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# Corporate & Commercial ALERT

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### **Directors' duties under South African Law**

A director is required at all times to act in the best interests of the company. "Company" in this context, is widely considered to be the present and future shareholders of the company, collectively. Essentially, for as long as a company operates as a going concern, a director must act in the interests of the general body of shareholders. However, the King IV Code adopts a stakeholder-inclusive approach to company governance, being a balancing of the needs, interests and expectations of material stakeholders in the best interests of the company. While the interests of the collective shareholders retain primacy, the interests of other stakeholders such as creditors have also become relevant in determining the best interests of the company.



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INCORPORATING  
KIETI LAW LLP, KENYA



## Directors' duties as they approach the abyss

### Directors' duties under South African law

A director is required at all times to act in the best interests of the company. "Company" in this context, is widely considered to be the present and future shareholders of the company, collectively. Essentially, for as long as a company operates as a going concern, a director must act in the interests of the general body of shareholders. However, the King IV Code adopts a stakeholder-inclusive approach to company governance, being a balancing of the needs, interests and expectations of material stakeholders in the best interests of the company. While the interests of the collective shareholders retain primacy, the interests of other stakeholders such as creditors have also become relevant in determining the best interests of the company.

When a company is insolvent, directors must act in the best interests of the creditors, no matter their class. This duty faces much debate in the event of insolvency and formal liquidation proceedings as the interests of the shareholders are trumped by the interests of the creditors when liquidating the assets of the company and distributing the proceeds. Naturally, this raises the question of precisely when the director of a company that may be financially distressed, on the verge of insolvency, or insolvent but not yet in liquidation, must start to consider the creditors' interests above the shareholders' interests, or to nebulously weigh them.

### West Mercia Rule

This question took centre stage in *BTI 2014 LLC v Sequana SA and Others* (BTI case). In the *BTI case*, a company distributed a dividend to its shareholder despite having a contingent liability. Once it became apparent that the liability was greater than originally estimated,

the company had become insolvent. BTI argued that the directors of the company failed to consider the interests of the creditors when they made the distribution. The English Supreme Court considered the duties of a director and noted that the traditional view of the general body of shareholders has shifted over the years. This shift was captured in the judgment of *West Mercia Safetywear Ltd (in liq) v Dodd* (West Mercia case).

In previous times, a creditor only had a contractual right against the company and was said to "be the guardian of its own interests". This approach evolved in a raft of Australian and New Zealand case law where it was recognised that directors, as part of their duty to the company, must also consider the interests of creditors when the company is insolvent or nearly insolvent. The *West Mercia* case authoritatively approved a dictum in *Kinsela v Russell Kinsela Proprietary Ltd*, in which it was stated that when a company is



The graphic features a gold diagonal stripe across a grey background. At the top left, it reads 'The LEGAL 500 EMEA'. Below this, the text 'Corporate, Commercial/M&A 2023 Rankings' is displayed in a bold, gold font. Underneath, three categories are listed in gold: 'Corporate & Commercial practice is ranked in Tier 1.', 'CDH Kenya's Corporate & Commercial practice is ranked in Tier 3.', and 'Leading Individuals: Willem Jacobs | David Pinnock'. The next category is 'Recommended Lawyers: Vivien Chaplin | Peter Hesselting Justine Krige | Sammy Ndolo David Thompson | Roxanna Valayathum Njeri Wagacha'. The final category is 'Next Generation Lawyers: Justine Krige' and 'Hall of Fame: Ian Hayes'.

## Directors' duties as they approach the abyss

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solvent, the proprietary interests of the shareholders make them, as a collective, the "company". However, when the company is insolvent, the creditors' interests "intrude", in light of the fact that their interests become paramount during liquidation proceedings. Consequently, the directors must consider the interests of the creditors as part of their duty to act in the best interests of the company (West Mercia Rule).

The court in the *BTI* case was not able to determine when the West Mercia Rule applies, thereby creating the shift in interests. However, it was clear that it would be when the company is commercially insolvent, commercial insolvency is imminent, or liquidation or administration is probable. A "real risk" of insolvency is not sufficient to trigger the need to consider the interests of the creditors. It is therefore only upon liquidation that the interests of the creditors attain paramountcy.

The Supreme Court, after considering the West Mercia Rule, agreed that creditors' interests become relevant to the duty to act in the best interests of the company as the creditors have an economic interest in the company's assets and liabilities when the company is insolvent or nearing insolvency. The court cautioned that an economic interest is not the same as a proprietary interest, and that the creditors do not have a duty owed to them that they can enforce. The directors owe duties only to the company, which has a separate legal identity to the shareholders and creditors.

### **What does the *BTI* case mean for South African law?**

The similarity between South African and English company law allows us to foresee that the reasonings underlying the *BTI* case may affect our interpretation of

"the best interests of the company". When a company is insolvent or faces imminent insolvency, directors must consider the interests of the creditors and other stakeholders as opposed to the general body of shareholders only. The *BTI* case affirms our view that where a company is on the brink of financial distress, directors will need to also consider the interests of creditors in addition to those of the shareholders. The major shortcoming is that directors do not yet have any legal assistance as to how to weigh and balance these interests, especially where they pull in opposite directions.

**Brian Jennings, Storm Arends and Keagan Hyslop**

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**BBBEE STATUS:** LEVEL ONE CONTRIBUTOR

Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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