 7 *J. of Financial Economics* 117; p127.

¹³³ Cf: *ibid*; p136 and RJ Lister: *Debenture covenants and corporate value*; (1985) 6 *Co. Law.* 209; pp210-211.

¹³⁴ Fisher; n.121.

¹³⁵ *ibid*.

¹³⁶ *ibid*; p37-38.

one practitioner noted: "One of the critical things in determining net equity is whether you are going to include the intangibles such as goodwill or brands in that definition."¹³⁷ Thus, from a legal perspective, it is the definition of the ratio's components which are important - once this is established, the problem arises of monitoring compliance with the formulas.

.CHANGE OF BUSINESS

An event of default occurs if "the Borrower is unable or ceases, for any reason, whatsoever, to conduct its normal line of business in an ordinary and regular manner."¹³⁸ While such a covenant is aimed at deterring a borrower from changing his 'normal line of business'¹³⁹ and, therefore, possibly engaging in a more risky venture, the covenant does not prevent a borrower from expanding to include a new line of business and so imposing additional risk upon his venture. However, an affirmative drafting of such a covenant would seem to cater for such an expansion. The affirmative form can be stated as follows: "the borrower [shall] continue to conduct and operate its business substantially as conducted and operated during the present and preceding calendar year".¹⁴⁰

A 'change of business' covenant can act as a means of overcoming credit/event risk;¹⁴¹ however, it can also prevent

¹³⁷ *ibid*; p38. The practical consequence of all this is illustrated as follows:

"When a corporate is covenanted to be able to borrow a certain multiple of its shareholder funds, it can increase its borrowing threefold if it is able to increase its shareholders funds by 150%." (*ibid*)

¹³⁸ This covenant appeared in a bank loan agreement.

¹³⁹ Simmons (n.131; p190) gives the example of "a manufacturer of knitting machines decid[ing] to abandon that business and becom[ing] a producer of motion pictures".

¹⁴⁰ *ibid*. See also WA Klein and JC Coffee: *Business organisation and finance: Legal and economic principles*; 4th ed, 1990; Foundation Press, New York; p225.

¹⁴¹ See n.125 and text for definition of credit/event risk.

a corporation from expanding into more profitable ventures.

.MATERIAL ADVERSE CHANGE

An event of demand/default occurs: "if a material change in the financial condition of the Borrower occurs, subsequent to the date of its last audited financial statements and such change will, in the opinion of [the Bank's] auditors prevent or aggravate the Borrower's ability to perform or observe its obligations in terms of this Agreement."¹⁴²

Reference to the borrower's 'last audited financial statement' allows for a yearly review of the corporation. However, of pre-eminent concern is the definition of the phrase 'material (adverse) change'. A particularly compelling elucidation of this phrase is provided by Simmons:

"There is doubt that it could be used as a basis for refusing to [continue with the loan service] where the loan agreement contains substantial financial covenants with respect to which the borrower was still in compliance, such as maintenance of tangible worth and working capital."¹⁴³

While this type of covenant does not offer the best protection - namely, the lender having his investment returned to him before the material adverse change - at minimum, it allows a lender to have a greater rate of return than waiting until insolvency and only then claiming repayment. However, some do dispute its effectiveness in offering protection to lenders.¹⁴⁴

.ACCESS TO FINANCIAL INFORMATION

This type of clause pertains to an 'undertaking' by the corporation rather than a covenant giving rise to an event of default.

¹⁴² This covenant appeared in a bank loan agreement.

¹⁴³ Simmons; n.131; p187.

¹⁴⁴ Fisher; n.121; p40.

Example:

"(1) The Lender shall be entitled to receive from the Borrower, on demand, and from time to time, a copy of the Borrower's most recent audited annual financial statements or most recent unaudited interim report, or such other financial information or reports relating to the Borrower's solvency as the Johannesburg Stock Exchange would be entitled to require from the Borrower if the Borrower were a public company listed on the Johannesburg Stock Exchange.

(2) In the event of a significant deterioration in the financial strength of the Borrower or in the principal markets in which it operates, the Lender shall be entitled to receive from the Borrower on demand a copy of the Borrower's most recent management accounts or such other financial information or reports relating to the Borrower's solvency as the Lender may reasonably request."¹⁴⁵

Smith and Warner argue that "bondholders find financial statements to be useful in ascertaining whether the provisions of the contract have been (or are about to be) violated."¹⁴⁶ Consequently, if a borrower can tabulate such information at a smaller cost than would be expended by the lender, it is to the borrower's advantage to covenant for the above undertaking.¹⁴⁷ It should be noted that where the borrower has subsidiaries, the lender should require the financial statements to be consolidated.

Failure to supply such information results in breach of contract, for which the lender has the remedy of specific performance; unless it is provided that any breach of the agreement constitutes an event of default - hence, the borrower would be faced with an accelerated maturity date of repayment of the loan. Regarding the occurrence that the composition of such information is incorrect or incomplete, the lender can protect himself by requiring the borrower to warrant the correctness of such information.

¹⁴⁵ This covenant appeared in an agreement where the lender was an institutional investor.

¹⁴⁶ Smith and Warner; n.132; p143.

¹⁴⁷ *ibid*; pp143-44.

.CHANGE OF CONTROL

Change of control by way of take-overs is the credit/event risk that has gained prominence in this age of take-overs and mergers; consequently,

"[a]t its most sophisticated, the change of control provision seeks to measure the effect of a bid on the credit of the borrowers and thereby achieve what was originally intended - protection not against any particular happening in itself, but against adverse consequences for the borrower's credit."¹⁴⁸

A 'change of control' covenant can result in the borrower's directors breaching their fiduciary duty to their shareholders. Beaumont and Crosthwait offer the following advice:

"If all likely lenders insist upon such a term, so that the company cannot borrow without agreeing to it, then the directors should find no difficulty in reaching the required conclusion. In other cases, the directors may find that they can borrow on financial terms which are more advantageous to the company if they agree to the change of control provision, and that may constitute proper grounds for such agreement. It is an area where the borrower's directors must move with caution."¹⁴⁹

CONCLUSION

"What is important about these covenants is the strength of the whole. In each case it may be possible to find a way round a single covenant, but a bond structure with [a variety of] covenants provides a firm and sensible framework of liability management."¹⁵⁰

However, irrespective of whether one is dealing with relationship or transactional lending, a great deterrent to a borrower 'abusing' its lenders is the adverse consequences it

¹⁴⁸ Beaumont and Crosthwait; n.125; p59.

¹⁴⁹ *ibid.*

¹⁵⁰ Quinn and Rees; n.130; p52.

has upon the borrower's reputation and consequently its ability to obtain financing in the future.

SUMMARY

- . The subordinated creditor only has a claim against the debtor once the other creditors are paid in full.
- . Once the debtor is sequestrated, the condition upon which the enforceability of the subordinated debt depends (i.e. excess assets remaining), will have become incapable of fulfilment.
- . If subordination is regarded as the waiver of the *pari passu* right, then it is still permissible to subordinate a claim, because, in waiving one's right, no public right is offended, nor are third party rights adversely affected.
- . A negative pledge in the affirmative form can be enforced by specific performance.
- . The original lender can sue for damages where the negative pledge is in either a negative or an affirmative form, because he has bargained for something more.
- . It is best to use a negative pledge in the affirmative form as it imposes an obligation upon the borrower.
- . The negative pledge lender should require security to be given in 'another asset of equal value' so as to overcome the problem of timing of registration.
- . The subsequent lender takes 'in fraud' of the original lender only where the negative pledge is in the affirmative form.
- . When using or agreeing to be bound under 'other standard covenants/restrictions', one must bear in mind the ease with which to monitor compliance with such covenants.
- . Standard covenants are used to protect the lender against credit risk.
- . Defining key concepts/phrases used in the standard covenants/restrictions is important.

CHAPTER 7

THE USE AND LEGAL EFFECTIVENESS
OF COMFORT LETTERS AND
NOTARIAL BONDS^{*1}LETTERS OF COMFORT¹

"A comfort letter is a letter written usually by a parent company, or even by a government, to the lender giving comfort to the lender about a loan made to a subsidiary or a public company."²

Thus the term 'comfort' refers to the degree of protection or security tendered to the lender - specifically protection concerning the repayment of the loan. Consequently, "[a]t its legal maximum ... a comfort letter should contain the promise of a surety [or guarantee]. At its weakest, a comfort letter is a mere introduction, an act of comity."³

^{1*} I have chosen to discuss these two forms of 'security' so as to clarify the protection or preference they offer the holder of such documents. There are other forms of security, such as, guarantees, co-principal debtors, or joint and several liability, which one could discuss, however it has been in the fields of comfort letters and notarial bonds that recent development has occurred - and it is upon such events that I have decided to enumerate.

¹ Such letters are also referred to as letters of assurance, support, responsibility or awareness. Cf: R Sacasas and D Wiesner: *Comfort letters: the legal and business implications*; (1987) 104 *Bank. L.J.* 313; p314n3.

² PR Wood: *Law and practice of international finance*; 1980; p307. See also Sacasas and Wiesner (*ibid*) at pp316-29 for an overview of the variety of comfort letters in existence.

³ Sacasas and Wiesner; n.1; p315.

Examples of comfort offered are the following:

"The parent company undertakes for the life of the loan extended to the subsidiary:

- a) to maintain its present participation in the subsidiary;
- b) [not applicable to South African law];
- c) to exercise its influence on the subsidiary that it meets its financial obligations;
- d) to provide its subsidiary with the financial means to meet its obligations;
- e) to maintain a certain equity capital of the subsidiary."⁴

"f) Should during the life of your loan our shareholding in [subsidiary] company be disposed of or be reduced by more than x per cent, we shall on your demand assume a guaranty in accordance with the enclosed draft.

g) We hereby confirm that it is our present and future business policy to provide to our subsidiaries financial means which are sufficient to enable them to fulfil all of their present and future obligations; or as a variation thereof:

h) It has always been our business policy to provide our subsidiaries with sufficient means to fulfil their financial obligations, and we shall act accordingly during the life of your loan.

i) We shall not financially exhaust (or drain) our subsidiary to the extent that it is no longer able to fulfil its financial obligations.

j) In view of our company's standing we have always looked at our subsidiaries obligations as our own obligations."^{5:6}

Because comfort letters are generally used as an expedient to overcome issuing a guarantee, the problem of form arises - namely, whether a comfort letter constitutes a contractual obligation. Failing liability based on contract, other remedies suggested to be of use are that of estoppel and especially misrepresentation. What follows, then, is an

⁴ Letters of responsibility; (1978) 6 *Intern. Bus. Law*. 288; p290.

⁵ *ibid*; p291.

⁶ See also W Faul: Letters of comfort; 1990 *TSAR* 73; p77; and Sacasas and Wiesner; n.1; p33ln54 for examples of comfort letters.

analysis of such liabilities and remedies.

CONTRACTUAL LIABILITY

For an agreement to constitute a contract, there must have been the necessary intention to create binding obligations. However, apart from this element of serious intention, another factor which plays a vital role, is the construction or interpretation of the terms of a comfort letter. As Reynolds states, "usually the wording is so vague that it would be difficult to show an enforceable obligation",⁷ or as Wood points out, "[e]ven if the letter is legally binding, commonly its terms are so woolly and the commitments of such limited effect that the letter does not give rise to substantial rights."⁸ Consequently, when analysing the construction of the relevant comfort terms, the following guideline has been proffered:

1. The intention of the relevant parties is ascertained from the language employed in the letter.
2. Its ordinary meaning and, in appropriate circumstances, its technical comprehension, are attributed to the words of the letter; provided that to do so will not result in some farcical understanding of such words nor will it create a consequence not envisaged.
3. The interpretation of the letter always is set within the context of the entire content of the comfort letter.
4. To assist an interpretation, background circumstances are admissible, however surrounding circumstances are relied

⁷ L Sarna: *Corporate structure, finance and operations*; vol. 3; Carswel Co. Ltd., Toronto; cf chapter by JI Reynolds: *Assuring contractual performance: standby letters of credit, performance guarantees and letters of comfort - new flasks for old wine*; p261.

⁸ Wood; n.2; p307.

upon only in the instance of ambiguity.⁹

5. The letter will be 'void for vagueness' where its terms are so vague and woolly that no intention can be gauged from such terms.¹⁰

An example of a comfort term which the court was called upon to analyse is the following: "It is our policy to ensure that the business of [the subsidiary; i.e. the borrower] is at all times in a position to meet its liabilities to you."¹¹ Hirst J concluded that:

"The wording ... is unequivocal and categorical I think that the phraseology is fully apt to express a legal obligation I do not think that any greater strength would have been added ... if it had begun "We confirm that it is our policy ...". Thus I ... consider the wording ... completely apt to constitute a contractual undertaking."¹²

However, on appeal, the decision of Hirst J was reversed. Ralph Gibson LJ held that the term:

"contains no express words of promise. [The paragraph ... is in its terms a statement of present fact and not a promise as to future conduct [I]n this regard, the words of [this] paragraph ... are in sharp contrast with the words ... 'We confirm that we will not [etc].'

The force of this point is not limited, as Hirst J stated, to the absence from [the] paragraph ... of the words "We confirm". The real contrast is between the words of promise, namely, "we will not"..., and the words of statement of fact "it is

⁹ see *Farlam and Hathaway; Contract cases, materials and commentary*; G Lubbe and C Murray, (eds); 3rd ed., 1988; Juta and Co. Ltd., Cape Town; at pp460-63 concerning the admissibility of background and surrounding circumstances.

¹⁰ G Radesich and A Trichardt: Comfort letters: are they binding under South African law?; 1988 *De Rebus* 795; p797.

¹¹ *Kleinwort Benson Ltd v Malaysia Mining Corp. Berhad* [1988] 1 WLR 799 (QB); see headnote; p799.

¹² *ibid*; p809BC.

our policy" in [this] paragraph¹³

Ralph Gibson LJ concluded that if the comfort letter had stated that 'It is and will be our policy ...', then only, could Hirst J have concluded that a contractual undertaking existed.¹⁴ Thus, Ralph Gibson LJ concluded that the above linguistic interpretation of the word 'policy', together with its contextual setting,¹⁵ indicated an absence of an intention to promise future conduct.

Forte argues that the phrase 'at all times' did refer to future performance and therefore it is not necessary to state that "it is and will be our policy". But this consequence still did not result in the comfort letter being legally binding, because:

"If one applies to the term 'policy' the basic rule of construction that words are to be interpreted in accordance with their normal or popular meaning, then 'policy', as defined in the *Concise Oxford Dictionary*, refers to some 'prudent, expedient, or advantageous procedure; prudent or politic course of action'; or to 'any course of action adopted as advantageous or expedient'. Accordingly, a representation that it is one's 'policy' to support a subsidiary is merely one of intention and not a statement of immutable fact. One's policy might change and there is no assurance given that it will not."¹⁶

While Forte is correct to interpret 'policy' as a concept that changes and therefore cannot refer to a future policy or performance; the interpretation of the comfort term as having

¹³ *Kleinwort Benson Ltd v Malaysia Mining Corp. Berhard* [1989] 1 WLR 379 (AC); p390EF.

¹⁴ *ibid.* Brown argues that the concept of future performance is found in the phrase "at all times". I Brown : *The letter of comfort: placebo or promise?; 1990 J. of Bus. L.* 281; p288.

¹⁵ *ibid*; p390H-93D.

¹⁶ ADM Forte: *Letters of comfort or letters of cold comfort; (1990) 21 J. of Mar. L. and Com.* 99; pp107-08.

a "future effect"¹⁷ and consequently his rejection of the Appeal Court's decision is flawed. The comfort clause stated that it was the company's *policy* to ensure that the business of the borrower was at all times in a position to meet its liability. Forte interprets the phrase *at all times* as qualifying a future commitment of the company's *policy*. But this is incorrect. There is a difference between saying: (1) 'the company's policy at all times is to ensure ...'; and (2) 'the company's policy is to ensure that the borrower is at all times able to meet its liabilities'. The relevant comfort clause did not follow the wording of example (1), which in terms of Forte's approach would have placed an obligation on the company. Instead, the clause was of the second example and the policy was not stated as being of a future nature.

Whether a statement that "it is our present and future policy ..." ¹⁸ gives rise to a legally enforceable obligation, is unclear. Ralph Gibson LJ indicated that it does constitute a legal obligation.¹⁹ But Smart seems less inclined to follow such an answer: while the reference to a 'future policy' "[w]ould make it a little more difficult for the parent company"²⁰ to argue that its policy has changed, "at the same time I do not think that they would significantly improve the bank's position. How can one say what one's policy is going to be in the future?"²¹ Schneider makes no express reference to the effect of the phrase 'future policy'; however, he reasons that it is implicit and axiomatic that the policy statement is to be discerned as remaining in existence until such time as the interests and financial well-being of the company dictate that the policy requires amendment.²² Bylund

¹⁷ *ibid*; p107.

¹⁸ See point (g) of list above.

¹⁹ *Kleinwort Benson v Malaysia Mining* (1989, AC); p390GH.

²⁰ Letters of responsibility; n4; p298.

²¹ *ibid*.

²² *ibid*; p308; see also his remarks at point (e) on p308.

seems uncertain as to whether a commitment would result,²³ while Miller argues that it "appears to be a statement on the issuer's present intention as to future policy, and unenforceable as an agreement under the laws of the United States [of America]."²⁴ However, even though the word 'policy' incorporates the element of change in the future, I think that once the parent company states that it is their present and future policy, such a statement commits the company to preventing any change in the future and gives rise to a legal obligation.

In *Commonwealth Bank v TLI Management*²⁵ Tadgell J held the following phrases and words in a comfort letter to be ambiguous: 'We confirm that we will ...',²⁶ 'complete', 'take-over arrangements', 'as soon as legally possible'; 'injection of sufficient capital'.²⁷ The terms of the comfort which the parent provided, were:

"We confirm that the company will complete take-over arrangements (subject to shareholders' approval) of [the subsidiary] as soon as legally possibly. These arrangements include the injection of sufficient capital to repay the temporary facility as mentioned above to (*sic*) take-over date or within 30 days of this date."²⁸

Tadgell J interpreted the phrase 'we confirm that we will', as follows:

"It would have been very simple, if [a contractual obligation] had been intended, to have used words of promise, such as 'we agree', 'we undertake', or even

²³ *ibid*; p314,

²⁴ *ibid*; p331.

²⁵ *Commonwealth Bank of Australia v TLI Management Pty Ltd* [1990] VR 510.

²⁶ *ibid*; p515.

²⁷ *ibid*; p516.

²⁸ *ibid*; see headnote; p510.

'we promise'. The words 'we confirm that we will ...' were, in the circumstances, at least ambiguous."²⁹

In contrast to Tadgell J's approach, is that of Rogers CJ in *Banque Brussels v Australian National*.³⁰ Rogers CJ held that a term stating that "it is our practice to ensure ...", was a contractual promise.³¹ Such a finding is surely incorrect because the understanding of the word 'practice' is similar to that of 'policy' and, therefore, being susceptible to change, is not a statement as to a continuing, future performance. However, Rogers CJ's decision is understandable considering his statement that:

"there should be no room in the proper flow of commerce for some purgatory where statements made by businessmen, after hard bargaining and made to induce another business person to enter into a business transaction would, without any express statement to that effect, reside in a twilight zone of merely honourable agreement."³²

Even if one does decide that phrases, such as, 'it is our policy/practice', or 'we confirm that ...', are of contractual effect, the obstacle which must be overcome is that often it will be difficult to enforce compliance with the content/substance of such policy, practice or confirmation. For example, if the company states that it is its policy to ensure that the borrower is able to meet its liabilities, the question arises as to how such 'assurance' will be attained: will the parent company pay the lender directly or will it give the money to the borrower who then is under the obligation to pay the lender (and the parent company does not need to police such obligation)? Hence, one is again dealing with problems

²⁹ *ibid*; p515.

³⁰ *Banque Brussels Lambert SA v Australian National Industries Ltd* [1989] 21 NSWLR 502.

³¹ *ibid*; pp525G-26A.

³² *ibid*; p523B.

of vagueness. To protect himself as a means of last resort, the borrower can include an *undertaking* that the 'comforter' will provide him with prior written notification of any change to his policy. Thus, if his policy changes, without notice being given to the borrower, the latter can use such breach of the undertaking as a cause of action, rather than using the comfort clause.

MISREPRESENTATION AND DELICT

Delictual liability exists whether the comfort letters constitute a contract³³ or not. However, Wood sounds the following warning: the intention must be with reference to the time of contracting the comfort letter and it must be established that the parent company did not have the relevant intention; however, problems of causation then arise, because the loss suffered must be as a result of the absence of such relevant intention.³⁴

The following point was included in a set of guidelines concerning the issuance or acceptance of comfort letters:

'A letter must have been relied upon BEFORE a transaction was entered into (i.e. the letter must confirm a misrepresentation made in the course of negotiations which induced the parties to contract).'³⁵

But, such a guideline is worthless where the representation refers to the company's policy/practice/intention: as Clark notes with respect to *Kleinwort Benson v Malaysia Mining* about the company's change of policy:

³³ See *Bayer South Africa (Pty) Ltd v Frost* 1991 (4) SA 559 (AD) where the Appellate Division confirmed that "in principle, a negligent misstatement which induces a person to enter into a contract may, depending on the circumstances, give rise to a delictual claim for damages at the suit of the person to whom it was made." (ibid; headnote; p560A).

³⁴ Wood; n.2; p308.

³⁵ Banking document.

"The assumption must be, then, that the decision not to cover the subsidiary's debt was made at some point after the bank had made its last advance under the loan agreement, so that despite the lack of notice no *material* detrimental reliance could be made out. Potential liability in misrepresentation is thus so theoretical as to be illusory."³⁶

For reliance upon misrepresentation, Faul lists the following requirements:

- "(i) The representation must be *false* as to existing fact.
- (ii) The fact misrepresented must be *material*. This means the misrepresentation must be of such a nature and probable effect of *inducing* the person to whom it was made to enter into a contract.
- (iii) The representation must have been made with the *intention* that it must be acted upon by the injured party.
- (iv) The misrepresentation must have *actually* deceived the other person into entering into the contract."³⁷

ESTOPPEL

Radesich and Trichardt provide the following illustration of when estoppel may exist:

"There may be situations where a comfort letter is not a contract. However, if one of the parties subsequently acts as though the comfort letter was a contract which created a legal obligation, that party may be estopped later from denying the existence of that legal obligation."³⁸

This statement only seems to have significance for the parent company issuing the comfort letter; but surely there will be no occurrence of it acting as if the letter is a contract.

³⁶ DH Clarke: Case comments; (1990) 69 Can. Bar Rev. 753; pp758-59. Also see *Kleinwort Benson v Malaysia Mining (1989, AC)*; p386AC.

³⁷ Faul; n.6; p79.

³⁸ Radesich and Trichardt; n.10; p797.

Even if it did so act, as Wood points out, "commonly its terms are so woolly and the commitments of such limited effect that the letter does not give rise to substantial rights."³⁹

CONCLUSION

Considering the remedies available to the lender to secure repayment of a loan, one is tempted to question the use and viability of comfort letters. A prudent lender must allow two factors to be weighed when considering the 'comfort' provided: the strength and solvency of the issuing company and the adverse reputation affecting the issuer upon 'default' of the letter. Hence, Sacasas and Wiesner remark that "one cannot discount moral suasion as an enforcement vehicle."⁴⁰ Thus, when rating the strengths of promises of repayment, they regard a "[c]omfort letter without actionable words given by [a] substantial entity with excellent reputation within [a] highly competitive industry where potential for 'moral suasion' exists"⁴¹ as offering greater protection than an "[a]bsolute guarantee of payment or collection or a comfort letter with actionable words given by [an] unsubstantial entity with [a] poor reputation."⁴²

Concerning the intentions behind the issuance of comfort letters, Bohlhoff provides the following reasons: firstly the comfort letter issuer wishes to avoid a legal commitment; secondly, conscious of its credit rating, the comfort issuer regards it as an inferior practice to guarantee its subsidiaries' loans; and finally, by issuing a comfort letter, the issuer believes that he does not incur any liability and consequently he does not have to disclose the comfort as a

³⁹ Wood; n.2; p307.

⁴⁰ Sacasas and Wiesner; n.1; p329.

⁴¹ *ibid*; see point (7.0); p336.

⁴² *ibid*; see point (9.5).

contingent liability.⁴³ Apart from point (a) - where it would be clear that no contractual obligations are contemplated - the question is whether the other reasons still allow for some sort of legal consequence. In *Banque Brussels v Australian National Rogers* CJ concluded that:

"in relation to letters of comfort generally ..., consistently with intending to make a legally binding commitment, a company may wish it not to have the character of a guarantee. Secondly, the letter makes clear that the defendant is not assuming secondary liability for the debts of the principal debtor.... The statements made in the letter are more remote from the liability of [the subsidiary] to repay the facility. By reason of this, a failure to adhere to the statements made will, at best, give rise merely to a claim for damages and throw up considerable questions of causation. Nonetheless, the promises, had they been fulfilled, were calculated to put the plaintiff in a position to receive payment from [the subsidiary]. It is these factors which ... distinguish the letter from a guarantee...."⁴⁴

And other points raised to support a finding of legal consequence are "the commercial importance of the letter of comfort to the [lenders] and the fact of reliance carried forward into performance."⁴⁵

However, there are equally convincing opposing arguments concerning legal consequence. The 'fact of reliance' by a lender does not necessarily mean that the lender is entitled, logically, to rely upon the comfort letter as having legal consequence; a lender's reliance can equally be based upon the 'moral suasion' which he can exercise upon the issuer.⁴⁶ The

⁴³ Letters of responsibility; n.4; p289.

⁴⁴ *Banque Brussels v Australian National*; n.30; p522EG. See also Hirst J's judgment in *Kleinwort Benson v Malaysia Mining* (1988); n.11; p809EH, for a similar argument.

⁴⁵ Brown; n.13; pp288-289; and Faul; n.6; p84.

⁴⁶ Cf: BJ Davenport: A very comfortable comfort letter; 1988 *Lloyds Mar. & Com. L. Q.* 290; pp293-294; and *Kleinwort Benson v Malaysia Mining* (1989, AC); p391DH.

vague words employed in comfort letters seem indicative of the fact that it is primarily a moral responsibility which the issuer will incur. One must accept that a comfort letter signifies a bargaining situation where one party - the parent company - is in a more powerful position; because, if the lender were the stronger party, it could insist on a guarantee or some other standard form of security.

NOTARIAL BONDS

(Other than the Natal-type bonds)

The central question concerning notarial bonds is whether a special notarial bond gives the bondholder any preference with respect to the free residue of the bond issuer's insolvent estate. The Appellate Division in the case of *Cooper v Die Meester*⁴⁷ has decided in the negative, thereby rejecting the decision of the court *a quo* in *Cooper v Die Meester* (1991).⁴⁸

The controversy arose because s 102 of the Insolvency Act 24 of 1936 provides for the preference of a claim 'secured by a general mortgage bond'; the entire section states the following, under the heading, 'Preference under a general bond':

s 102: Thereafter any balance of the free residue shall be applied in the payment of any claims proved against the estate in question which were *secured by a general mortgage bond*, in their order of preference with interest thereon' (emphasis added.)

Unfortunately, no definition of 'general mortgage bond' is provided in the Insolvency Act.

⁴⁷ *Cooper NO en Andere v Die Meester en 'n Ander* 1992 (3) SA 60 (AA).

⁴⁸ *Cooper NO en Andere v Die Meester en 'n Ander* 1991 (3) SA 158 (OPA).

COOPER V DIE MEESTER (1991)

Olivier J in *Cooper v Die Meester* (1991) concluded as follows:

"Wat het die Wetgewer bedoel in art 102 met 'n algemene verband'?

Die gemelde woorde kan:

- (a) die gemeneregtlike betekenis dra van 'n verband, hetsy oor roerendes of onroerendes, oor algemeen-omskrewe goedere, of
- (b) die tegniese betekenis dra van 'nie 'n spesiale verband wat sekuriteit gee nie'.

Ek meen dat die bedoeling van die Wetgewer was om (b) uit te druk."⁴⁹

Olivier J's final remarks concerning payment were that:

"[d]ie applikant se advokaat het myns insiens tereg toegegee dat die preferensie net geld tot die mate van die opbrengs van die bates wat aan die verband onderhewig was. Die rekening moet dus so opgestel word dat die volgorde van preferensies soos in die Insolvensiewet neergelê, gehandhaaf word. Wanneer die onderhawige preferensie aan die beurt kom, geld dit slegs, as preferente eis, tot die opbrengs van die versekerde goed wat dan nog in die vrye oorskot beskikbaar is."⁵⁰ (Emphasis added)

Once Olivier J had concluded that the phrase 'general mortgage bond' refers to all bonds other than those as defined in the Insolvency Act as 'special mortgages', he had two options from which to choose when deciding which part of the free residue would provide payment: preference could be either "in relation to all the free residue that ranks equally with the genuinely

⁴⁹ *Cooper v Die Meester* (1991); n.48; p173FG. The Insolvency Act defines 'spesiale verband'/'special mortgage' as: 'a mortgage bond hypothecating any immovable property or a notarial mortgage bond hypothecating specially described movable property in terms of section one of the Notarial Bonds (Natal) Act, 1932 (Act No. 18 of 1932), but excludes any other mortgage bond hypothecating movable property'.

⁵⁰ *ibid*; p174FG.

general bond (subject, of course, to time priority)"⁵¹ or, as he concluded, in relation to the proceeds of the secured goods, which goods are still available in the free residue. Sacks predicted that when faced with this choice, this latter option would probably be chosen.⁵² The result achieved using the latter option is the same as that obtained under the argument that the reference to a general bond excludes a special bond, but the common law preference still exists - "[i]n this situation, the special bondholder may be allowed a preference only in relation to such of the free residue that consists of the proceeds of the specially hypothecated movables."⁵³

COOPER V DIE MEESTER (AD)

In *Cooper v Die Meester (AD)* Joubert JA agreed with the submissions of the appellants that the list of preferent creditors contained in ss 96(1) to 102 of the Insolvency Act is a closed list and consequently, one cannot include a preference which is not specifically therein mentioned⁵⁴ - therefore, it seems that permitting the special notarial bondholder preference in terms of the common law preference, is now not a viable interpretation. Joubert JA also confirmed that anomalies are reached if a special notarial bond is included within the ambit of a general mortgage bond and because of such anomalies, one can conclude that it was not the Legislature's intention to include special notarial bondholders as preferent creditors:

⁵¹ P Sacks: Notarial bonds in South African law; 1982 SALJ 605; p;613.

⁵² *ibid.*

⁵³ *ibid.*; pp612-13. The case relied upon as advocating this common law approach is *Vrede Koöperatiewe Landboumaatskappy v Uys* 1964 (2) SA 283 (O). Also see: *Wille' law of mortgage and pledge*; ;TJ Scott and S Scott (eds); 3rd ed, 1987; Juta and Co. Ltd.; p68.

⁵⁴ *Cooper v Die Meester (AA)*; n.47; p82GH; and point (2), p85EF.

"Van die vernaamste anomalieë wat deur sodanige opstel van die boedelrekening veroorsaak word of kan word, is die volgende:

(1) Wat van die koste van die instandhouding en tegeldemaking van die betrokke beswaarde bates. Moet dit van die opbrengs van die betrokke beswaarde bates afgetrek word?... [D]ie Wetgewer [het] nie voorsiening gemaak vir 'n ... bepaling ten aansien van die opbrengs van bates onderhewig aan 'n vrye oorskot-preferensie nie.

(2) Die vrye oorskot is 'n enkele omvattende fonds Die Wetgewer maak geen voorsiening daarvoor om die opbrengs van nie-sekuriteite in die vrye oorskot te oormerk nie...

(3) Dit gebeur dikwels in die praktyk dat die trustee nie-sekuriteit en masse te gelde maak in welke geval dit onmoontlik sal wees om die opbrengs van roerende bates wat deur 'n spesiale notariële verband beswaar is, vas te stel.⁵⁵

The bondholder did not emulate the reasoning of Olivier J; instead, he asserted that the common law preference afforded to a special notarial bondholder still existed and that the Insolvency Act had not abolished such common law preference.⁵⁶ The respondent attempted to circumvent the reference in s 102 to 'general mortgage bond' by asserting that ss 86 and 102 must be read together: while s 86 prohibits preference being given to a general mortgage bond over immoveables and a mortgage bond hypothecating immoveables by means of a general clause, s 102 'reassures' the holder of the general mortgage bond that he still has a preference where such general mortgage bond secures movable property. However, it must not be inferred from this 'reassurance' that the common law preference of special notarial bonds is thereby abolished.⁵⁷ In essence the

⁵⁵ *ibid*; pp82I-83E.

⁵⁶ *ibid*; pp 67D-68C for the entire argument.

⁵⁷ *ibid*. Respondent argued as follows:

"Artikel 86 moet saamgelees word met art 102.... Artikel 86 is dus 'n kwalifikasie van die bepalings van art 102 in die sin dat dit uit art 86 blyk dat 'n *algemene verband* oor *onroerende goed* geen preferensie verleen nie. Die afleiding uit 'n saamlees van hierdie artikels is dus dat 'n *algemene verband* oor *roerende goed* wel 'n preferensie verleen. Daar is egter nog 'n kwalifikasie op laasgenoemde stelling, wat ook uit die bepalings van

bondholder is advocating that there are two species of bonds over movables: (1) the general mortgage bond, and (2) the notarial bond (both special and general notarial bonds).

The bondholder's argument neglects the prohibitions in s 53 of the Deeds Registries Act 47 of 1937 which provides that the Registrar of Deeds 'shall not attest any mortgage bond which purports to bind movable property or which contains ... [a] general clause, purporting to bind generally all the ... movable property of the debtor' Therefore, s 53 invalidates the above argument of the respondent. Regrettably Joubert JA did not accentuate this importance of s 53. Instead, Joubert JA includes a reference to s 53 within his larger argument of why a general mortgage bond in s 102 of the Insolvency Act means a general notarial bond.⁵⁸ Understandably the court had to conclude as to the meaning of the phrase 'general mortgage bond'; however, s 53's importance in defeating the bondholder's approach, should have been noted.

Joubert JA's approach to analysing the meaning of 'general

art 86 blyk, naamlik dat geen algemene klousule in 'n verband wat onroerende goed verhipotekeer, enige preferensie verleen nie Die doel van art 102 was dus om as kwalifikasie te dien van die bepalings van art 86 om dit wat hierbo uiteengesit is, duidelik na vore te bring. Uit die feit dat die 1936-Wet nie uitdruklik bepaal dat 'n spesiale notariële verband 'n preferensie het nie, kan nie by wyse van 'n noodwendige implikasie afgelei word dat die Wetgewer die bestaande gemeenregtelike preferensie van 'n spesiale notariële verband wou afskaf nie." (ibid; p67DH)

However, Joubert JA interpreted respondent's argument as follows:

"Sy submissie was dat art 102 nóg met algemene notariële verbande nóg met spesiale notariële verbande handel. Die begrip 'algemene verband' word afgesien van art 102 ook in arts 86 en 88 aangetref. In art 102 beteken 'algemene verband' nie 'n algemene notariële verband nie. Volgens hom het die algemene verband oor onroerende goed bestaan totdat die registrasie daarvan deur art 53(1) van die Registrasie van Aktes Wet 47 van 1937 verbied is." (ibid; p83FG)

⁵⁸ ibid; p85CD.

mortgage bond', was to understand it as referring to a 'general bond' which 'bond' has the capacity of being either a mortgage bond having 'general' characteristics or a notarial bond having 'general' characteristics and through a process of elimination he concluded that the 'general bond' referred to a general notarial bond.⁵⁹ The various 'general bonds' are:

A. Mortgage bond over:⁶⁰

- 1) specified immovables plus a general clause over immovables;
- 2) specified immovables plus a general clause over movables;
- 3) immovables generally; and
- 4) movables generally.

B. Notarial bond over:⁶¹

- 1) specified movables plus a general clause over movables;
- 2) movables generally; and
- 3) immovables generally.

Joubert JA eliminated the various options as follows:

- 1) Bond A:1 offers no preference to the bondholder (s 86, Insolvency Act) and such a bond cannot be registered (s 53, Deeds Registries Act);⁶²
- 2) Bond A:2 is prohibited from being registered (s 53, Deeds Registries Act);⁶³
- 3) Bond A:3 offers no preference to the bondholder (s 86, Insolvency Act);⁶⁴
- 4) Bond B:3 cannot be registered (s 53, Deeds Registries

⁵⁹ *ibid*; pp84B-85D.

⁶⁰ A mortgage bond over specified immovable property, given such specification, is not an example of a 'general bond'.

⁶¹ A notarial bond over specified movable property, given such specification, is not an example of a 'general bond'.

⁶² *Cooper v Die Meester* (AA); n.47; p85BC.

⁶³ *ibid*; p85C.

⁶⁴ *ibid*; p85AB.

Act).⁶⁵

To the list one must also add that Bond A:4 is also eliminated, as one cannot register such a bond (s 53, Deeds Registries Act); while the legal position of a special notarial bond which includes a general clause over the movables (Bond B:1) remains to be decided. Consequently, given the above eliminations, the only bond remaining is Bond B:2, a general notarial bond.⁶⁶ Joubert JA's reasoning also lends itself to disproving Olivier J's conclusion that 'general bond' in s 102 of the Insolvency Act means a bond which is not a 'special bond' as defined in s 2 of the Act.

CONCLUSION

If one accepts the list of statutory preferences is a closed list, it seems that Joubert JA was forced into arriving at his conclusion. If he had failed to do so, the relevance of s 102 would have been questioned. Given Joubert JA's judgment, we now have the situation where a general mortgage bond means a general notarial bond, but s 102 of the Deeds Registries Act defines a mortgage bond as a bond over specified immovable property and a notarial bond as a bond over movable property. Thus on either side of the equation 'general mortgage bond' = 'general notarial bond', the key concepts of mortgage bond and notarial bond refer to opposing concepts - namely, immovable property and movable property (respectively). Not even the approach of Wunsh can overcome this lamentable state of affairs.⁶⁷ What is required is legislative reform

⁶⁵ *ibid*; p85D.

⁶⁶ *ibid*; p85D. Joubert JA concluded that:
 "Alles in ag geneem het die Wetgewer na my oordeel met 'algemene verband' in art 102 'n algemene notariële verband wat al die roerende sake van die verbandgewer beswaar, bedoel." (*ibid*)

⁶⁷ B Wunsh: What rights of preference are enjoyed by a special notarial bond?; 1960 *THRHR* 112. Wunsh attempts the following reasoning to argue that 'general bond' must be understood as encapsulating all other bonds other than special

addressing the criticisms raised by the appellant. Consequently the following aspects must be considered:

- 1) The apparent exclusion of special notarial bonds from preference as a concurrent creditor.
- 2) 'Costs to which securities are subject' (s 89 of the Insolvency Act) - are such costs to be applied to special notarial bondholders? One cannot merely make the assumption as the court in *B Ebrahim Ismail and Co v Kahn's Trustee*⁶⁸ made - namely,

"I can see no difficulty in so framing the distribution accounts as to allocate to a particular creditor a preference in respect of the proceeds of a particular asset. When I use the word 'proceeds' I mean, of course, the net proceeds which remain after deducting from the price realised by that asset such expenses as are incidental to bringing into the estate, maintaining and conserving it, and selling it, including also such statutory preferences as rank before the bond."⁶⁹

Reform is needed, as one can well understand bondholders wishing to specify movable property so as to secure their loan.

SUMMARY

COMFORT LETTERS

. Whether comfort letters constitute contractual obligations

bonds as defined in the Insolvency Act:

"Section 88 [of the Insolvency Act] ... commences 'a mortgage bond other than a kustingsbrief, whether special or general ...'. The section clearly intended to deal with all categories of mortgage bonds and has done so on the basis that the dichotomy is 'general' and 'special' bonds so that the former must refer to notarial bonds in the general whether such bonds be general or special bonds in the technical sense."

⁶⁸ 1930 NPD 136.

⁶⁹ *ibid*; p143.

is a question of form.

- . Both the intention of the parties and the construction of the terms determine whether the letter gives rise to contractual obligations.
- . One must distinguish between words of promise and words of fact.
- . A statement as to the issuer's 'policy' is not necessarily a statement as to his future policy. It is unclear whether a statement as to the issuer's 'present and future policy' gives rise to enforceable obligations.
- . Delictual liability exists irrespective of whether the letter constitutes a contract or not; however, it will be problematical to establish causation.
- . Even if the issuer may act as though a contract exists, it will be difficult to enforce the letter, because generally its terms are so woolly and vague.
- . When all else fails, one still has moral suasion as an enforcement mechanism.

NOTARIAL BONDS

- . A special notarial bond does not have the common law preference, because the list of preferred creditors in the Insolvency Act is a closed list.
- . A special notarial bond is not a general mortgage bond.
- . A general notarial bond is a general mortgage bond.
- . A special notarial bondholder ranks as a concurrent creditor.
- . Reform is needed.

CHAPTER 8

COMMERCIAL PAPER

In conforming with international developments concerning the issuance of debt instruments, the corporate treasurer in South Africa now has the ability to raise finance through the medium of commercial paper (CP).¹ However, the issue of CP constitutes deposit-taking in terms of the Deposit-taking Institutions Act 94 of 1990;² consequently, the Office of Deposit-taking Institutions (DTI's), noting the desirability of a market in CP, has supported the exemption, within an appropriate regulatory framework, of the trade in CP from the strict application of the provisions of the DTI Act. Such regulatory framework presently in force came into operation on 26 January 1993 and expires on 31 December 1993, and this Notice governs 'the acceptance of money from the general public against the issue of CP in accordance with the provisions of the Notice'.³

CP's have the capacity of being termed a deposit because of the definition of a deposit in the DTI Act:

"Deposit ... means an amount of money paid by one person to another person subject to an agreement in terms of which:

- . an equal amount or any part thereof;
- . will be conditionally or unconditionally repaid;
- . with or without a premium;
- . on demand or at specified or unspecified date or in circumstances agreed upon; and
- . interest may or may not be payable at specified

¹ For an overview of CP in Europe, cf: *Guide to Commercial Paper in Europe, 1991*; Supplement to: 1991 (September) *Corporate Finance*.

² s 1 (Definitions), DTI Act.

³ The regulatory framework is contained in Government Gazette No. 14553; Vol. 331; Government Notice No. 122. The predecessor was contained in Government Gazette No. 13723; Vol. 319 of 3 January 1992, which expired on 31 December 1992.

intervals or otherwise;
 even though the initial payment is limited to a
 fixed amount and may or may not be subject to
 repayment terms and interest clauses."⁴

The acceptance of deposits from the general public as a regular feature of the business in question, will constitute the business of a DTI. A non-DTI can accept 'deposits', without such action constituting the business of a DTI, in the following circumstances:

- 1) it can accept deposits from not more than twenty persons, but the non-DTI must not hold itself out as accepting deposits on a regular basis and it must not have advertised for such deposits;⁵
- 2) it can accept deposits where the aggregate does not exceed R500 000 and again the requirements of regularity and advertising in point (1) above, apply;⁶
- 3) 'any activity... of any person or category of persons, designated by the Registrar, with the approval of the Minister [of Finance] ..., provided such activity is performed in accordance with such conditions as the Registrar may with the approval of the Minister determine ...'⁷ It was in terms of this paragraph that the Notice of 26 January 1993 (concerning CP was issued;⁸ and
- 4) the acceptance, subject to conditions established by the Registrar, of money against debentures, bills of exchange, promissory notes or other similar financial instruments, provided the money is not used for granting loans to the public.⁹

⁴ *The Deposit-taking Institutions Act (1990): An Executive's Guide*; Published by Aiken and Peat: KPMG.

⁵ s 1(1)(xxxvi)(aa)(i), 'the business of a DTI', of the DTI Act.

⁶ *ibid.*

⁷ *ibid*; para (cc).

⁸ n.3.

⁹ n.5; para (ee) - amended in terms of No. 42 of 1992: Deposit-taking Institutions Amendment Act, 1992.

TYPES OF CP¹⁰

A CP is defined as:

1. Debt instruments issued to acquire working capital: three forms of instruments are envisaged:
 - a) short-term secured or unsecured promissory notes with a fixed or floating maturity;
 - b) call bonds; and
 - c) any other secured or unsecured written acknowledgement of debt;
2. Debentures issued for a fixed period in terms of the provisions of the Companies Act, 1973; and
- 3) Any interest-bearing written acknowledgement of debt issued for a fixed period in terms of the provisions of the Companies Act, 1973.

A number of difficulties seem to be present. Firstly, with which provisions of the Companies Act must the interest-bearing written acknowledgement of debt comply? Must they comply with the provisions governing the debenture? The answer seems uncertain. The actual wording used in the Notice is as follows: 'Commercial papers means ... (d) debentures or any interest-bearing written acknowledgement of debt issued for a fixed term in accordance with the provisions of the Companies Act, 1973'. Secondly, with respect to a written acknowledgement of debt issued to raise working capital, is the understanding to be that such a form of CP, if it is interest-bearing, must have a floating maturity so as to escape adhering to the provisions of the Companies Act; but, if it is not interest-bearing, then it can have a fixed term and not comply with the Companies Act?

¹⁰ Para 1 (Definitions) of Notice 122 of 26 January.

ISSUERS

The denomination of CP must be equal to or greater than R1 million.¹¹ And a requirement which must be adhered to simultaneously with this 'denomination' requirement, is that the issuer must have a net asset value (NAV) (certified by its auditors) exceeding R100 million.¹² Unlike its predecessor, there is no stipulation concerning which items are to be deducted or excluded from the gross value so as to arrive at the R100 million NAV.¹³ In any event, it is clear that a certain quality of corporation only will be able to adhere to the requirements of the R1 million and the R100 million. However, if a corporation cannot attain either or both of these requirements, it still can issue CP in terms of a choice of five exceptions:

- (i) the instruments are listed on a recognised financial exchange; or
- (ii) the instruments are endorsed by a DTI; or
- (iii) the instruments are issued for a period of longer than 5 years; or
- (iv) the instruments are issued by the Central Government; or
- (v) the instruments are backed by an explicit Central Government guarantee.¹⁴

Thus, these five exceptions, while allowing for some lee-way concerning the quality of issuer and therefore the quality of the CP, still attempt to keep the CP more within the scope of 'upper class' corporations - especially the exception of the

¹¹ Para 3(1)(a).

¹² Para 3(1)(b).

¹³ Para 3(1)(b) of the Notice of 3 January 1992 provided that to calculate NAV, the following items were to be excluded or deducted (as the case may be):

- (i) intangible assets which are not readily marketable;
- (ii) the amount by which assets secure a liability by mortgage, pledge or otherwise; and
- (iii) the total amount of the company's off-balance-sheet liabilities and contingent liabilities (ibid).

¹⁴ Para 3(1)(b); Notice 122.

listing of the CP on a financial exchange.

BUY BACK ARRANGEMENTS

Para 3(2) provides that the CP may be utilized for market making therein. While a buy back arrangement by means of a call or put option is an option available to the issuer, it has been noted that "[c]areful consideration will need to be given to [such] arrangements generally, as they would have an impact on stamp duty and the issuer's own cash flow requirements and its ability to place the notes elsewhere."¹⁵

There are three requirements to which adherence is necessary:

- 1) the CP must be in denominations of R1 million or more;
- 2) the CP must be listed on a recognized financial exchange;
- and
- 3) a DTI must have endorsed the CP.¹⁶

But, such buy back arrangements cannot be entered into where the aim is to obtain 'overnight funding'¹⁷ nor where the CP is an unlisted debenture with a maturity in excess of five years.¹⁸

ISSUING CP

The regulatory framework prescribes the minimum information which must be disclosed in the *placing document* or the *prospectus*:

- 1) the name of the ultimate borrower must be as a heading on the face of the brochure, thereby excluding the disclosure of an agent's name;

¹⁵ Banking document.

¹⁶ Para 3(2); Notice 122.

¹⁷ Para 3(2)(ii).

¹⁸ Para 3(2)(i).

- 2) a statement concerning the adequacy of the liquidity and solvency of the issuer: i.e. a statement signed by two directors of the issuer to the effect that in their opinion the issuer is a going concern and can in all circumstances be reasonably expected to meet its commitments;
- 3) certification by its auditors as to the total amount of the issuer's capital and reserves;
- 4) certification by its auditors concerning the total amount of the issuer's other liabilities;
- 5) the name of the auditor of the issuer;
- 6) the total amount of existing CP of the issuer, and an estimate of the amount to be issued during the current financial year;
- 7) other information necessary to assist a lender in ascertaining the risk of the investment;
- 8) whether there has been a material adverse change in the issuer's financial position;
- 9) whether the issue is to be listed;
- 10) the specific purpose to which the funds raised, will be employed;
- 11) whether the CP will be secured; and
- 12) a statement as to whether the issue complies with the provisions of the Notice.

In addition, the brochure must be accompanied by the issuer's latest audited financial statements, which statements must refer to a date not earlier than 12 months prior to the date of the brochure.¹⁹

The minimum disclosures prescribed in respect of the *CP Certificate* are:

- 1) the name of the ultimate borrower must appear as a heading on the face of the certificate;
- 2) a statement concerning the adequacy of the liquidity and solvency of the issuer; and

¹⁹ Para 4.

- 3) a statement as to whether the issue complies with the provisions of the Notice.²⁰

ADVANTAGES OF A CP MARKET

Issuers:

- 1) Compared with banking costs, borrowing by means of CP is cheaper;²¹
- 2) Funding sources are diversified;²²
- 3) The issuer has the ability to promote "[his] image in the money market and in circles of institutional investors";²³
- 4) "Flexibility in managing maturities to expected cash flows".²⁴

Investors:

- "1) Diversification of risk;
- 2) An improved return over other investment mediums;
- 3) Flexibility in matching short term investments with expected cash flows;
- 4) Liquidity under certain circumstances, eg. where a call option exists."²⁵

²⁰ Para 5.

²¹ *Guide to Commercial Paper in Europe, 1991; Supplement to: 1991 (September) Corporate Finance. G. Gray: Introduction; p2.*

²² *ibid.*

²³ *ibid; Chapter 5: Dutch guilder commercial paper; p18.*

²⁴ Banking document.

²⁵ *ibid.*