Shareholder Loans: Fact or Fiction?

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Abstract

Shareholder loans are often used as an alternative to traditional third-party loans or equity especially for private companies in various jurisdictions, including South Africa, to finance their business activities. These loans provide companies with greater flexibility to meet their financing needs, i.e., there is no need to seek external financing while offering shareholders a potentially profitable investment opportunity. However, the legal nature of shareholder loans could pose complex legal questions and this form of loans may not necessarily be as straightforward as it first appears. This article explores the legal framework and practical considerations surrounding shareholder loans in South Africa in small private companies, with a focus on developments in case law and their implications for companies and shareholders. Amongst other issues, the application of the principle of *arbitrium boni viri* to the interpretation and enforcement of these agreements will be discussed. The article aims to provide a critical analysis of the legal questions associated with shareholder loans in South Africa.

Keywords

Shareholder loan accounts; private companies; *Companies Act*; shareholders; creditors; *Insolvency Act.*

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1 Introduction

Limited liability[1] as a cornerstone of company law can be traced back to the English *Limited Liability Act* of 1855.[2] The *Limited Liability Act*, however, was replaced within a year by the *Joint Stock Companies Act*.[3] Generally, limited liability is a concession granted by the state, often viewed as one of the natural consequences of separate juristic personality. Consequently, this means that should the failure of the business of the company lead to its liquidation, the creditors have no recourse against the shareholders of the company. Concomitantly the risk for shareholders is restricted to the amount which they invested in the company. Limited liability and the inability of creditors to demand payment for the obligations of the company from its shareholders are not restricted to cases of liquidation. Creditors are also, in principle, precluded from demanding payment from the shareholders of the company during its existence, subject to certain exceptions.[4] Creditors also have recourse against directors for payment of their debts in limited circumstances only.[5]

Gower refers to two arguments that are used to advance the principle of separate juristic personality and limited liability in English law.[6] One argument is of mere historical significance and is therefore not relevant here.[7] The other regards the intention of the legislator when it introduced the concept of limited liability which was to promote investment by individual

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1 The foundation of limited liability is that all debts incurred by a company are the company's liabilities and are not directly the legal liabilities of the company's shareholders or directors.

2 Farrar *et al Farrar's Company Law* 20. Also see Gibbons *Limited Liability Act*; Paterson "Limited Liability Act".

3 *Joint Stock Companies Act*, 1856, which required seven members to incorporate a company with a profit purpose to enjoy limited liability. Davies *Gower and Davies' Principles of Modern Company Law* 5.

4 Section 19(3) of the *Companies Act* 71 of 2008 (hereafter the *Companies Act*) provides that in the case of a personal liability company the directors of the company are jointly and severally liable for the contractual debts of the company incurred during their terms of office. S 20(9) of the *Companies Act*, and the common law, provide for veil piercing in certain cases.

5 Section 424 of the *Companies Act* 61 of 1973, which is still in effect where an insolvent company is liquidated.

6 It has been stated and acknowledged that English Law has had a decisive influence on South African Company Law, which is why it is critical to discuss the English influence when discussing limited liability. See Girvin 1992 *J Legal Hist* 77, where he states, "[t]he most important influence on South African company law has been English Law following the establishment of a British settlement at the Cape in 1806."

7 Davies *Gower and Davies' Principles of Modern Company Law* 178.

investors. The idea was that these individuals who were not investment experts would not want to risk their personal assets by becoming shareholders of a company with unlimited liability. They would prefer being lenders to the company instead. The company, however, sought investments and not loans, and, the concept of limited liability was introduced to facilitate investment.[8]

The nature of a private company is an obstacle from an investment point of view since such a company must restrict the transferability of its securities and may not offer securities to the public.[9] As private companies may not raise equity funding from the public, companies of this type can raise equity funding only from their own shareholders or through private placements that do not offend against the principle that offers may not be made to the public. This obstacle to raising equity finance from external sources, however, places shareholders in the following predicament: if the business venture should fail, they as shareholders would stand at the back of the queue in liquidation, and their claims would be satisfied only after the claims of concurrent creditors are satisfied. Shareholders in private companies would, from a risk perspective, prefer to have a component of their funding to the company be equity, and the other component be loan financing over and above any other external debt financing that the company might secure. Shareholder loans are, therefore, very common in private companies. Usually (if not always) shareholders are obliged (when debt financing is required) to provide loans to the company in proportion to their shareholding.

The terms in respect of the repayment of these shareholder loans, which are often (if not always) contained in shareholder agreements, often do not envisage (a) repayment (date). This raises the question of whether typical shareholder loans are, in fact, true loans or whether they are not, in effect, equity financing disguised as loans, as they are missing an essential characteristic of loans: that of certainty of contract relating to performance. When equity financing is framed as a loan, shareholder funding has the same status as other concurrent creditor claims in liquidation, instead of being ranked below concurrent claims. As mentioned above, this article, therefore, seeks to address whether typical terms in shareholder agreements dealing with shareholder loans satisfy the test for true loans. Put differently, what is the legal nature of a shareholder loan account?

Typical terms in shareholder loan agreements indicate either that these loans are subordinated to external creditor loans, alternatively that these loans are repayable only at the discretion of the company (exercised either by way of a board decision or by a super majority shareholders' vote of 75%;

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8 Davies *Gower and Davies' Principles of Modern Company Law* 177.
9 Section 8(2)(b)(ii) of the *Companies Act*.

i.e. a special resolution imposed by the memorandum of incorporation or in the shareholders' agreement, or even a higher percentage), or the repayment date is simply not provided, which implies that repayment would be on demand. The latter two typical terms are the focal point of the question raised in this article, namely whether loans provided with these terms (or lacking them) are, in fact, true loans. The reader may wonder at the outset what the ultimate significance of a potential finding may be that some loans are *de facto* equity: should the loans then also be treated as equity, and not enjoy any preference? Would this require legislative change in insolvency law, or could a similar effect be achieved by the courts "subordinating" the loan agreements, so that it is practically speaking equity?

An ancillary issue is that the financial interest of a shareholder, i.e., a shareholder has an equity interest (in the form of securities) and also a claim as creditor, is more than often (if not always) treated as a disposable interest. Shareholders would ordinarily not dispose of their shares without also disposing of their creditor claims. This makes sense because should a shareholder dispose of his shares but retain the claim as a creditor, the shareholder who exits the company would have no more right in terms of the *Companies Act* to view the annual financial statements of the company and would be unable to safeguard his interests.[10] This is especially important because the company can decide when to repay the loan or where the debt has been subordinated. This raises the question of whether the equity interest and the loan interest are, in fact, one indivisible "right" because shareholders and private companies treat them practically as such.

2 The paradox: equity or debt financing

Despite being common in small private companies, shareholder loans remain a paradox due to the *prima facie* inability to determine to which financing structure they ascribe (debt or equity). The funding of small private companies is governed by two distinct areas of the law, namely company law regarding equity finance and contract law regarding debt finance, each of which has its own set of applicable legal principles. The classification of a shareholder loan as either equity or debt financing has a significant impact on an investor. In analysing the financing structure of a company where one person holds shares in a company as well as having provided loan financing to the company, it must be appreciated that such a person is both a shareholder and a creditor and that this can result in a complex relationship between the person and the company.[11] The objectives of a shareholder and a creditor differ. On the one hand, a shareholder's intention is to invest in a company and bear the risk of the venture, more often than not with a

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10 Section 26(1)(c) of the *Companies Act* provides holders of beneficial interests with the right to view the annual financial statements.

11 Goldstein 1960 *Tax L Rev* 3.

long-term view of the company. On the other hand, a creditor is a party to an obligation[12] which must be performed as set out in the contract terms or residual rules of law.[13] The intention of a creditor is to provide debt financing with interest and the creditor is not necessarily invested in the long-term success of the company but simply in having his debt repaid. In a situation where the same person is the shareholder and the creditor, these divergent objectives could create legal uncertainty in so far as determining whether the investment is equity or debt.

2.1 Equity financing

In South Africa, a private company is regulated by the *Companies Act* 71 of 2008 (hereafter the *Companies Act*). Section 19(2) of the *Companies Act* provides the concession of limited liability to shareholders of companies that comply with the requirements in the *Companies Act* that are applicable to them.[14] These requirements provide that a private company means a profit company that is not a public, personal liability or state-owned company, and that satisfies the criteria in section 8(2)(b).[15] Section 8(2)(b) lists two requirements that need to be satisfied. Firstly, the Memorandum of Incorporation (MOI) of a private company must prohibit the offering of its securities to the public and secondly, the transfer of its securities must be restricted.[16] Due to the latter restriction, shares in a private company are not liquid, i.e., they are not easily disposed of by shareholders because there is no open or clear market for them. Although a share becomes part of a shareholder's personal estate, the restriction on its transferability places an obstacle on how the shareholder may deal with his shares.[17] Regarding shareholder loans, the restriction on the transferability of securities could become essential because if a shareholder loan is regarded as a form of

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12 Hutchison and Pretorius *Law of Contract* 499: "[o]bligation: a legal bond (*vinculum iuris*) between two or more persons obliging the one (the debtor) to give, do, or refrain from doing something to or for the other (the creditor)."

13 Goldstein 1960 *Tax L Rev* 3.

14 Section 1 of the *Companies Act* defines a company as follows: "A domesticated company, or a juristic person that, immediately before the effective date (a) was registered in terms of the (i) Companies Act, 1973 (Act No. 61 of 1973), other than as an external company as defined in that Act; or (ii) Close Corporations Act, 1984 (Act No. 69 of 1984), if it has subsequently been converted in terms of Schedule 2; (b) was in existence and recognised as an 'existing company' in terms of the Companies Act, 1973 (Act No. 61 of 1973); or (c) was deregistered in terms of the Companies Act, 1973 (Act No. 61 of 1973), and has subsequently been re-registered in terms of this Act."

15 Section 1 of the *Companies Act* defines a private company as a "[p]rofit company that– (a) is not a public, personal liability, or state-owned company; and (b) satisfies the criteria set out in section 8(2)(b)."

16 The term securities, which is used in the *Companies Act*, is more general than the term shares, which is included in this definition.

17 Morse *Charlesworth's Company Law* 205.

equity it will be subject to the restrictions as contained in section 8(2)(b) as it becomes part of the "securities" as referred to in this section.

The business needs of a company will determine the amount of financing that it requires.[18] Whilst public companies are permitted to raise capital from the public, private companies may not do so.[19] Due to the prohibition on issuing securities to the public, private companies need to be more creative to obtain financing in circumstances where shareholders do not necessarily want to provide more equity financing and external financiers are not willing to extend debt financing for the operational needs of the company. Even if the MOI of the company provides for redeemable preference shares which could be structured to resemble a loan repayable with interest, it would still create a financial risk for shareholders during the period prior to the right to redeem their shares. The shareholder remains a shareholder and not a creditor. Furthermore, even if redemption is triggered, the provisions of the *Companies Act* in respect of making a distribution would have to be satisfied.[20] Loan financing from shareholders, therefore, becomes an attractive alternative to taking up more shares, even if those shares have preferent rights attached to them.

Equity financing entails that a company issue shares to one or more investors[21] and that in return for the shares the shareholder pays the issue price of the shares.[22] The company receives funding and the shareholder receives an asset – shares in the company.[23] The shares in a company do not make the shareholders owners of the property of the company or its assets.[24] This merely means that the shareholders receive certain rights, which are normally rights in respect of dividends, voting, and the return of capital when a company is wound up.[25] In this regard, a share is seen as a bundle of rights.[26] The contract that is established by the MOI with regard to the issuing of shares defines the nature of the rights attached to the shares.[27] This distinguishes a shareholder from a debt holder, whose rights

18 McLaughlin *Unlocking Company Law* 138.
19 Cassim *Contemporary Company Law* 73.
20 Section 46 of the *Companies Act*. Although the section of the *Companies Act* does not explicitly provide that a redemption is a distribution, it would appear that it is. It is beyond the scope of this article to go into the question whether a redemption is in fact a distribution.
21 McLaughlin *Unlocking Company Law* 146.
22 McLaughlin *Unlocking Company Law* 146.
23 McLaughlin *Unlocking Company Law* 146.
24 Davies *Gower and Davies' Principles of Modern Company Law* 615.
25 Davies *Gower and Davies' Principles of Modern Company Law* 615.
26 *Standard Bank of SA Ltd v Ocean Commodities Inc* 1980 2 SA 175 (T) 188.
27 Davies *Gower and Davies' Principles of Modern Company Law* 617. Also see s15(6) of the *Companies Act,* which provides that the MOI is binding between the company and its shareholders. Although this is viewed to mean that the MOI creates a contract between the company and its shareholders, the MOI does not have all the features

are defined by the contract, which grants the debt holder rights against the company.

The restriction on the company in respect of whom it may issue securities limits the options for the company to secure investment financing because investment finance, or equity finance, can be raised only from existing shareholders or private placements which are not in contravention of "offers to the public". The *Companies Act* does provide shareholders of private companies with an anti-dilution measure should the company issue new shares. Note that this right applies to shares and not to securities. Essentially the Act provides shareholders with the right to maintain their existing shareholding before the company may issue to non-shareholders where a new share issue is done.[28] This is an alterable provision, however, as the Companies Act also provides that the memorandum of incorporation may exclude this right.[29]

Shareholders are not creditors for the amount they invested in the company.[30] As mentioned above, in a situation where a person is a shareholder and a creditor of the company these roles can become merged, which means that these shareholders will benefit as creditors even if they lose out in their capacity as shareholders in the event of the liquidation of the underlying company. This could be to the disadvantage of other external creditors because the pool of creditors is now larger because shareholder loans are now included in the pool. If these shareholder loans were treated as equity or had been subordinated to the loans of external creditors, those external creditors would not be disadvantaged.

Interestingly German law recognises shareholder loans as loans, but effectively reduces them to equity should the company go into liquidation. Courts in Germany initially took the initiative to protect external creditors against internal creditors.[31] The *Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen Gesetz* (Law for the Modernisation of the German Limited Liability Company Law and the Prevention of Misuse) came into effect on 1 November 2008. Amongst other amendments, it amended the German *Insolvency Act*. In essence, section 39 of the *Insolvency Act* provides that all shareholder loans are subordinated to those of external creditors if the company goes into liquidation. An exception is where the shareholder holds 10% or less shares and does not participate in the

of a true contract. In this regard see Cassim *Contemporary Company Law* 3rd ed 184-186.

28 Section 39(2) of the *Companies Act*.

29 Section 39(3) of the *Companies Act*.

30 Cassim *Contemporary Company Law* 17.

31 Raiser and Veil *Recht der Kapitalgesellschaften* 623.

management of the company.[32] If the loan was called up within a year of Insolvency, the payment can be set aside.[33]

There are substantial differences between a shareholder and a creditor of a company with regard to rights against the company and the ranking of claims on insolvency.[34] Shareholders do not have the right to insist on the return of their share capital; they only have a hope of receiving a distribution and not an expectation or a right.[35] The company has the complete power to retain the share capital until the company is liquidated and the assets of the company are distributed amongst the creditors.[36] If a company is liquidated, a shareholder will not be able to share in the distribution until all the creditors and the cost of the liquidation have been recovered.[37]

The provisions of a shareholder loan agreement are subject to the usual rules of contract law and depend on the particular agreement between the company and the shareholder. Among the common provisions that may be included in such an agreement are the specified loan amount, the interest rate charged, if any, and the repayment terms, including any provisions for the early repayment or extension of the loan term.

2.2 Debt financing in a private company

As mentioned above, the law that regulates debt financing is contract law.[38] Despite strong legislative inroads, loans are principally still governed by common law.[39] It is a well-established principle in common law that a loan, where no specific repayment terms have been agreed upon, is repayable as soon as it has been incurred.[40] If the repayment of the loan is not specified, it will be payable on demand.[41]

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32 Section 32a III of the German *Insolvenzordnung* (Insolvency Act), 1994. See further Raiser and Veil *Recht der Kapitalgesellschaften* 626-635.

33 Section 135 of the *Insolvenzordnung*, 1994.

34 Cassim *Law of Business Structures* 171.

35 Davies *Gower and Davies' Principles of Modern Company Law* 613.

36 McLaughlin *Unlocking Company Law* 147.

37 McLaughlin *Unlocking Company Law* 147; section 37(3)(b)(ii) of the *Companies Act*.

38 McLaughlin *Unlocking Company Law* 139.

39 Diamond *Commercial and Consumer Credit* 8. Also see Vessio *Effects of the In Duplum Rule* 22, which explains that "[l]oan agreements are still influenced by South African common law which is of Roman and Roman-Dutch extraction."

40 *Standard Bank of SA Ltd v Oceanite Investments (Pty) Ltd* 1995 4 SA 510 (C) 546I-547B: "A loan without an agreement as to a time for repayment, is in common law repayable on demand. Although by no means linguistically clear, the phrase 'payable on demand' is used in this context in our law to mean that no specific demand for repayment is necessary and the debt is repayable as soon as it is incurred." This passage was met with approval in *De Bruyn v Du Toit* (1162/2015) [2015] ZAWCHC 20 (27 February 2015) as well as *Praesidium Capital Management (Pty) Ltd v Kay-Davison* (17332/2010) [2010] ZAWCHC 531 (8 November 2010).

41 See *Standard Bank of SA Ltd v Oceanite Investments (Pty) Ltd* 1995 4 SA 510 (C) 546I-547B: "A loan without agreement as to a time for repayment is at common law repayable on demand."

The foundation of debt financing is that a company has a contractual obligation to repay the amount that was loaned to it according to the terms of performance as set out by the loan agreement.[42] The person who lends money to the company is known as a creditor.[43] Debt financing has three important characteristics. The first is that it must have a fixed performance date of when the loan has matured and is deemed payable.[44] The second is the right to receive interest on the sum loaned where such a provision has been made in the loan agreement despite the turnover or profit of the company.[45] The third is the right to share in the distribution of company assets with other creditors upon the liquidation of the company.[46]

Most contracts, including loan agreements, are reciprocal in nature. One party's performance is undertaken on the understanding that there will be a reciprocal performance by the other party.[47] The undertaking by one or both parties will be in the form of an undertaking to give something, to do something or to refrain from doing something.[48] In theory and *prima facie* a shareholder loan appears to be no different to this general point of departure for a loan between a shareholder and the underlying company.

One of the main requirements for a valid contract is that its contents must be certain or ascertainable.[49] This is necessary in order to establish a consensus between the parties.[50] Another reason for the requirement of certainty is that the rights and duties established by the contract must be expressed in a way that renders the contract enforceable at the instance of the court.[51] Uncertainty can relate to the terms in the contract or to the application of a contractual prescribed mechanism or standard that determines what must be performed and at what time performance must be rendered.[52]

A typical example of uncertainty, which is relevant in the present context, concerns contracts with an indefinite duration.[53] This is where there is no stipulation in the contract regarding the duration of the contract. Courts

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42 McLaughlin *Unlocking Company Law* 147.
43 McLaughlin *Unlocking Company Law* 140.
44 Goldstein 1960 *Tax L Rev* 31.
45 Goldstein 1960 *Tax L Rev* 31. Further, it is not an essential of a loan contract that it must bear interest. It could bear no interest at all, and a requirement for interest should be contained in the loan agreement if there is to be such a requirement; see *NBS Boland Bank Ltd v One Berg River Drive CC* 1999 4 All SA 183 (A); *Deeb v Absa Bank Ltd; Friedman v Standard Bank of SA Ltd* 1999 4 SA 928 (SCA) para 17.
46 Goldstein 1960 *Tax L Rev* 31.
47 Hutchison and Pretorius *Law of Contract* 7.
48 Hutchison and Pretorius *Law of Contract* 7.
49 Lubbe and Murray *Farlam & Hathaway: Contract* 307.
50 Hutchison and Pretorius *Law of Contract* 219.
51 Lubbe and Murray *Farlam & Hathaway: Contract* 314.
52 Hutchison and Pretorius *Law of Contract* 222.
53 Hutchison and Pretorius *Law of Contract* 222.

usually give effect to these contracts by looking at the intention of the parties.[54] These contracts will normally contain a clause to the effect that a contract may be terminated on reasonable notice.[55] These contracts have to be interpreted in the ordinary sense in order to establish whether they should endure for a reasonable period or whether they are intended to endure in perpetuity.[56] In contracts where the agreement is incomplete because the parties could not decide on a material aspect and, therefore, did not reach a consensus, the contract will be regarded as void.[57]

According to the maxim *id certum est quod certum reddi potest*,[58] something can be said to be certain if it can be rendered certain.[59] Thus, a contract can provide discretion to one of the parties to determine what must be performed, and thereby render performance certain. Conversely, discretion to determine one's *own* performance is traditionally regarded as invalid. A discretion awarded to a debtor to perform only if the debtor wants to (*a condicio si voluero*) has always been invalid. These conclusions were based on the prevailing legal principle that such contracts are invalid.[60] However, this position in South African law seems to be changing. In *NBS Boland Ltd v One Berg River Drive CC* (hereafter the *NBS Boland* case),[61] the court held a clause that grants one party the discretion to determine the performance of the other party is legally valid and enforceable based on certain criteria.[62] The court went on to establish three criteria for the legitimacy and enforceability of such discretionary power. Firstly, the discretion should not pertain to setting a purchase price or rental payment;[63] secondly, the discretion should specifically involve regulating the performance of the other party;[64] and thirdly, this discretion must be exercised *arbitrio boni viri*.[65]

In *Erasmus v Senwes Ltd* (hereafter the *Senwes* case)[66] the court extended the requirement to include a discretion that relates to a party's own

54 Hutchison and Pretorius *Law of Contract* 222.
55 Hutchison and Pretorius *Law of Contract* 222.
56 Lubbe and Murray *Farlam & Hathaway: Contract* 317.
57 Lubbe and Murray *Farlam & Hathaway: Contract* 317.
58 If something is capable of being made certain, it should be treated as certain. In Law and Martin *Dictionary of Law* 72.
59 Hutchison and Pretorius *Law of Contract* 214.
60 Du Plessis 2013 *PELJ*; *NBS Boland Bank Ltd v One Berg River Drive CC* 1999 4 All SA 183 (A)*; Deeb v Absa Bank Ltd; Friedman v Standard Bank of SA Ltd* 1999 4 SA 928 (SCA).
61 *NBS Boland Bank Ltd v One Berg River Drive CC* 1999 4 All SA 183 (A) (hereafter *NBS Boland*).
62 *NBS Boland* para 24.
63 *NBS Boland* para 24.
64 *NBS Boland* para 24.
65 *NBS Boland* para 25.
66 *Erasmus v Senwes Ltd* (31964/04) [2005] ZAGPHC 5 (1 January 2005) (hereafter *Senwes*).

performance. The court clearly recognised that the debtor (promissor) could also have such a power, as long as this power is also (like that of the creditor/promissee) exercised reasonably. In fact, the court went on to argue that there is no reason to restrict the rule (that discretionary contractual rights must be utilised *arbitrio boni viri*[67]) to situations in which the authority is vested in the promissee. In fact, given that all contracts are subject to the concept of good faith and that parties should be held to their contracts to the greatest extent feasible, there is a compelling reason to apply the rule also in circumstances when the power is provided to the promissory.[68] The *prima facie* implication of these cases which allow a debtor to decide "what" to perform could have a profound impact on the status of a shareholder loan because a company could conceivably decide to allocate a portion thereof as equity. This clearly illustrates the conundrum that can be faced regarding performance when there is uncertainty as to the legal nature of the shareholder loan account.

3 *Arbitrium boni viri*

3.1 The principle of arbitrium boni viri *in South Africa*

We now discuss the application of the principle of a*rbitrium boni viri* to the interpretation and enforcement of shareholder loan accounts in more detail. In this article it is necessary to differentiate between two scenarios regarding the debtor (the company): i) the debtor is using his contractual right or power to modify the terms of the contract that pertain to his obligations (as described by *Senwes*), or ii) the debtor is using his contractual right or power to determine the timing of his performance without altering any particular term.[69] This article mainly deals with the second scenario where the debtor has the power to decide when to perform without varying any specific term. If a shareholder loan account agreement does not contain a provision to determine the performance of the loan, such performance would be subject to the requirement of reasonableness under the principle of *arbitrium boni viri*. In this situation the debtor may have a degree of discretion as to when he will perform his obligation, but he must still do so within the overall contractual framework. The exercise of this power will be subject to the

67 *De Lange v ABSA Makelaars (Edms) Bpk* 2010 3 All SA 403 (SCA) para 17 "[d]iscretion in this regard had to be exercised *arbitrium boni viri,* 'with the judgment of a fair-minded person.'"

68 In *Juglal v Shoprite Checkers (Pty) Ltd t/a OK Franchise Division* 2004 5 SA 248 (SCA) para 26 the Supreme Court of Appeal applied the rule to the case of a mortgagee who was given very wide powers in terms of a notarial bond to take over and run the business of the mortgagor and thus to determine the manner in which it was to exercise its own contractual rights.

69 In *NBS Boland* para 23 a distinction is made between the validity of a *condicio si voluero*, i.e. a condition that the promissor is bound to perform only should he wish to do so and a contract or stipulation where the promissor may determine his own prestation.

principle of *arbitrium boni viri*, meaning that the debtor must act reasonably and in good faith when deciding on the timing of his performance. Determining what is a reasonable way of exercising such power will depend on the specific circumstances of each case. Contracts normally demand a more or less absolute quality of certainty in each and all the terms of the agreement. In terms of performance this can be satisfied with a relative quantum of certainty; namely, with that which is reasonable in the particular circumstances of the case.[70]

The principle of *arbitrium boni viri* was discussed in both the *NBS Boland*[71] and the *Senwes* cases. At issue in the *NBS Boland* case was the right of the mortgagee (promisee) to unilaterally amend the rate of interest payable in terms of the bond. The court held that a stipulation conferring the right to determine performance upon a contractual party is generally acceptable, except in cases where a party has been given the power to fix his own obligation, purchase price or rental.[72] Furthermore, in some situations there may not be an enforceable agreement until a discretionary determination is made. Once this discretionary determination is exercised, an unconditional contract is formed.[73] However, it is important to note that the exercise of such contractual discretion may not always be unchallengeable, and the other party may have the ability to void it.[74] According to the common law, unless a contractual discretionary power was explicitly intended to be completely unrestricted, the exercise of such discretion must be based on the *arbitrum bono viri* principle; i.e. the "judgement of a reasonable person".[75] The court further stated that the entire argument was based on the claim that the clause was invalid. However, it was held that the clause is indeed valid, although the use of power it grants the mortgagor may be questionable.[76]

The *Senwes* case centred on an employment contract and a clause regarding a subsidy for a medical scheme. Senwes provided its employees with a medical scheme membership through SAKAV[77] and was obliged to pay a subsidy based on SAKAV's "Supreme" option.[78] Later, retirees were allowed to choose from a range of options, with the subsidy based on 90% of the premium payable for the "Providential Plus" option. However, from January 2002 retirees could choose from any of the five schemes and any

70 Samek 1970 *Can Bar Rev* 203.
71 *NBS Boland* para 7.
72 *NBS Boland* paras 16-17.
73 *NBS Boland* para 24.
74 *NBS Boland* para 25.
75 *NBS Boland* paras 24-25.
76 *NBS Boland* para 29.
77 Membership of a medical scheme called SAKAV (the judgment does not provide full name of medical scheme, only the abbreviation) in *Senwes* para 6.
78 *Senwes* para 6.

of the options available.[79] In 2004 Senwes proposed reducing the subsidies substantially and offering three choices to pensioners.[80] The applicants submitted that the options on which Senwes offered to base the subsidies provided significantly fewer benefits than those they had had before.[81] They went on to contend that they possessed a contractual entitlement to receive financial assistance towards their medical scheme premiums.[82] Senwes maintained that it did not have a contractual obligation to provide a subsidy, or that it was required to pay only a reasonable subsidy and could determine what that subsidy was.[83] The court proceeded to consider whether Senwes and each of the applicants had a contract in terms whereof Senwes had to pay a subsidy in respect of the applicant's medical scheme premiums.[84] A further issue was that the employment agreement provided that Senwes' board of directors and its management could amend any of the terms of the employment contract without notice to or the consent of the applicants.[85]

It has been stated that in certain cases if one party to a contract is allowed to modify its terms (*condictio si voluero*), this will render the contract void.[86] The issue at hand for the court was whether Senwes could modify its obligation to pay medical scheme premiums, and if such an action rendered the obligation unenforceable.[87] The court held that the power that Senwes had to amend the contract had to be exercised *arbitrio boni viri*, which requires reasonable discretion. In other words, Senwes had to act reasonably when exercising its power to modify the contract.[88] The court held that reasonableness is an objective standard that can be justiciable by a court, and therefore the power of Senwes to modify the contract was not unfettered and was subject to the standard of reasonableness.[89]

Ultimately the court had to determine whether Senwes acted reasonably when it made its decision and whether the changes were necessitated by financial need or motivated by a desire to increase profitability.[90] While there was nothing inherently wrong with a desire to increase profitability, the evidence suggested that Senwes had sought to do so at the expense of the applicants.[91] When exercising discretion to amend contractual terms, it was essential to consider the rights and interests of all parties involved and to

79 *Senwes* para 8.
80 *Senwes* para 10.
81 *Senwes* para 11.
82 *Senwes* para 15.
83 *Senwes* para 15.
84 *Senwes* para 16.
85 *Senwes* para 22.
86 *Senwes* para 23.
87 *Senwes* para 24.
88 *Senwes* para 26.
89 *Senwes* para 28.
90 *Senwes* para 32.
91 *Senwes* para 32.

balance these interests in a reasonable manner, always bearing in mind the nature and content of the original contractual obligation.[92]

In the context of the scenario where the company may decide when to repay the loan, it would appear that in the light of these recent case law developments, such a provision would not necessarily be void. The company, through its board of directors, would have to act reasonably in determining when to repay the loan of the shareholder. Whether the company could refuse to repay a loan where no time for performance has been provided appears to be the more vexing problem. It is, however, entirely possible that a shareholder loan agreement would provide no time for the repayment of the loan. In theory, this would mean that it would be payable on demand. What if the shareholder, however, never in his lifetime calls up the loan? Would the law still treat the loan as a loan?

3.2 Possible criteria for the exercise of the **arbitrium boni viri** *in the performance of a shareholder loan: the Cork Report*

Determining what is reasonable in the context of the performance of a shareholder loan account can amount to a complex exercise. Certain criteria need to be established to provide insight into such an exercise. An interesting perspective in the context of inter-group loans is the Cork report,[93] which was published in the United Kingdom in 1982.[94] Under the heading of "Group Trading" the Cork Committee addressed the issue of intercompany indebtedness. Intercompany indebtedness is found between companies in a group. The relevance for the purposes of this report is the simple fact that a juristic person shareholder in another company is, in law, no different to a natural person shareholder. Where a holding company, for example, lends money to its subsidiary company, it is *prima facie* no different to a natural person shareholder lending money to the company of which he is a shareholder, subject to legislative provisions where relevant.[95]

The report focussed specifically on the effect on creditors when one of the companies in the group becomes insolvent. The report considered different options to protect external creditors of the liquidated company due to the fact that the inter-company indebtedness could often rank above the claims of these external creditors and therefore prejudice them. One possibility that was considered was to defer the intercompany indebtedness; i.e. all the debts that a company owes to other companies in the same group should

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92 *Senwes* para 32.

93 The aim of the report was to review the law in the United Kingdom that related to insolvency, bankruptcy, liquidation and receivership and to consider necessary or desirable reforms.

94 Cork *Insolvency Law and Practice* 460.

95 Section 45 of the *Companies Act*.

be suspended until the claims of external creditors have been met.[96] This would allow a Court that is confronted with such a situation where liabilities are owed to connected persons or companies to assess whether all or part of the long-term capital of the company should be deferred/subordinated to the claims of other creditors and to be met only once those claims have been satisfied.[97]

The report further stated that in terms of connected persons, a director's loan to his own company will also be deferred where it has formed part of the company's long-term capital structure.[98] It is to be a discretionary process of the court which will consider factors to determine the nature of the substance matter.[99] The report states that if the money is advanced with an expectation of repayment, the money should be treated as a loan. However, "if as a matter of substantial business reality, it is risked upon the success of the venture", the money should be treated as capital.[100] The report mentioned six factors that should be considered relevant to the determination of the question.[101] These factors were specifically formulated for group trading between parent and subsidiary companies. Nonetheless, they address the same issue that is the subject matter of this article. They are used to determine the legal nature of a purported loan account between two connected companies, which is identical to a loan account between a company and a connected person, as in this case the shareholder.

Effectively the report suggested that the payment of a loan account that has been defined as equity should be deferred until the claims of creditors have been met.[102] This is similar to a subordination agreement, which is a legal agreement that makes one party's claim subordinate to the claim of another party. A similar type of approach is followed by both the German and United States legal systems where shareholder loan accounts in these countries may be subject to subordination or recharacterised as equity when the company that is the recipient of the loan is under financial stress.[103]

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96 Cork *Insolvency Law and Practice* 440.
97 Cork *Insolvency Law and Practice* 442.
98 Cork *Insolvency Law and Practice* 442.
99 Cork *Insolvency Law and Practice* 442.
100 Cork *Insolvency Law and Practice* 442.
101 Cork *Insolvency Law and Practice* 442; these were:
" (a) the original debt-equity ratio;
(b) the adequacy of the paid-up share capital;
(c) the absence of reasonable expectation of payment;
(d) the terms on which the advance was made and the length of time for which it has been outstanding;
(e) whether outsiders would make such advances; and
(f) the motives of the parties."
102 Cork *Insolvency Law and Practice* 442.
103 Cahn 2006 *EBOR* 287-300.

From this one can deduce that the intention of the shareholder plays an important role in determining what is reasonable in the circumstances and how performance should be determined. This is also evident in the *Senwes* case, when the court had to determine whether Senwes had acted reasonably when it made its decision, whether the changes had been necessitated by financial need or motivated by a desire to increase profitability. The court clearly focussed on the intention of the party in its determination of what was reasonable in terms of performance.

3.3 Case law

In *Burman v Commissioner for Inland Revenue* (hereafter the *Burman v Commissioner* case)[104] Burman and other members invested in property companies by acquiring shares and providing loans as operating capital. However, there was no agreement on the interest rate or repayment of the loans.[105] Unfortunately, the ventures failed, and Burman was forced to liquidate the companies.[106] The legal issue was whether the loans had been of a capital or income nature, which would determine if Burman could deduct the losses from his taxable income.[107] The majority decision held that the losses were not deductible because the loan and shareholding were separate interests in the company. Goldstone JA wrote the majority decision and viewed the transactions between Burman and the property companies as contractual loans, and it was accepted that Burman was entitled to the capital sums lent, regardless of his intentions. However, the minority decision held the transactions to be one economic interest due to the intention of the shareholder. It considered the status of the loans by looking at the purpose of the loans. The minority found that the purpose of the loans was to provide the company with working capital finance to allow it to acquire the assets it needed.[108] The loan accounts and shares had been regarded as one indivisible economic interest by Burman, and the minority took this into account in coming to their conclusion that the shares and loan accounts should be regarded as one economic interest.[109]

Goldstone JA held that the minority judgment disregarded the commercial reality and legal consequences of Burman's loans.[110] The intention had been for the loans to be recouped through the payment in shares of a public company. However, the intention throughout had been that the company was indebted to Burman. Therefore, the loans could not be considered

104 *Burman v Commissioner for Inland Revenue* 1991 3 All SA 950 (AD) 962 (hereafter *Burman v Commissioner*).
105 *Burman v Commissioner* para 958.
106 *Burman v Commissioner* para 959.
107 *Burman v Commissioner* para 950.
108 *Burman v Commissioner* para 967.
109 *Burman v Commissioner* para 967.
110 *Burman v Commissioner* para 953.

fictitious or disguised transactions.[111] If Burman had proved his claims against the insolvent property companies, the liquidator would not have been able to plead that Burman had intended to recover his loans in any other way than direct payments by the borrower, or that he had not intended to be repaid if he did not sell his shares simultaneously.[112] Of specific interest was Goldstone's statement that Burman had been a minority shareholder in the property companies, and if the majority had chosen to repay the loan accounts in whole or in part, Burman would not have been able to object.[113] The case, therefore, confirms that there was consensus that the shareholder provided loan financing to the company. One party could, therefore, not unilaterally decide to change the nature of the funding to equity. To convert the loan to equity would require compliance with the relevant mechanisms of the *Companies Act*. Where a shareholder has passed away prior to enforcing the loan claim, this claim would be an asset in his estate which would be enforceable by the executor of his estate.

In the light of *Burman v Commissioner*, one should ask the question of whether a shareholder loan account should not be considered *sui generis* in nature. It does not ascribe to either of the traditional categories of equity or debt financing and yet it has characteristics of both. In truth, the way a shareholder loan will be structured very much depends on the type of agreement that is concluded between the company and the shareholder, which can take the form of a loan agreement including all the requisite terms for a loan, or it can be an informal agreement between the parties with almost no specific terms. Essentially the foundational agreement of a shareholder loan can fundamentally differ from one agreement to the next. It is most common for a shareholder loan to lack terms regulating the repayment of the loan. The difference between the majority and the minority illustrates that even the courts find the categorisation of this form of financing difficult.

Two main arguments emerge, namely the first, as upheld by the majority, of the commercial reality of the loan agreement, and the second of the purpose or intention of the agreement, both of which are subject to the specific circumstances of the shareholder loan in question. This again reinforces opinion of the *sui generis* nature of the loan, since no two shareholder loans may have the same purpose, as this will be determined by the intentions of the parties to the foundational agreement. It appears, however, that the mere fact that the economic interest of a shareholder may consist of both equity and loan financing is not sufficient to hold that the loan financing is not a loan. Should a shareholder dispose of his shares in the company, it

111 *Burman v Commissioner* para 953.
112 *Burman v Commissioner* para 953.
113 *Burman v Commissioner* para 954.

makes practical sense also to dispose of the loan account that he holds. This should therefore not be held to treat the loan as equity.

4 Conclusion

The article has explored two issues regarding the legal nature of loan accounts in two specific contexts and whether these contexts change the legal nature of a loan possibly into equity: the first, where no provision is made for their repayment. The second issue concerns the situation where there is a clause in the shareholder's agreement in which the majority has the power to decide when repayment is due. The question was whether these two situations differ and if they do, the nature of the difference.

In the context of small private companies, the practical reality is that they are often financed by loans. The equity finance (share capital) is usually only a nominal amount and the shares that have been issued constitute the minimum number to reflect each shareholder's interest in the company.[114] Thus, the majority of the working capital is provided by loans from the shareholders, usually in a framework where there is no stipulation as to the performance.

In South Africa *NBS Boland* and *Senwes* make it clear that a debtor can have the discretion to determine performance. Where no date for repayment has been set but the right to decide when to repay the loan is vested in the company; i.e. the board, the *prima facie* implication of these cases which allows a debtor to decide "what" to perform could have a profound impact on the status of a shareholder loan where the company may decide when or how to repay it, because the company is able to allocate a portion thereof as equity. However, it creates a limitation whereby it is held that the exercise of such discretion must be based on the *arbitrium bonum viri* principle, i.e. the "judgement of a reasonable person". Arguably, changing the loan to equity could not be within the power of the board as this would be an attempted unilateral amendment to the contract.

Further, issues that arise from such an agreement where no date has been set for performance could be detrimental to external creditors of the company. In this scenario, the debt would be payable on demand. However, here the unique position of a shareholder creditor comes to the fore. The shareholder, or rather the person with the beneficial interest, will have access to the annual financial statements of the company.[115] If the creditor shareholder is also a director, he will have access to the management accounts of the company. He will, therefore, have better information regarding the financial position of the company than external creditors. If

114 McLennan 1993 *SALJ* 686-710.
115 Section 26(1)(c) of the *Companies Act*.

there is no repayment date in the loan agreement, the loans may, therefore, be called up when the company is not able to service its debt. Should the company go into liquidation, the *Insolvency Act* may assist by having these dispositions (payments of the loans) set aside. However, this is a costly and reactive process. Instead, it could be advisable to legislate proactive measures with respect to the repayments of loans made by shareholders. Here a recommendation in the Cork Report that these loans be deferred could be helpful. Considerations could be (a) the initial debt-equity ratio, (b) the sufficiency of the paid-up share capital, (c) the lack of a reasonable expectation of repayment, (d) the terms and duration of the advance, (e) whether external parties would provide such advances, and (f) the intentions of the parties involved. Furthermore, the automatic subordination of shareholder loans to those of external debt providers could be considered. The provisions of the German *Insolvency Act* in terms whereof the shareholder loans are subordinated to those of external creditors are also something that the legislature could consider. Where the company has issued only one class of shares, these shares rank equally in liquidation.[116] Subordination of these shareholder loans reduces them to equity, although legally speaking they remain loans.

The article has not attempted to argue that shareholder loans are simulated equity because the intention of the lender and the debtor is to enter into a loan agreement due to the benefits a loan agreement provides in insolvency of the debtor company. The question is whether the lack of repayment terms, or where the debtor decides when/how to pay, makes loans of this type valid loans. The article attempts to show the unique nature of loans of this type. Where ordinary loans from external debt providers are usually clear in respect of when the debtor has to perform, shareholder loans are typically not clear in this respect. Either they do not stipulate a time of repayment or they provide the company with a discretion in respect of repayment. There is essentially no difference between these two situations. In the second scenario, the company must exercise its discretion reasonably. Ultimately, however, shareholder loans appear to be loans, and this is not a fiction but a fact. If external creditors are concerned about the pool of creditors becoming larger in the event of the insolvency of the company, the only intervention which would assist them would be by the legislature. The nature of legislative intervention would be to subordinate the claims of shareholder creditors to those of external creditors. The only tool that the courts could use would be to hold the loan as a simulated transaction to disguise the true nature of the transaction, i.e. that the shareholder intended to provide equity finance. This option, however, appears to be unlikely.

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116 Section 37(3)(b)(ii) of the *Companies Act*.

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List of Abbreviations

Can Bar Rev	Canadian Bar Review
EBOR	European Business Organization Law Review
J Legal Hist	Journal of Legal History
MOI	Memorandum of Incorporation
PELJ	Potchefstroom Electronic Law Journal
SALJ	South African Law Journal
Tax L Rev	Tax Law Review