In the consolidated matter of:

PHILOTEX (PTY) LTD	1st Appellant
UNION SPINNING MILLS (PTY) LTD	2nd Appellant
GREGORY KNITTING MILLS (PTY) LTD	3rd Appellant

(Case no 4608/91 TPD)

and

BRAITEX (PTY) LTD	1st Appellant
ARANDA TEXTILE MILLS (PTY) LTD	2nd Appellant
SA FINE WORSTEDS (PTY) LTD	3rd Appellant
TRICOT FASTENERS (PTY) LTD	4th Appellant
DA GAMA TEXTILE COMPANY LTD	5th Appellant
MARTILON TEXTURED YARNS (PTY) LTD	6th Appellant

(Case no 15656/91 TPD)

versus

JOHANNES ROUSSEAU SNYMAN	1st Respondent
JOACHIM VERMOOTEN	2nd Respondent
PIETER JOHANNES GOUS	3rd Respondent
ANDRIES DEWALD NIEMANDT	4th Respondent
STEPHANUS JACOBUS NEL	5th Respondent
S J DU PLOOY	6th Respondent
S M PRETORIUS	7th Respondent
E F ZONDAGH	8th Respondent
P R BOTHA	9th Respondent
N S READ	10th Respondent
J P SMIT	11th Respondent

CORAM: Eksteen, Howie, Marais, Schutz JJA et Van Coller AJA

DATES OF APPEAL: 1, 2 and 3 September 1997

DATE OF JUDGMENT: 13 November 1997

J U D G M E N T

HOWIE JA:

Wolnit Limited ("Wolnit") was placed in voluntary liquidation on 20 November 1989. In the Court below appellants, former concurrent creditors of Wolnit, instituted action against respondents, at all material times directors of the company, in which relief was claimed in terms of s 424(1) of the Companies Act, 61 of 1973 ("the Act"). The main prayer was for an order declaring respondents personally liable for the debts of Wolnit incurred after 1 July 1987. In the alternative, appellants sought payment of the amounts owing to them at the time of liquidation. The crucial allegation upon which the claim was founded was that respondents had, from the date just mentioned, carried on Wolnits business

recklessly. This allegation respondents denied. The case, comprising two actions consolidated for purposes of trial, came before Van Dijkhorst J in the Transvaal Provincial Division who dismissed appellants' claims on the ground that recklessness had not been proved. The matter is on appeal with the leave of the Court a quo and whether recklessness was proved is the decisive issue. The applicable legal principles

Before recounting the material facts it is appropriate, first, to deal with the relevant legal position. Omitting presently irrelevant wording, s424 provides as follows:

> "Liability of directors and others for fraudulent conduct of business
>
> (1) When it appears, whether it be in a winding-up, judicial management or otherwise, that any business of the company was or is being carried on recklessly or with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court

may, on the application of the Master, the liquidator, the judicial manager, any creditor or member or contributory of the company, declare that any person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct.

(2) (a) Where the Court makes any such declaration, it may give such further directions as it thinks proper for the purpose of giving effect to the declaration,

(b) . . .

(3) Without prejudice to any other criminal liability incurred, where any business of a company is carried on recklessly or with such intent or for such purpose as is mentioned in subsection (1), every person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be guilty of an offence.

(4) The provisions of this section shall have effect notwithstanding that the person concerned may be criminally liable in respect of the matters on the ground of which the declaration is made."

The precursor of this section, s 185 bis of the previous Companies Act, 46 of 1926 (introduced into that Act in 1939), did not include reckless trading and only applied to the case of a winding-up or judicial management. Obviously, therefore, the legislative intention in enacting s 424 was to broaden the scope of the earlier provision and to extend the remedy by means of which a restraining influence can be exercised on "over-sanguine directors". Gordon N O and Rennie NO v Standard Merchant Bank Ltd and Others 1984 (2) SA 519 (C) at 527 A - B. That, of course, does not mean that recklessness is lightly to be found. The remedy is a punitive one; a director can be held personally liable for liabilities of the company without proof of any causal link between his conduct and those liabilities: Howard v Herrigel and Another NNO 1991 (2) SA 660(A) at 672 E. The onus is upon the party alleging recklessness to prove it and, these being civil proceedings, to establish the necessary facts according to the

required standard, which is on a balance of probabilities. (In a prosecution under s 424(3) the meaning of recklessness would be no different but the necessary facts would, of course, have to be proved beyond reasonable doubt.)

Before discussing the meaning of recklessness, it is convenient first to dispose of the aspect of being "knowingly a party".

"Knowingly" means having knowledge of the facts from which the conclusion is properly to be drawn that the business of the company was or is being carried on recklessly; it does not entail knowledge of the legal consequences of those facts: Howard's case at 673 I - 674 A. It follows that knowingly does not necessarily mean consciousness of recklessness.

Being a party to the conduct of the company's business does not have to involve the taking of positive steps in the carrying on

of the business; it may be enough to support or concur in the conduct

of the business: Howard's case at 674 H.

As far as "recklessly" is concerned its meaning, to which the meaning of "recklessness" corresponds, has been the subject of many reported judicial pronouncements. It suffices to refer to the following. In Shawinigan v Vokins and Co Ltd [1961] 3 All ER 396 at 403 F it was said that "recklessly" means "grossly careless" and that recklessness is –

> "gross carelessness - the doing of something which in fact involves a risk, whether the doer realises it or not; and the risk being such, having regard to all the circumstances, that the taking of that risk would be described as 'reckless' ".

That definition seems, with respect, to involve some circuity of reasoning but the important point it contains is the involvement of a risk, whether or not the doer realises it. That was the point adopted, together with indicia distilled from i a earlier judgments of this Court,

in S v Van Zyl 1969(1) SA 553 (A) at 559 D -G in arriving at the conclusion that the ordinary meaning of "recklessly" includes gross negligence, with or without consciousness of risk-taking. In S v Dhlamini 1988 (2) SA 302 (A) at 308 D - E gross negligence was described as including an attitude or state of mind characterised by "an entire failure to give consideration to the consequences of one's actions, in other words, an attitude of reckless disregard of such consequences".

The test for recklessness is objective in so far as the defendant's actions are measured against the standard of conduct of the notional reasonable person and it is subjective in so far as one has to postulate that notional being as belonging to the same group or class as the defendant, moving in the same spheres and having the same knowledge or means to knowledge: S v Van As 1976 (2) SA 921 (A) at 928 C - E. One should add that there may also be a subjective

element present if the defendant has the risk-consciousness mentioned in Van Zyl but that, as indicated, is not an essential component of recklessness and its existence is no impediment to the application of

the objective test referred to above.

It remains, as far as subjectivity is concerned, to warn that risk-consciousness in the realm of recklessness does not amount to or include that foresight of the consequences ("gevolgsbewustheid") which is necessary for dolus eventualis: Van Zyl at 558 E, 559 E - F. Accordingly, the expression "reckless disregard of the consequences" in Dhlamini must not be understood as pertaining to foreseen consequences but unforeseen consequences - culpably unforeseen -whatever they might be.

In its ordinary meaning, therefore, "recklessly" does not connote mere negligence but at the very least gross negligence and nothing in s 424 warrants the word's being given anything other than

its ordinary meaning.

In the application of the recklessness test to the evidence before it a Court should have regard i a to the scope of operations of the company, the role, functions and powers of the directors, the amount of the debts, the extent of the company's financial difficulties and the prospects, if any, of recovery: Fisheries Development Corporation of SA Ltd v Jorgensen and Another: Fisheries Development Corporation of SA Ltd v A W J Investments (Pty) Ltd and Others 1980 (4) SA 156 (W) at 170 B - C. In that case, with regard to the question of a director's negligence, the principles applicable to a director's duty of care and skill were summarised. Although the focus there was upon the duty owed to the company, whereas here one is concerned with alleged recklessness vis-a-vis creditors, much of what was said there is applicable to the instant matter, subject to what this Court said in Howard's case, to which I

shall revert. The relevant passage in the Fisheries Development judgment (at 1(55 G - 166 F) reads as follows:

> "The extent of a director's duty of care and skill depends to a considerable degree on the nature of the company's business and on any particular obligations assumed by or assigned to him. See In re City Equitable Fire Insurance Co 1925 Ch 407 at 427. Compare Wolpert v Uitzigt Properties (Pty) Ltd and Others 1961 (2) SA 257 (W) at 267 D-F. In that regard there is a difference between the so-called full-time or executive director, who participates in the day to day management of the company's affairs or of a portion thereof, and the non executive director who has not undertaken any special obligation. The latter is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at any other meetings which may require his attention. He is not, however, bound to attend all such meetings, though he ought to whenever he is reasonably able to do so. City Equitable Fire case supra at 429. Of course if he has reasonable grounds for believing such to be necessary, he ought to call for further meetings. Nowhere are his duties and

qualifications listed as being equal to those of an auditor or accountant. Nor is he required to have special business acumen or expertise, or singular ability or intelligence, or even experience in the business of the company. Ibid at 428; In re Brazilian Rubber Plantation and Estates Ltd (1911) 1 Ch 425 at 437. He is nevertheless expected to exercise the care which can reasonably be expected of a person with his knowledge and experience. City Equitable Fire case supra at 428-9; and Brazilian Rubber case supra at 427, A director is not liable for mere errors of judgment. City Equitable Fire case supra at 429; Brazilian Rubber case supra at 437; and Lagunas Nitrate Co v Lagunas Nitrate Syndicate (1899) 2 Ch 392 at 435. In respect of all duties that may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly. He is entitled to accept and rely on the judgment, information and advice of the management, unless there are proper reasons for querying such. Similarly, he is not bound to examine entries in the company's books. Dovey v Cory 1901 AC 477 at 485, 492; the same case in the Court of Appeal, reported under In re National Bank of Wales Ltd (1899) 2 Ch 629 at 673; the City Equitable Fire case supra at 429-30;

> Huckerby v Elliot (1970) 1 All ER 189 at 193 J- 194 D. Obviously, a director exercising reasonable care would not accept information and advice blindly. He would accept it, and he would be entitled to rely on it, but he would give it due consideration and exercise his own judgment in the light thereof. Gower (Modern Company Law, 4th ed) at 602 refers to the striking contrast between the directors' heavy duties of loyalty and good faith and their very light obligations of skill and diligence. Nevertheless, a director may not be indifferent or a mere dummy. Nor may he shelter behind culpable ignorance or failure to understand the company's affairs."

The extent to which that summary was respectively approved and disapproved by this Court in Howard's case is apparent from the following passage (at 678 A - F):

> "In my opinion it is unhelpful and even misleading to classify company directors as 'executive' or 'non-executive' for purposes of ascertaining their duties to the company or when any specific or affirmative action is required of them. No such distinction is to be found in any statute. At common law, once a person accepts an

appointment as a director, he becomes a fiduciary in relation to the company and is obliged to display the utmost good faith towards the company and in his dealings on its behalf. That is the general rule and its application to any particular incumbent of the office of director must necessarily depend on the facts and circumstances of each case. One of the circumstances may be whether he is engaged full-time in the affairs of the company: see the Fisheries Development case supra at 165 G - 166 B. However, it is not helpful to say of a particular director that, because he was not an 'executive director', his duties were less onerous than they would have been if he were an executive director. Whether the inquiry be one in relation to negligence, reckless conduct or fraud, the legal rules are the same for all directors. In the application of those rules to the facts one must obviously take into account, for example, the factors referred to in the judgment of Margo J in the Fisheries Development case and any others which may be relevant in judging the conduct of the director. His access to the particular information and the justification for relying upon the reports he receives from others, for example, might be relevant factors to take into account, whether or not the person is to be classified as an 'executive' or 'non-executive' director."

As to a company's annual financial statements, their preparation and presentation is the responsibility of the directors' (s 286 of the Act), not the auditors. In that regard the directors act on behalf of the company. The auditors function, on the other hand, is to report to members, not on behalf of the company but independently, concerning the reliability of the company's accounts and, consequently, to report to members on their investment. Powertech Industries Ltd v Mayberry and Another 1996 (2) SA 742 (W) at 746 B - H.

Having applied these criteria to the facts and circumstances before it, a Court dealing with a s 424 claim based on alleged recklessness will have cleared the way to the question whether reckless trading has been shown. The following approach by means of which to answer that question was stated in Ozinsky N O v Lloyd and Others 1992 (3) SA 396 (C) at 414G-H:

"If a company continues to carry on business and to incur debts

> when, in the opinion of reasonable businessmen, standing in the shoes of the directors, there would be no reasonable prospect of the creditors receiving payment when due, it will in general be a proper inference that the business is being carried on recklessly."

It seems clear enough that this is largely a paraphrase, suitably adapted to the case of recklessness, of a statement made with regard to fraudulent trading in In re William C Leitch Bros Ltd [1932] 2 Ch 71 at 77 ([1932] All ER 892 at 895). Leitch's case concerned the corresponding section of the English Companies Act of 1929 but the statement there, instead of the words "no reasonable prospect of the creditors receiving payment when due", contained the words "no reasonable prospect of the creditors ever receiving payment". The difference in wording in Ozinsky's case is justified. The word "ever" in Leitch's dictum was found inappropriate when the latter case was considered by the Court of Appeal in R v Grantham [1984] QB 675

([1984] 3 All ER 166), which concerned a prosecution before a jury under the corresponding section of the 1948 Companies Act. In Grantham it was pointed out that the Court in Leitch's case had expressly disavowed an intention to define fraud and was not having to direct a jury as to the meaning of the section in question. The Court of Appeal approved, instead, the trial Judge's direction to the :. jury in Grantham, according to which they would be entitled to find fraud if the accused realised, when the debt in question there was incurred, that there was no reason for thinking that funds would become available to pay the debt when it became due or shortly thereafter (at 682 (QB) and 169 j - 170 a (All ER)).

It will be noted that a second respect in which the statement in Leitch was dissented from in Grantham was the substitution for "no reasonable prospect ... of payment" of the words "no reason for thinking that funds would become available to pay".

However, the change is understandable and warranted. Grantham concerned fraud and however much there might have been no reasonable prospect of payment, if the accused there had had reason, subjectively, for thinking there would be payment then he would have lacked intent. In Ozinsky. as here, one is concerned with an objective

criterion so that the term "no reasonable prospect" is entirely fitting.

As to the phrase "shortly thereafter" used in Grantham. this was omitted from the formulation in Ozinsky and not without reason. There is no present need to consider the uncertainty to which it could give rise.

The above-quoted approach suggested in Ozinsky is, of course, an evidential test, not a statement of substantive law. However, it appears to me to accord recognition to the difference between negligence, on the one hand, and recklessness, at least in the form of gross negligence, on the other. Participation in business

necessarily involves taking entrepreneurial risks but s 424 only penalises the subjection of third parties to risk where (apart from the case of fraudulent trading) it is grossly unreasonable. If, therefore, in a given case there is some ground for thinking that creditors will be paid but a reasonable businessman would nonetheless, because of circumstances creating a material but not high risk of non-payment, refrain from running that risk, the director who does run that risk by incurring credit, and thus falls short of the standard of conduct of the reasonable businessman, trades unreasonably and therefore negligently vis-a-vis creditors. That departure from the reasonable standard could not fairly be described as gross, however, and the director concerned would not be hit by the section. By contrast, an instance that manifestly would fall foul of the section is where the reasonable businessman would realize that in all the circumstances payment would not be made when due. To incur credit in that situation would,

as a matter of degree, be so plainly more serious a departure from the required standard than the conduct in the first example that one has no difficulty categorising it as grossly unreasonable and therefore grossly negligent. This second example, one must emphasize, is an extreme one and it would, in my view, impose an unduly heavy burden on a plaintiff in s 424 proceedings to require proof of circumstances in which a reasonable businessman would assess non-payment as a virtual certainty. So, if a plaintiff were to present evidence warranting the conclusion that when credit was incurred there was, objectively regarded, a very strong chance, falling short of a virtual certainty, that creditors would not be paid, that case would, I think, also involve the mischief which the section was intended to combat. It is not possible to attempt to draw the line between negligence and recklessness more exactly. Each case must turn on its own facts and involve a value judgment on those facts.

From what has been said above regarding the meaning of recklessness and the objective nature of the enquiry as to its proof, it will be plain that a director's honest belief as to the prospects of payment when due, while critical in a case of alleged fraudulent trading, is not in itself the determinant of whether he was reckless.

I

It will be irrelevant if a reasonable person of business in the same circumstances would not have held that belief.

It is therefore necessary to discuss a statement by Buckley J in the unreported case of Re White and Osmond (Parkstone) Ltd 30 June 1960 Ch D. It was quoted with approval in the 24th edition (1987) of Palmer's Company Law and from there quoted with approval in Ex parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (In Liquidation) 1993 (1) SA 493 (A) at 504 A - C. From there, in rum, it was quoted with approval by the Court a quo. The statement in question reads as follows:

> "In my judgment, there is nothing wrong in the fact that directors incur credit at a time when, to their knowledge, the company is not able to meet all its liabilities as they fall due. What is manifestly wrong is if directors allow a company to incur credit at a time when the business is being carried on in such circumstances that it is clear that the company will never be able to satisfy its creditors. However, there is nothing to say that directors who genuinely believe that the clouds will roll away and the sunshine of prosperity will shine upon them again and disperse the fog of their depression are not entitled to incur credit to help them to get over the bad time."

Three points need to be made about that statement. The first is that when it was relied on by counsel for the appellant in R v Grantham, to which I have already referred, the Court of Appeal said this of it (at 682 G - 683 A (QB) and 170 d - e (All ER)):

> "We have been fortunate enough to run to earth a transcript of the whole of that judgment. The judge eventually decided in favour of the trader on the basis that, although he might have been guilty of insufficient

> care and supervision of his business, he could not be said, in the words of Maugham J., to have been guilty of real moral blame so as to justify the judge in saying that he ought to be liable for the debts of the company without limit. In other words, he acquitted the trader of dishonesty - an essential ingredient to liability. In so far as Buckley I. was saying that it is never dishonest or fraudulent for directors to incur credit at a time when, to their knowledge, the company is not able to meet all its liabilities as they fall due, we would respectfully disagree."

Quite clearly the proposition contained in the first sentence in the statement of Buckley J was too widely stated and was rightly rejected by the Court of Appeal. Not surprisingly, Re White and Osmond finds no place in the current (1991) edition of Palmer's Company Law. The second point, and again concerning the proposition in the first sentence, is that it gives corte blanche to trading while commercially insolvent. When one remembers that a company's inability to pay its debts as they fall due, and despite its technical solvency, may result

in its liquidation at the instance of creditors this is indeed an extraordinary proposition. The third point is that even had Buckley J's statement been good law it had to do with fraudulent trading, as did that part of the judgment in Carbon Developments in which Buckley J was quoted. They did not have to do with reckless trading. (In passing, the corresponding sections in the English Companies Acts have never yet included reckless trading as a ground for the relevant statutory relief.) Consequently, the genuine belief referred to in the third sentence would, for reasons already advanced, not avail if objective considerations nonetheless established recklessness.

It follows, in my view, that the Court below was wrong in relying on the statement of Buckley J in assessing whether recklessness was proved in the instant case.

Finally as regards the law, although the standard by which a director's conduct must be measured is an objective one, the

subjective consideration discussed in Van As. in the passage referred to earlier, requires that regard should also be had to any additional knowledge, experience or qualification that the evidence reveals that director to possess and which is relevant to the question whether recklessness has been proved. So if director A, being, say, a farmer, did not know certain relevant facts which, by justified inference, would have been within the knowledge of his co-director B by reason of the latter's professional qualifications or experience, say, as a chartered accountant, then A's ignorance will be blameworthy if he ought reasonably to have sought B's advice, that is to say, not advice qua accountant but advice qua director having additional relevant knowledge. And B's position will be assessed, not just as a director-businessman, but as one having that extra knowledge. The enquiry will therefore be: what would the reasonable businessman having that additional knowledge, or having ready access to that knowledge, have

done in the circumstances? That is the question that must ordinarily be answered in the case of every individual defendant against whom recklessness is alleged under the section but where the crucial decisions in a given case were made by unanimous decision of the board of directors and it is those directors, or some of them, who are the defendants, the question referred to can simply be posed in respect

of the board's decision. Naturally, as the learned trial Judge pointed out, opinions, even among notional reasonable people, may differ, but in the case of a unanimous board decision it is that decision which must be subjected to the necessary objective test.

General Background

Turning now to the facts, Wolnit was a company in the Rentmeester group ("the group"). At the top of the pyramid was Rentekor (Pty) Limited. It was the holding company of Rentmeesterbeleggings Limited ("Rentbel") which, in turn, was the majority shareholder in Rentmeester Versekeraars Limited

("Rentmeester"). Rentmeester held 65% of the shares in Wolnit, the remainder being held by Finabel Limited. (Finabel's shareholders were Western Transvaal farmers.) The other group company of relevance was Trebbob Beleggings (Pty) Limited ("Trebbob"). All its shares were held by a wholly owned subsidiary of a company that in its turn was a wholly owned subsidiary of Rentmeester.

Wolnit was a clothing manufacturer and its business premises comprised a factory and ancillary buildings at Rustenburg. Its products comprised sports- and leisure wear, fashion wear, school clothing, and institutional wear (contracted for on tender) for State Departments such as the Army and Prisons. Its financial year ended on 30 June. The period crucial to the case began in mid-1985 and ended with liquidation. Throughout that period Wolnit's board of directors included second respondent, Joachim Vermooten B Comm Hons CA (SA), ("Vermooten"), third respondent, Dr P J Gous

("Gous"), fourth respondent, Mr P J Niemandt B Comm MBA, ("Niemandt") and fifth respondent, Mr S J Nel ("Nel"). , From March 1987 onward sixth respondent, Mr S J du Plooy B Comm ("Du Plooy"), seventh respondent, Mr S M Preterius B Comm Hons CA (SA) ("Pretorius") and ninth respondent, Mr P R Botha ("Botha") were also directors. Tenth respondent, Mr N B Read B Comm Hons CA (SA) ("Read") became an alternate director in October 1987.

(First, eighth and eleventh respondents were defendants in the Court below and formally cited on the appeal record but for various reasons the appeal does not involve them and it is unnecessary to mention them further.)

Vermooten was throughout the period Rentbel's managing director and chairman of the Rentmeester board. He was unquestionably the leading figure in the group and was one of two witnesses called on behalf of respondents. Gous, General Manager

of the National Association of Maize Producers Organisation, was one of two Finabel representatives on the Wolnit board. Niemandt, like Vermooten, was throughout the period a director of both Rentbel and Rentmeester. Nel, a farmer and businessman, was the other Finabel appointee. Du Plooy, Group Commercial Manager, was from 1987 a director of Rentmeester and a member of Rentbel's management committee. Preterius, Group Executive Officer, was a member of the Rentbel management committee from 1988 onwards. Botha was in 1987 general manager of Rentmeester and from 1988 its managing director. He was also on Rentbel's management committee from 1988. Read, Group Financial Manager, was from 1988 a director of Rentmeester and a member of the Rentbel management committee.

According to Vermooten's evidence Wolnit's directors acted as a board. It was not the position, therefore, that the board's

functions were carried out by only some directors delegated by the others. With some exceptions board meetings were held monthly and regular items for consideration were the minutes of the previous meeting and a management report (including a financial report) usually pertaining to the position of the business about two months earlier.

Until August 1987 Wolnit's auditors were Hoek and Wiehahn, accountants of Johannesburg. After that they were Havenga, Van Straten and Oosthuizen, an accountancy firm at Rustenburg.

At all relevant times appellants, who were among Wolnit's trade suppliers, were insured by Credit Guarantee Insurance Corporation ("Credit Guarantee") against non-payment of the debts

owing to them by Wolnit. The extent of their cover was 75% to 85%

of each such debt. Wolnit's statement of affairs filed in the liquidation reflected an excess of liabilities over assets in the sum of

R1 871 369 and stock in trade valued at R4 417 587. In the event, the stock realised little more than R1m and the deficit was thus very much greater in the end. Save for its banker, Volkskas Limited, and a few preferent creditors, none of Wolnit's creditors received any liquidation dividend. The relevant facts

I turn now to consider the events during the crucial period. For a full understanding of those events it is necessary to have regard to a brief history of what preceded that. Wolnit was incorporated in 1951. From 1971 to 1975 it was under judicial management. The judicial management order was discharged as a result of a compromise between Wolnit and its creditors, included among which was the Industrial Development Corporation of South Africa Limited ("the IDC"), In terms of the compromise the group, through Rentekor, which had made the offer of compromise, acquired

a one-third shareholding in Wolnit. Up to that time Wolnit owned the shares in Rustenburgse Nywerheid-Beleggings (Pty) Limited ("RNB") and the latter owned the factory. Wolnit also had a loan account in RNB. For convenience I shall refer to Wolnit's interest in RNB simply as "the RNB shares". Wolnit was indebted to the IDC in the sum of approximately Rl,5m in respect of past financial assistance. (Unless it is necessary to state amounts in full I shall, in what follows, continue to use that form of abbreviation when referring to millions or fractions of a million.) Pursuant to the compromise the RNB shares were transferred to the IDC in return for further financial aid and an agreement ("the first lease") was entered into between RNB as the lessor, Wolnit as the lessee, and the IDC which was styled "the option grantor". The agreement, entered into in January 1976, was to take effect when Wolnit was discharged from judicial management. In terms of the first lease, which was for a period of nine years and

eleven months, the rental was calculated as a percentage of the value of each of the factory's land, buildings and services respectively, the total value being R600 000. Finabel or another company in the group would provide security for payment of the rental. In addition, the IDC granted Wolnit the option to buy the RNB shares at a price based on the value of R600 000 plus such expenses as RNB and the IDC had incurred in the meantime in respect of the factory. If Wolnit did not exercise the option during the currency of the first lease it was obliged to do so on expiry. Although financial assistance by the IDC was not provided for in the first lease Vermooten testified that it was an "off balance sheet" financing transaction. In other words, one may add, what was made to look like the sale and repurchase of the RNB shares was in reality a loan by the IDC which Wolnit had to repay about ten years later.

According to Vermooten this loan was essential to enable

Wolnit to continue in business. Thereafter everything passed without relevant incident until the end of the ten years approached. A net profit before tax in 1984 of R114 161 changed to a net loss in 1985 of R199 178. At its meeting in May 1985, the Wolnit board decided that a rationalisation report jointly compiled by the Wolnit management and Rand Merchant Bank would be presented to the IDC. The essentials were that Wolnit would buy the RNB shares for approximately R385 000 and then offer them to the IDC as security for a further loan to finance certain developments, purchases and operating capital. The aim was, by rational use of Wolnit's assets and optimum employment of IDC financing, to improve the relationship between own and borrowed funds, to improve the creditor position and to replace bank overdraft facilities by own reserves. The IDC response was expected by the end of August 1985 and, in the interim, facilities at Volkskas had to be extended. At the board meeting in

July 1985, management having reported negatively on stock, work in progress and manufacturing and transport costs, Nel proposed, and it was generally accepted, that if Wolnit did not perform as it should in the 1986 year the board would have to decide on the future of the company.

Prior to the October 1985 meeting the IDC had responded to the rationalisation report by offering R2,1 m if shareholders contributed Rl,5m. After shareholders had rejected that proposal the IDC indicated its preparedness to advance R 1,55m (from which would be deducted an "option" amount of R384 000 - presumably the same amount, approximately, as Wolnit had contemplated paying for the "repurchase" of the RNB shares at the end of the first lease) if shareholders contributed R1,05m. One of the conditions set by the IDC was that at the end of a new 9 year and 11 months lease period the RNB shares would have to be repurchased for R2,15m.

At the October meeting the IDC's revised offer was approved, as also its conditions, as the basis for a new lease. The board noted that the shareholders' contribution would comprise R750 000 in cash and R300 000 raised by the sale of certain residential properties owned by Wolnit.

By January 1986 a new agreement ("the second lease") had replaced the first lease. It recorded i a that the repurchase price payable by Wolnit for the RNB shares under the option provision of the first lease was R384 000 but that the IDC now purchased that option for R1,55m, from which would be deducted the sum of R384 000. The second lease went on to provide that the IDC granted Wolnit what was called a second option, namely, to repurchase the RNB shares. This option Wolnit was obliged to exercise at the expiry of the second lease and the price payable would be R2,15m. In evidence, Vermooten, who was involved in negotiations leading

up to the second lease, said that the R 1,55 m was in reality a loan and that the rental payable under the second lease, as well as the additional R600 000 payable at its conclusion (i e the difference between R 1,55m and R2,15m) really constituted interest. The contract was drawn the way it was to suit the IDC so that the latter could reflect the R600 000 as a capital gain and because it did not want to be seen to be in competition with the banks.

In due course the IDC deducted not R384 000 but R387 875, calling it an "option price".

Wolnit's financial statements for the 1986 financial year reflected the sum of R 1,55m in the income statement as an extraordinary profit and the sum of R329 694 (i e nine-tenths of R387 875) was shown in the balance sheet as an asset designated pre-paid rental. The relevant notes to these items read as follows:

" 8. Die maatskappy huur sy fabrieks-geboue vanaf Rustenburgse Nywer-

heidsbeleggings (Eiendoms) Beperk. Wolnit het gedurende (lie jaar sy reg/opsie, om die aan-dele van Rustenburg Nywerheids-beleggings te koop vir 'n termyn van tien jaar tot 31 Desember 1995 aan die NOK vir R1 550 000 verkoop. Daar is R387 875 minder gerealiseer wat geag word voor-uitbetaalde huur te wees wat oor die oorblywende termyn van die opsie in gelyke paaiemente teen bedryfsinkomste soos volg ver-reken word.

Totale huur vooruitbetaal	387 875
Min: Bedrag gedurende die jaar geamortiseer	(19 394)
Bedrag wat in volgende jaar teen bedryfsinkomste ver-reken word, oorgeplaas na bedryfsbates	(38 787)
	329 694

17. BUITENGEWONE WINS

17.1 Die matskappy het 'n opsie om die aandelekapitaal en leningsrekening in Rustenburg Nywerheids Beleggings (Eien-doms) Beperk wat die grond

en geboue besit waarop besigheid
bedryf word te koop, verkoop teen
'n wins. (Sien aantekening 8) 1 550 000

17.2 Daar is geen belasting betaal-baar
nie aangesien die wins van
kapitale aard is."

In a further note the sum of R2,15m payable at the end of the second lease - in other words the loan capital plus interest - was shown as a contingent liability instead of a certain liability. (I shall, for convenience, refer to these items and the relevant notes as "the 1986 entries and notes".)

The financial statements were approved without discussion or comment at the board meeting in September 1986 at which i a Vermooten, Gous, Niemandt and Nel were present. (Similar entries and notes were repeated in the 1987 financial statements which were approved at the board meeting in August 1987. Among those present were Du Plooy, Pretorius and Botha.)

At a meeting of the board of Rentmeester on 15 August 1986, that is to say, before the 1986 Wolnit financial statements were approved, it was noted that Wolnit, which had by then become a subsidiary of Rentmeester (with the Rentmeester - Finabel shareholding in the proportion referred to earlier), had traded at a loss for the year of R926 150 but that an extraordinary profit of R1 162 128 (the sum actually received from the IDC pursuant to the second lease) had been made. (The net loss shown in the approved statements was in fact R948 051.) The explanation for the loss given in the directors' report attached to the financial statements was this:

> "Die verlies word toegeskryf aan die swak ekonomiese toestande, die onderkapitalisasie van die bedryf en sekere ondoeltreffendhede in die finansiele beheerstelsels. Finansiele herstrukturering het reeds plaasgevind gedurende die tweede helfte van die boekjaar en die beheerstelsels word tans bale indringend ondersoek en aangepas."

As a result of the 1986 entries a positive shareholders' interest was reflected in the annual financial statements throughout the crucial period when, in each financial year after 1986 it should have been a substantially negative figure.

A fundamental problem was that Wolnit was undercapitalised and at all times material to this case suffered from severe cash flow problems. Symptomatic of the onset of Wolnit's financial ills was the change in its fortunes in the 1985 financial year and the huge increase in nett loss in the 1986 year (from R199 178 in 1985 to R948 051). Financial aid from the group became essential. Rentmeester as major shareholder, being a registered insurer, could not lawfully advance money to Wolnit itself but did so through Trebbob, which began lending to Wolnit in November 1986. That the situation was cause for major concern is illustrated by what auditors Hoek and Wiehahn said in a letter to Wolnit dated 27 February 1987.

Enclosing draft financial statements for the six months ending on 31 December 1986, they said i a the following:

"Ons wil die volgende aangeleenthede onder u aandag bring:

a) Wolnit Beperk het die afgelope aantal jare verliese gehad. Die solvensie van die maatskappy is grootliks te danke aan die wins wat gerealiseer is met (lie verkoop van die opsie om aandele van Rustenburgse Nywerheidsbeleggings (Eiendoms) Beperk te koop aan die Nywerheid-Ontwikkelingskorporasie van SA Beperk gedurende die jaar geeindig 30 Junie 1986. Die maatskappy het as gevolg van die bedryfsverliese kontantvloei probleme ondervind wat die vraag laat onstaan het of die maatskappy as 'n lopende saak kan voortgaan. Die gevolg van die bogenoemde probleem plaas ons in die situasie dat gekyk moet word na die lopende saak beginsel, met die uitreiking van ons ouditverslag. Kan u vir ons 'n volledige skriftelike uiteensetting van die stappe wat geneem is en nog geneem gaan word met hul beplande uitwerking op die winsgewendheid van Wolnit Beperk verskaf.

Ons sal dit waardeer indien u skriftelik op die voorafgaande sal reageer."

On 18 March 1987, at the Wolnit board meeting following upon that letter, and after attention had been drawn to the contents of the letter, it was noted that Trebbob had by that time lent Wolnit about R700 000 (in actual fact the figure was R800 000), which loan would have to be repaid by 30 June 1987. It was said that if Finabel wished to lend money to Wolnit it could do so at the same interest rate payable to Trebbob. Cash flow was discussed and the importance of debt collection in this regard was stressed. As regards Wolnit's product range, it was suggested that the traditional winter ranges be supplemented by summer ranges and that the extent of supply be increased to include large chain stores. The only other comment of note in the minutes of that meeting was that Mr W Esterhuizen (the recently appointed managing director) undertook to react, not to Hoek

and Wiehahn's letter, but to the "ouditeurstate". In evidence, Vermooten said that Esterhuizen's proposed response was in fact intended to relate to the letter, which the witness conceded was indeed an important matter. However, nothing in the record shows either further discussion concerning this crucial point in the auditors' letter or that it was answered. Five months later, at the same meeting at which the 1987 accounts were approved, Hoek and Wiehahn were replaced because, said Vermooten, it was considered more practical and convenient to employ auditors in Rustenburg.

The budget for 1988 contained no reference to summer ranges as such but it was indicated that the Hang Ten range, which Wolnit produced under franchise, would be expanded and improved which would greatly improve the company's image. A nett loss was budgeted for, part of the reason for which was attributable to uneconomic State tenders from previous years to which Wolnit was

inextricably bound.

In the 1987 year the nett loss rose to R1,2m (1986 R948 051). The directors' report accompanying the financial statements contained an explanation for the loss which was word for word the same as the explanation they gave for the 1986 loss. At the meeting at which the statements were approved (referred to earlier) the board suggested that thought be given to Wolnit's providing security for the Trebbob loan. This had not been repaid by 30 June and stood at R985 755 as at that date. (With interest included it came to R1,12m.)

In the management report to the board for the period to 30 September 1987 the cash flow position, it was said, "bly haglik". The shortage for October was expected to be R756 623 and "ongeloofllke druk" was being exerted by creditors. At the board meeting of November 1987 there was a report on a tender commitment

to sell socks at R1,35 per pair when the current price was R4,37. In addition, four major creditors with claims totalling some R608 000 were insisting on payment.

The management report for the board meeting in February 1988 stated that audited statements for the first six months of the 1988 financial year showed a loss of R762 925. Remembering that the cash injection effected pursuant to the second lease comprised a loan of R1,1m received from the IDC and capital from shareholders in the sum of R600 000 (R750 000 was contemplated but the 1986 balance sheet shows the lower figure as the actual sum invested), it is clear that by December 1987 this had all been eaten away by the 1987 loss of Rl,2m and the loss of R762 925 for the first half of the 1988 year. In this report the remark was repeated that the cash flow position was critical. In the minutes of that meeting it was recorded that the cost of sales had increased considerably due to tender losses, sales of old

stock at very low prices and uncertainty about stock values. Efforts were made early in 1988 to extricate Wolnit from its commitments under the State tenders but to no avail.

For the purposes of a Rentbel board meeting on 29 March 1988 a discussion paper entitled "Wolnit Ltd: Future Prospects and Alternatives" was prepared. By this time Trebbob had lent Wolnit R2,2m and Rentbel had issued guarantees of R100 000 to the Frame Group for materials supplied to Wolnit and R400 000 to Rand Merchant Bank in respect of banker's acceptances. The paper referred to the uncertainty of stock valuations, stressed the need for profitability and improved cashflow and detailed various problems concerning Wolnit's product mix. With particular reference to stock valuations, it was reported that production stock that was readily usable accounted for only 50% of the stock. The remainder was obsolete or redundant stock, excess stock, slow moving stock or stock having a

restricted use. The alternatives offered in the paper were to retain the operation as it was, to scale it down, or to liquidate the company. Among the disadvantages inherent in carrying on were listed the following:

> " - Will have to change product mix and exploit new markets unknown to Wolnit May require cash injection should sufficient stock not be realized in the short term Cash realized from stock will be applied to reduce unsecured debts (trade creditors) and not secured debts . . ."

A disadvantage mentioned with regard to scaling down was

> " - Profitable activities cannot be positively identified."

And disadvantages to liquidation included

> " - Rentmeester Insurers will probably have to write off its total investment in Wolnit, including loan accounts totalling R3,3m.

> Rentbel group may lose credibility if we allow bankers to lose on Wolnit."

A letter from Volkskas was annexed to the paper in which Wolnit's overdraft facilities were extended to R1m subject i a to security in the form of a cession of book debts and a general notarial bond for R500 000 over all movables. (The latter form of security I shall refer to simply as a bond.)

Vermooten said in evidence that this meeting was prompted by the cash flow crisis. He did not comment upon the various points of disadvantage quoted above and simply said that the decision taken by Rentbel was to continue supporting Wolnit by way of Rentmeester issuing letters of comfort and by Trebbob paying creditors direct.

According to the minutes of that meeting Botha expressed his objection to continuing to put money into Wolnit. It is not

without some small irony that the lot befell him in due course to write the letters of comfort. They read as follows:

> "After consideration and due consideration of your outstanding account in Wolnit's books, we would suggest that the present overdue amounts requested for payment as at 31/03/88 be settled under the following terms and conditions:
>
> 1. Amount under consideration R1 237-00 as per Wolnit accounts supplied to Rentmeester Versekeraars Beperk.
>
> 2. Payment will be made by Rentmeester Versekeraars Beperk.
>
> 3. Equal payments over 3 months.
>
> 4. First payment within 7 days after acceptance.
>
> 5. All outstanding Wolnit orders be supplied timeously.
>
> In order for you to accept the previous proposals, we, Rentmeester Versekeraars Beperk, the holding company, are prepared to issue the following Letter of Comfort:
>
> I, the undersigned, P R BOTHA, in my capacity as Managing Director of Rentmeester Versekeraars Beperk, and properly authorised thereto, do hereby undertake and

confirm the following on behalf of Rentmeester Versekeraars Beperk:

That Rentmeester Versekeraars Beperk is conscious of and will be kept informed of all credit facilities that are and will be made available by yourselves to Wolnit;

That it is Rentmeester Versekeraars Beperk's group policy to enable its subsidiary companies to meet their commitments and obligations;

That Rentmeester Versekeraars Beperk will do everything possible within its power that (sic) Wolnit will be managed according to sound management principles which will enable Wolnit to meet its various obligations.

Please do not hesitate to contact the following persons if there are any other queries regarding the above.

PR BOTHA
N READ
J DU PLOOY "

On 8 April 1988 Mr B Power, Credit Guarantee's senior manager in charge of reinsurance, who also dealt with the insurance of Wolnit's trade creditors, wrote to Rentmeester after coming to hear of the letters of comfort from creditors who had asked Power to advise

led to the issue of die letter of comfort and requested information concerning Wolnit's financial position. In the latter regard he pointed out that copies of the 1987 financial statements had been promised but not yet delivered. Without those statements and details concerning Wolnit's latest financial status, Credit Guarantee was unable, he said, to consider the payment conditions proposed in the letter of comfort. Power also asked whether Rentmeester was, in effect, guaranteeing payment of Wolnit's debts and intimated that insurance cover on Wolnit was suspended in the interim.

Subsequently Power met with Rentmeester and Rentbel representatives and later recorded the gist of their discussions in a memorandum for his office file dated 19 April 1988. This document mentions receipt of Wolnit's 1987 financial statements and December 1987 interim accounts. Power noted that the financial statements presented a very bleak picture and that the 1988 year would probably

be worse. He recorded having asked about the holding company's giving security and was told that Rentmeester, being an insurance company, was precluded by legislation from giving guarantees or lending money but that financial assistance had been given by Trebbob. Pending the satisfactory outcome of discussions with Rentbel, cover remained suspended. What he sought from Rentbel was subordination of the Trebbob loan account and some form of tangible security from the holding company. Later he; decided to forego security and rather limit Credit Guarantee's exposure to Rl,5m. He also noted in the memorandum having been told that Rentmeester had given serious consideration to allowing Wolnit to go into liquidation.

In evidence, Power confirmed the contents of the memorandum and said that the meeting he had had was with Botha and Read. They told him the letter of comfort was not intended as a

guarantee. Nevertheless he reinstated Wolnit's cover on the strength of the letter of comfort and in the belief that with the holding company's support Wolnit was viable, particularly with the high level of expertise of its "backers". Power testified that he and others at Credit Guarantee believed that it was absolutely necessary for them to know what the true position was at Wolnit and for this purpose they were furnished with each year's financial statements and also unaudited management accounts. Had he known that Wolnit was unable to pay its debts he would have withdrawn cover.

At the Wolnit meeting on 12 April 1988 it was announced that Rentmeester, through Trebbob, would make a further R1,2m available to Wolnit in exchange for stock of a like value which Wolnit would then sell on Trebbob's behalf and, with the proceeds, repay the loan debt. This was subsequently referred to as the del credere agency. It was pointed out in discussion that the high stock holdings

were the cause of the negative liquidity situation and that action was needed to restore cash flow to a more acceptable level. Wolnit's future was then discussed, the two options mentioned being liquidation and continuing the business but with closure of the sock-knitting division. In the light of Rentmeester's support the second option was decided on.

At the Wolnit meeting on 18 May 1988 Combrink, the company's secretary, informed the board that cash flow was improving and repayments to Trebbob would commence from July.

Despite existing indications, already mentioned, that stock was overvalued, and possibly by as much as 50%, a stocktaking on 27 May 1988 resulted in an upward valuation of finished stock, the increase being R413 575.

In the budget for the 1989 financial year management announced that Wolnit would, as a totally new venture, enter the

fashion market. It was conceded that no predictions could be made about likely market share but what was considered to be a valuable asset was the Hang Ten range which was very popular. In this entirely different sphere, experience and innovation would be decisive. As a sombre background to this bright new idea the following negative factors appeared in a strengths and weaknesses analysis, namely, inadequate work flow as a result of poor factory layout; the adverse effect of poor liquidity on trading activities; an excess holding of redundant stock; faulty production and planning systems; two uncompleted State tenders; supplier resistance as a result of negative cashflow and tardy payment; an unknown market; and a poor image in the market place.

The climate in which this bold step had to be considered must needs have been chilled by the 1988 financial statements. In reporting to members, the new auditors, Havenga, Van Straten and

Oosthuizen, expressed the qualification that in their view the future survival of the company was dependent on the continuing support of the holding company. In their report the directors disclosed a trading loss of Rl,lm (1987 Rl,2m) and proffered nothing more than the identical explanation, by rote, as in the two preceding years.

In the meanwhile, at its July meeting, the Wolnit board had welcomed Mr W Hollis, the newly appointed general manager.

Earlier optimism that regular repayments of Trebbob's loan would begin from July proved to have been ill-founded. It was clear by early August 1988 that the del credere agency was not providing any answer. By letter dated 9 August 1988 Read addressed the directors of Finabel as follows:

> "By vorige aangeleenthede was die Direksie van Wolnit ingelig omtrent die betaling van sekere krediteure se uitstaande saldo's deur Trebbob (Edms) Bpk, 'n filiaal van

Rentmeester Versekeraars Beperk, (sien Bylaag 'A').

As sekuriteit daarvoor sou Trebbob 'n del credere agentskap-ooreenkoms aangaan met Wolnit, waar sekere van die klaarvoorraad geidentifiseer word en dan hierdie voorraad aan Trebbob verkoop word vir die bedrag van die kontant voorgeskiet.

Wolnit sou dan namens Trebbob die voorraad verkoop en die geld wat daaruit realiseer aan Trebbob oorbetaal.

Die posisie tans is dat Wolnit, weens kontant probleme, nie in staat gaan wees om die oorbetalings te kan doen nie wat veroorsaak dat dit net weer 'n lening word waarvoor geen sekuriteit beskikbaar is nie.

Om bogenoemde probleem te oorkom en Rentmeester Versekeraars Beperk se optrede te regverdig by die Registrateur van Versekeringsinstellings, word die volgende beoog:

Wolnit moet vir Volkskas Beperk 'n Notariele verband gee vir R500 000 ter ondersteuning van die oortrokke fasiliteite.

Daar word met Volkskas onderhandel dat saam met hulle, Trebbob ook 'n Notariele verband vir R1 128 000

registreer wat 2de sal rangeer na hulle verband.

Bogemelde optrede sal beteken dat Rentmeester Versekeraars Beperk se lening wat oor die periode April - September 1988 gegee is, 'n mate van sekuriteit sal geniet.

Ons hoop dat u bogenoemde in orde sal vind."

At the August board meeting Read obtained the board's approval for the registration of two bonds, the first in favour of Volkskas for R500 000 (as had been required by the bank) and the second in favour of Trebbob for Rl,128m. By this stage Trebbob had lent Wolnit just over R2,2m in cash and had made payments to Wolnit's creditors in a total sum of R 1,19m. It had received but two repayments (R14 245 in June 1987 and R300 000 in June 1988) and the interest on the outstanding loan amount was now about R450 000.

Reverting to the Wolnit board meeting of 16 August 1988, the minutes do not contain any reference to the 1988 financial

statements. Nor do any other minutes. In past years the financial statements were dealt with and confirmed at the August meeting. To judge by the dates on the auditors' and directors' reports the 1988 accounts were obviously prepared for the meeting on 16 August and Mr P W G Oosthuizen, the auditor concerned, said as much in evidence. Mr J J Wessels, a practising chartered accountant called as an expert witness on behalf of respondents, testified that he was briefed with the information that the statements were indeed confirmed at that meeting.

The auditors' qualification of the financial statements was what was called in evidence, in auditing parlance, a "going concern" qualification. It conveyed that Wolnit was not a going concern without holding company support. According to Mr H E Wainer, a practising chartered accountant called as an expert witness on behalf of appellants, the expression of this qualification by a company's

auditor is a matter of crucial importance and, in effect, sounds the warning that serious consideration must be given to the question whether the company should continue to carry on business. Wessels confirmed this. Vermooten seemed reluctant under cross-examination to agree but eventually did so. At all events he readily conceded that Wolnit's existence was entirely dependent on support by the holding company. Vermooten said, however, that the copy of the 1988 financial statements given to him did not contain the qualification. As against that, the copy Power received from Wolnit did. So did the copy Wainer obtained from the liquidation file. The evidence does not reveal or refer to any other incomplete copies. In all the circumstances Vermooten's evidence on this point seems curious and inherently improbable. That impression is heightened by the absence of any reference to these accounts at the meeting in question and by a revealing statement at another point in his evidence,

to which I shall refer in due course. What one does find in the minutes that was important to Wolnit's future is the following. Botha opined that the interest burden was killing the company. Hollis agreed and repeated an earlier suggestion that the Trebbob loan be capitalised. Gous thereupon declared that he (meaning Finabel) would only invest capital if a fair return were obtainable. Testifying in relation to this meeting, Vermooten admitted that the clear implication was that Finabel refused to commit any more capital to Wolnit. (It had earlier advanced about R50 000 which was credited to its loan account.) This effectively blocked Rentmeester's itself putting in any more money because, if it did so, the shareholding ratio between it and Finabel would be disturbed and that, said Vermooten, "was 'n baie teer punt".

As it happened, after only one more direct payment to creditors (R9 007 in September 1988) the Rentmeester-Trebbob

assistance to Wolnit ceased altogether.

The other matter of importance referred to in the August minutes was the decision to pass a bond in favour of Trebbob. In that regard Vermooten's evidence was as follows:

!

> "Die probleem was dat toe daardie geld moes terugbetaal gewees het aan Trebbob kon Wolnit dit nie doen nie en was dit duidelik dat ons nie die geld sal terugkry nie. Derhalwe het ons eintlik gese dat ons sal 'n langer termyn lening dan gee as daar 'n ander vorm van sekuriteit verskaf kan word wat toe in die vorm van 'n tweede verband, wat na Volkskas sal rangeer sou gewees het."

The minute dealing with the bond is quite full. There is no reference to any discussion on either a long term loan or the fact that Trebbob would not get its money back. The expression "ons sal nie ons geld terugkry nie" as supposedly denoting a long term loan according to Vermooten, is an aspect that also arises in respect of a later meeting, to which I shall refer in due course. Asked whether the bond would

only assist in the event of liquidation, Vermooten testified that liquidation was not in the directors' minds at that stage. He said the bond was required because the Rentmeester members of Wolnit's board had promised the holding company that security would be obtained. I interpose here to say that if such promise was necessary it would seem that already at this stage the group had in mind some protection in the event of liquidation.

I have dwelt somewhat on the situation prevailing in August 1988 because the thrust of Wainer's expert opinion was that there was no reasonable justification for Wolnit's having continued in business beyond that time.

At a meeting of the Rentmeester board on 5 October 1988 Vermooten reported that serious efforts were being made to try to sell Wolnit but that there was approximately R4m worth of stock "wat moeilik gerealiseer gaan word".

On 8 November Power addressed a letter to Read. By

this time Power had been furnished, in accordance with past practice, with Wolnit's 1988 financial statements. He wrote:

> "I refer to our recent telephone discussion and as mentioned to you our exposure on Wolnit presently stands at ± R1.6 million. In view of the results reflected in the management accounts, we believe our exposure to be on the high side.
>
> Whilst we appreciate that projections anticipate a reversal of the loss trend, the present balance sheet structure offers limited cover for creditors.
>
> As discussed we note that the Company's main support is by way of the loan of R3.1 million by Trebbob Beleggings (Edms) Bpk. In view of our involvement through guarantees given to Wolnit's creditors, may we suggest that consideration be given to capitalizing the loan account, or at least subordinate the loan account.
>
> Would you kindly let us have your response to the above suggestion."

Read responded as follows:

> "With regard to your letter dated 8 November 1988 I would like to respond as follows:

> We have been considering the capitalization of the whole or portion of the ± R3 million loan account of Trebbob Beleggings (Edms) Bpk for some time.
>
> This capitalization is, however, complicated to a certain extent due to the minority shareholding in the company i e in Wolnit Ltd.
>
> We are at present busy evaluating the possibilities and will keep you informed of the developments."

No answer ever was forthcoming from Read, or anyone else on Wolnit's behalf, concerning subordination. Partial capitalisation eventually occurred (about R1,1m of the Trebbob loan debt) and, instead of subordination, the Trebbob bond was registered. That was in December 1988. Power only learnt of the bond after liquidation. He testified that having regard to Wolnit's history as a debtor it was vitally important for him to have been told of the bond. In his view it went "completely against the grain of the letter of comfort". Had he been told that it was registered or in the process of

registration he would have withdrawn cover from the insured creditors. On 23 November 1988, at a Rentmeester board meeting attended i a by Vermooten and four others who were also Wolnit directors, it was reported that several parties were interested in buying Wolnit but that nothing had yet materialised. There was also talk of a management buy-out by Hollis. In the ensuing discussion on the sale of Wolnit or its possible amalgamation with another company, the suspicion was aired that a low offer from one of the interested parties would suit Hollis's bid. The meeting was unanimous that Hollis should not meet with the other party without a Rentbel representative being present. In addition, so it was felt, attention should be given to strengthening the Wolnit management committee because it was too much in Hollis's hands. The following entry then appears in the minutes:

> "Die vergadering is dit redelik eens dat die maatskappy nie sy geld gaan terugkry al sou Wolnit winsgewend raak."

The phrase "nie sy geld gaan terugkry" acquired a significance already alluded to and to which I shall revert.

On 29 November 1988 the Wolnit board met for the first time since its August meeting. The directors had before them the management report for August 1988. It described results as disappointing. The report shows that the bank account was overdrawn close to the R1m limit, that the business was basically illiquid and that stocks would have to be sold at cut prices to maintain cash flow even though that would not help profitability. Cash flow was reportedly in a critical state, requiring daily monitoring, and the 1988 financial statements were to be presented to Credit Guarantee. (This had happened by the time of the meeting.) To help cash flow, creditors had granted a concession, effective for three months, whereby credit

terms were extended

Revised business and financial plans for 1989 were also before the meeting. Part of the former concerned fashion clothing in which sector it was proposed to offer two types of clothing: "knitted outerwear" ("a new area for Wolnit") and "outerwear" (a market as yet little penetrated but "with great potential"). Samples of the new ranges were shown to the meeting. The documentation indicated that the move into fashion wear would entail higher costs, greater stocks and more expensive stocks.

The minutes of the meeting record that Hollis gave the board a general review of the preceding month's results. No discussion appears to have ensued regarding the perennial liquidity problem. Botha noted from the financial statements in the August report that there was a R1,2m shortage and said this indicated that there would be no repayment to Trebbob and that interest had

therefore not been provided for adequately.

In evidence Vermooten explained that aspect as follows:

> "Wel ek dink mnr Botha het net kommentaar gemaak oor die bedrae in die balansstaat en ek dink dit dui alreeds daarop dat ons die siening gehad het dat daardie geld van 'n permanente aard gaan raak ... dit gaan nie terugbetaal word nie. Die maatskappy gaan met sy beplanning om hoer tipe van en duurder tipe van produkte te produseer nie oor die kontant vermoe beskik om ons te kan terugbetaal nie ... Dit verander dit net na 'n meer permanente aard ... 'n vaste tipe van versekerde vaste belegging."

Concerning the new clothing ranges, Vermooten confirmed that they would involve higher and more expensive production and stock levels.

At a Rentmeester board meeting on 13 February 1989 it was reported that a buy-out offer had been mooted by management but that the offerors expected unrealistic discounts. (Hollis had in fact

offered to buy the stock at a 70% discount. I shall refer to that again below.) It was also pointed out that the interest payable to Trebbob was possibly not recoverable and suitable provision might have to be made against that eventuality.

The first Wolnit board meeting of 1989 was held on 17 February. The management reports for November and December 1988 were presented. The November report referred to cash flow as tight and forecast that the overdraft limit would be exceeded by reason of the December wages and salaries bill. Extra facilities for two weeks had been arranged. However, the cash flow position was expected to improve in December. The annexed financial report reflected a negative shareholders' interest of R216 856 and a loss to date of R368 145.

The December report revealed no cash flow improvement. It was tight and remained a problem but the company, it was said,

could "survive" the situation until April 1989 by when an improvement was expected. (As to that, Vermooten testified that any additional cash needs had been provided for by guarantees in respect of the overdraft. I shall deal with the matter of the guarantees in due course.) Hollis's assessment of the first six months of the 1989 financial year was that it had been "hard and difficult". However, the company had a full order book until the end of March and probably April 1989 at higher prices, a leaner staff and a much lower cost base. "The next six months", his report continued "will determine the future of the company and management is confident that we can turn the tide and move into a new era". Vermooten called the full order book "baie bemoedigend". However, the financial report showed a negative shareholders' interest of R571 441 and a loss to date of R727 730.

The minutes of this meeting record that Combrink

informed the board of management's complete confidence that the projected loss of only R140 000 at the close of the financial year could be achieved.

In a memorandum dated 23 February 1989 which Vermooten wrote to Rentbel directors concerning the possible sale of Wolnit, he referred to the management buy-out offer (from Hollis and Combrink) as involving i a a 70% discount on stock. One imagines this should have been interpreted as a sobering indicator to the group's directors that Wolnit's stock was overvalued and that future sales ex-stock would necessarily entail losses. In evidence, Vermooten claimed to have exchanged sharp words with Hollis because the latter had constantly reassured the Wolnit board regarding the value of the stock and here he was trying to buy it cheaply. In the memorandum, however, Vermooten reported to Rentbel:

> "On the question of their offer, Mr H Combrink responded that it was based on the approach that an 'independent buyer would have and that they are still very optimistic about the future of the company and believe that the turnaround is imminent. . . Mr B Hollis still would like a price on which he could put a package together."

If Vermooten really had thought that the management offer was absurdly low, it would have been appropriate to say so in the memorandum but such comment is absent. There is here an implied acceptance that the stock was indeed overvalued.

At the board meeting on 20 March 1989 Wolnit directors had before them the January management report. It contained the following positive comments by Hollis:

> "Management still remains confident that the (cash flow) position will change even under difficult circumstances";

> "The results of January were very encouraging ... we managed to make a profit before interest. This does show that with better production and higher prices we can become profitable"; and
>
> "The future of the company looks a lot better but Wolnit is far from being an efficient company".

As against those remarks, he reported that a debt collection of more than was budgeted for had helped to keep Wolnit "afloat"; that cash flow remained critical; that only through some "good friends in the business" had Wolnit kept abreast and that the ensuing two months would determine the future of the business; that some larger suppliers had withheld deliveries until settlement of payment terms and this would affect the company's ability to deliver orders; and that Credit Guarantee had declined any further exposure and management had had continually to shift cover from one supplier to another. He ended by warning that it would take another six to twelve months before staff

was trained and new systems effective. The annexed financial report disclosed a negative shareholders' interest of R576 654 and a loss to date of R739 943.

The March minutes contain the following important passage:

> "Mnr Vermooten verneem na die huidige kontantvloeie. Mnr Hollis meld dat dit kritiek is en dat daar huidiglik na 'n tekort van ongeveer R300 000 gekyk kan word.
>
> Mnr Hollis vermeld voorts dat daar ook probleme bestaan t o v die plasing van krediet versekering deur Credit Guarantee, wat 'n verdere negatiewe invloed op die kontantvloei het. Mnr Read vermeld dat Credit Guarantee ook met hom geskakel het en hom versoek het om tussentydse finansiele jaarstate voor te le. Hy vermeld verder dat die ouditeure van die maatskappy egter nie bereid is om in die huidige omstandighede verslag sonder kwalifikasie voor te lê nie. Mnr Vermooten versoek die Rentbel en Rentmeester lede teenwoordig op die vergadering om bymekaar te kom en die kapitalisasie van die leningsrekening te bespreek ten

einde te verseker dat die state kan uitkom."

Asked in evidence whether this situation did not call for Wolnifs liquidation, Vermooten replied in the negative. He said the directors all felt that Wolnit was in the process of improving, that it would become an exceptional company and a very profitable business. Referring to Hollis's report that it could take up to a year for production to become efficient and effective, Vermooten said that at the meeting all concerned were very positive about Wolnit's future and it seemed that Hollis had control over the organisation. Vermooten added that Hollis knew what products to introduce and how to market them and that he had brought down the cost per unit. It was, therefore, "'n baie goeie prentjie". As regards the auditor's foreshadowed qualification, Vermooten said this occasioned no urgency.

The Rentmeester board met on 22 March 1989. It was

again noted that Wolnit was not paying Trebbob interest and that such interest was being capitalised monthly. As regards capitalisation of the Trebbob loan, Pretorius warned that this would have to be done before 30 June otherwise Wolnit would, on its own financial statements, be insolvent. As regards Wolnit's overdraft, Read undertook to arrange extra facilities of R300 000 until 5 May. The minutes then read, with conspicuous understatement: "Dit wil voorkom of Wolnit 'n kontanttekort ondervind".

The Wolnit board met again on 20 April. The February management report stated that that month's results were encouraging as the gross profit level had improved up to 30% and there was a profit before interest of R21 234. It also stated, however, that cash flow remained critical and creditors had increased. A policy had been adopted of paying only those who were pressing. Also, stocks had increased. And the annexed monthly financial report revealed that

shareholders' interest was a negative R680 918 and the loss to date R808 457.

The March management report was also before the meeting. The month's results were said to be "very encouraging" due to an increase in gross profit and a nett profit after interest. In addition, production was improving daily. In evidence, Vermooten said that the gross profit increase was a very promising tendency, being very much higher than usual, that the signs were positive and that the company's success was a definite probability. As against that one must read the rest of the March report and the minutes of this particular meeting. The report referred to cash flow as critical. R600 000 was needed to carry the company through the next three months. This position was due to stock increases and lower than budgeted sales and debt collection. The combined effect of inflation, increases in raw material prices, costs, labour and salaries made it

increasingly difficult for the company, which had to carry raw material, work "in process" and finished material, to maintain sound cash flow without making reasonable profits. In addition, stock reduction would only help in the short term; the board had to address the long term financing of the company with the ever increasing inflation rate in mind. An immense amount of work was necessary to make Wolnit an organised and efficient company.

The minutes show that in discussion concerning the various problems besetting the business Vermooten, in contrast with his evidence, told the meeting he would have to satisfy Rentbel that further support for Wolnit was needed and pointed out that as a result of wrong raw material orders, production far exceeding sales, increases in stock values and the resultant illiquidity of the company, he needed much stronger motivation for his case than the management reports provided. Read reported that temporary overdraft facilities in the

amount of R300 000 had been arranged (in addition to the ordinary limit of R941 000) but that even the extended limit had been exceeded and the account could soon be Rl,55m overdrawn. Further, it was noted that, there being a shortage of about R950 000, the company appeared insolvent on its balance sheet and the need was stressed for capitalisation to overcome that. Attention therefore had to be given to valuing the shares. The monthly financial report showed a negative shareholders interest of R613 756 and, after a small profit of R23 303, a loss to date of R785 154.

Asked in evidence whether without capitalisation the 1989 financial statements would have reflected technical insolvency, Vermooten said that without capitalisation the books would merely have shown liabilities as exceeding assets and although this would not be the true position the board did not want the books to show an apparent such excess. He went on —

> "Die ouditeurs sou ook nie daarvan hou nie en ek is seker dat ons weer eens 'n kwalifikasie sou kry. So, ons sou - dit is nie; 'n aanduiding dat die maatskappy tegnies insolvent is nie maar dit is net 'n aanduiding dat die balansstaat syfers nie lekker sou wees nie." (My emphasis.)

He had, it is to be noted, said earlier in his evidence that he was unaware of any previous qualification. He returned to his earlier stance after appropriate questioning by respondents' counsel, but without explaining the answer just quoted.

At a Rentbel meeting which appears to have been held after 20 April and before 2 May 1989, the position of Wolnit was considered. The value of stock, it was noted, continued to rise and was at that stage in excess of R4m. As regards Wolnit's overdraft, it was mentioned that extra facilities of R300 000 had earlier been arranged (referred to in the Wolnit April minutes) and that Rentbel had lent Wolnit R70 000 until 27 April. However, Wolnit needed a

R200 000 extension to the overdraft limit to bring it up to R1 441 000. Volkskas was prepared to grant the facilities on condition that Rentbel provided a guarantee limited as to amount but unlimited as to time. The meeting approved the provision of a guarantee but on the express understanding that Wolnit reduced the overdraft by R300 000 by 30 June and by a further R200 000 by 30 September to bring the account back to the original level of R941 000. If these conditions were not met, so it was decided, Rentbel would be compelled to close Wolnit down. Concerning a request that Rentbel transfer its current R100 000 guarantee in favour of the Frame Group to Gregory Knitting Mills (third appellant), the meeting decided that the Frame guarantee had first to be cancelled. The difficulty in doing this was that Wolnit still owed the Frame Group R49 000 but such cancellation appears to have been effected for on 2 May 1989 a R100 000 guarantee in favour of third appellant was provided by Rentbel. A month later, on 2 June,

Rentbel issued two guarantees to Volkskas, one for R200 000 expiring on 29 June and the other for R300 000 expiring on 30 September.

To sum up the Rentbel assistance by this time, it comprised a very short term loan of R70 000, a guarantee of R500 000 until 29 June and thereafter of R300 000 until 30 September. The loan must have been repaid, at least largely so, for Rentbel is reflected as a creditor for only R39 918 in the Liquidation and Distribution Account and, as mentioned earlier, it did make a loan of R30 000 to Wolnit in August 1989 to which the entry in the liquidation account no doubt mainly refers.

As regards the overdraft guarantees, these were described in a written submission to the Rentbel board compiled by Vermooten, Du Plooy and Hollis as carrying relatively low risk, seeing that debtors were R2,4m and Volkskas would recover first under its cession of Wolnit's book debts. That submission, apparently drawn up early

in May to motivate the request for aid that resulted in the guarantees to Volkskas, listed the causes of the need for help as being increased production, increased stocks, lower than budgeted sales and debt collections, and inflation affecting stock values. The submission ended with the comment that the "present results show conclusively that Wolnit is on the mend and that the prospects for 1990 look very promising." Once again, however, that must be read with other statements in the document. Although about R2m worth of stocks had been sold during the 1989 year the value of unsold stock was over R4m and increasing. And the following was said regarding cash flow.

> "Unfortunately although management was acutely aware of the critical cash flow problem, and have repeatedly stated so in the monthly reports, cheques were issued on the assumption of a higher debt collection rate, resulting in an immediate cash shortfall. This has been rectified and we will withhold all payments to creditors until

money is available."

On 24 May 1989 the Rentbel board had before it a report concerning capitalisation of between R600 000 and R1m which, according to the relevant minute "by Wolnit gedoen moet word voor 30 Junie 1989". Approval was granted.

On 19 June the Rentmeester board approved an application by Trebbob for capitalisation of R1m of its loan to Wolnit "ten einde te voorkom dat Wolnit in 'n insolvente situasie teen 30 Junie 1989 sal wees". The amount was amended by subsequent resolution on 21 August to R 1,1m.

The next time the Wolnit board met was on 29 June 1989 when the April and May management reports were before it. In April, sales were below budget and raw material stocks increased. Cash flow remained critical and reduction of stock was required to improve that. There was a net loss after interest of R34 301 and

a negative shareholders' interest of R648 057.

As for the May report, it expected the serious cash flow situation to remain in the near future. Payment to creditors was being held back as long as possible. Stock levels had gone up yet again. There was a net profit after interest of R7 402 but this was very much below budget. The shareholders' interest and year-to-date figures were much the same as in April. On the positive side production was continuing to improve and management was very confident that the start of the 1990 year would be a new era for Wolnit. Despite those remarks management warned that stock reduction would only be a short term solution. With the high interest burden, the board would have to address the "long term situation" sooner or later. In addition, the paradoxical statement was made that "except for the high interest burden, Wolnit is in a much healthier position that last year".

In evidence Vermooten said the January to May results

were very encouraging. However, it will be noted that apart from small after-interest profits in two of the five months, the other three showed losses. It is appropriate in this connection, and for the purposes of considering what is said below, to tabulate Wolnit's relevant trading figures as stated in management reports comparing results actually achieved with those budgeted. That tabulation follows:

See original judgement table.

Also before the June meeting was a "Business Plan for 1990". It included an overview of 1989. On the positive side, forward orders totalled an average R4m; only 25% of all raw material and work in process was unallocated to orders; costs of raw material consumption had been cut; and staff morale had improved. On the negative side, stocks of finished goods had increased and this put extreme pressure on cash flow. As far as the new year was concerned, management expected much higher raw material prices, high wage demands, high interest rates and a "cash flow which will continue to be critical". The forecast went on to say that the board would have to address the high loan capital position if Wolnit was to have any chance of showing profits after interest. As regards the fashion market, it was proposed to develop a range suitable for sports and casual wear. In addition, the Hang Ten range had been developed for the forthcoming summer by a top Cape Town designer

with input from Hang Ten in America.

The minutes of the June meeting reveal that Vermooten queried the discrepancy in costing, comparing actual and budgeted results. Reasons were given by Combrink and Hollis and debated. Vermooten wanted to know if costing had been adequately adjusted. Combrink said this had been done in the 1990 budget and that costing would be more effective in future. As to cash flow, Read noted that the desired cash levels had not been restored. Combrink said he very confidently expected the situation to be put right by November.

Wolnit's 1989 financial statements were qualified by the auditors, as expected. They were sent to members under cover of a letter dated 19 September. In their draft report (it does not appear to have been signed) the directors announced a trading loss of R946 936 which they ascribed, as before, to poor economic circumstances and undercapitalisation of the business. These accounts were not

considered at any board meeting before liquidation but, considering the facts and circumstances outlined thus far, the thrust of their contents would, on the probabilities, have been expected. It is also of note that despite registration of the Trebbob bond in December 1988 the Trebbob loan was expressly stated to be unsecured.

On 21 July Hollis made a written presentation to the Rentbel board on the occasion of a visit by Rentbel directors to the Wolnit factory. Contrary to Vermooten's protestations in evidence that the company was never factually or commercially insolvent, at least not to the board's knowledge before liquidation, Hollis said in the document in question that when he took over as general manager in July 1988 the company was basically insolvent and only the payment of creditors by Rentmeester sustained the company. (It will be recalled that Rentmeester's last payment was in September 1988.) The factory, he went on, was not in a position to run effectively with

reduced stocks "and all this has to be rectified before a large reduction of stocks can be considered". The company had not achieved effectively in the fashion area in the past but a big improvement was expected in the 1990 financial year. A crucial passage in the presentation reads as follows:

> "As you can see a trading profit has been made in the last six months. NB for June 1989 we have taken some actuals and some budgeted figures. The biggest problem facing management has been the constant shortage of cash flow. We are aware that we need to reduce stocks to improve this position and have set ourselves a reduction program to be achieved by end September. Stocks have been difficult to reduce because as stocks have been sold they have been replaced by additional stocks. If one considers that if all unallocated stocks as of 1st July 1988 were converted into saleable product we would have to sell in excess of R4 million. Up to date we have sold in excess of R2,5 million ex stock and this has severely affected our bottom line. Once the factory's raw material stocks and work in process is 95% against orders we will be able to reduce

> our stocks and improve the cash flow. Management is confident that we should see the results from August onwards as we then start delivering the new summer ranges."

There were indeed some positive comments in the presentation but the message to the Rentbel and Wolnit directors was painfully clear: if operating capital were not put in, the cash flow crisis would continue;

the only other way to improve cash flow was to sell stock, the value of which was over R4m; sales ex stock severely affected the loss figures but large scale selling was nevertheless planned from August through to September. Of the report Vermooten said in evidence

> "Ek dink dit was bale positief gewees en dat Wolnit 'n uitstekende winsgewend bedryf sal raak. Ek dink daarna was dit die algemene gevoel van die direksielede van Rentbel ook.'

At the August board meeting the June management report was before the Wolnit directors. Again they could read that action

was necessary to improve the critical cash flow, and that profit after interest would be possible only once all present stocks had been "cleared up". The minutes of that meeting reflect Read's concern about ex-stock sales, to which Hollis responded by saying that production was now geared to orders except for certain standard items. Combrink said an acceptable stock value was R1,3m or 8 weeks' worth. A Rentbel representative, invited to the meeting, Mr R Stoltz, asked if the 1990 budget catered for an increase in operating capital. Combrink replied in the affirmative. No such capital was ever invested.

At the next ensuing Wolnit board meeting, on 1 September, the July management report was presented. Debt collections were well below budget and had created a very difficult problem. In line with what Hollis had told Rentbel directors in his July presentation, the report stressed that cash flow could only be

improved by stock reduction or the availability of capital. The month's results were not acceptable and drastic action would be taken. Ex-stock sales still continued to affect the company's performance. The report continued:

> "If one considers that we have had to sell ± R4 million ex stock and even if we get 75% of the cost back, it still leaves us with at least a R1 million loss which is something management can do nothing about and can only weather the storm until all the stock has been sold and production is up to scratch."

Vermooten was referred to that passage during his evidence and said it was an exaggeration to say that management had had to sell R4 m worth of stock and pointed out that Hollis's presentation to Rentbel had merely said if all stock were sold it would involve R4 m worth. His answer was correct but the point is, nonetheless, that that was how large the stock figure was and its

substantial reduction would inevitably bring about major loss. The management report said just that in the following description of the vicious cycle into which Wolnit had become locked:

> "The present cash crisis does put extreme pressure on the management team and certainly does affect our performance. We unfortunately find ourselves in a 'catch 22'situation. If
>
> we sell off stocks to improve the cash flow we record losses.
>
> we do not sell stocks we cannot bring in raw material and get out the orders.
>
> we make orders we need to fund the debtors.
>
> we borrow more money we end up with higher interest payments which negatively affect our performance.
>
> we don't pay our creditors we do not get a good raw material supply which in turn affects our production resulting in lower than budgeted sales. I believe that there are only two options available which are (i) reduce the stocks drastically and thereby post

> up paper losses but keep the company viable and at the same time rationalise the business (ii) The Board will have to finance the stock until it can be sold at more realistic prices and at the same time pay the creditors to keep production going.
>
> Long term margins only solution:
>
> The Wolnit Board faced this position numerous times and unless proper action is taken it will have to face this situation again. Wolnit has firstly to be properly funded which will allow management the opportunity to operate the business correctly. Secondly, the company needs to be rationalised and brought into line with its funding. Unless this is done the company will continue limping along with new management every 12 - 18 months and each era making a contribution, but without ever really effectively coming to grips with the real problem which is lack of funding for a company of this size."

As the report emphasised, this was no recent predicament.

The minutes of the meeting reveal active concern about the cash flow question. Hollis said that immediate ex-stock sales

would result in a loss of about R700 000. Read foresaw a shortage in January 1990 of R591 000. Preterius said that they should stop bluffing themselves and that in order to restore the cash position the company had to make profits. Nothing was said about further cash infusion.

On 20 September Rentbel furnished a further R300 000 guarantee to Volkskas to replace the one due to expire at the end of that month.

The Wolnit board next met on 3 October. The August management report recorded a trading loss of R164 124 and results that were "totally unacceptable". Ex-stock sales were R303 343 (well above expected levels) but these involved cut prices and this contributed to sales figures not being met. A non-existent cash flow was seriously affecting the company's performance. Management requested the board to have serious regard to the funding of the

company because although Wolnit had been kept going with a higher overdraft facility and extended terms from creditors, legal action by some creditors would follow unless something positive was done. Although a change for the better would be seen from September onwards, Hollis ended by saying he believed the board had only three options: proper funding, reduction of the company's operation to a size commensurate with existent funding or the sale of the business to another company that would be "prepared to invest" in Wolnit's future prospects. (I emphasise.)

The minutes record Read's comment that regular undertakings to reduce stock levels had not been met. He proposed that a full report concerning the cash shortage be given to Vermooten to present to Rentbel. The latter was not at that meeting but said in evidence that he felt that things were in hand and would improve.

On 3 November 1989 a meeting of Wolnit directors was

held at the premises of Rentbel. It was not an official board meeting. Stoltz was present as also Hollis and Mr J P Smit, Group Manpower Manager. A summary of results from July to September was presented. These showed a trading loss of R594 301 for September including a gross loss of R360 819. According to the minutes the view was expressed that Wolnit had deviated dramatically from its business plan in three respects. One was that expected turnovers had not been achieved and another was that profit before interest and tax was R938 000 below budget. The third was the most significant, namely, that gross profit had ended with a negative figure due to sales of finished goods at losses. The meeting expressed its grave concern and said that further financial assistance would not be possible without dramatic action proposed by management and approved by Rentbel. After discussion it was decided that Wolnit should be sold as a matter of urgency.

At a follow-up meeting on 7 November, again at Rentbel's premises, it was resolved immediately to stop the purchase of raw materials on account and to inform suppliers that Wolnit was re-organising and scaling down. Figures were to be put to Rentbel on which respective prices for the company as a whole, and for sections of the business, could be worked out. Unaudited October figures were presented showing a trading loss of R579 349, including a gross lossof R288 516.

Nothing came of the contemplated sale and liquidation ensued about two weeks later.

The gross losses are, as I have said, significant. Vermooten said in evidence that appreciable increases in gross profit had been anticipated and that sudden gross losses were wholly against that expectation. Explaining the reason for liquidation, he said:

> "(A)s (Wolnit) sulke groot bruto verliese uitgooi dan is daar iets wesenlik verkeerd. Dit is in stryd met alle versekerings wat ons tot en met daardie stadium ontvang het. Daar was 'n groot daling in die vlak van eindvoorrade en dit het die indruk geskep of die verwagting dat in alle waarskynlikheid sal daardie bruto verliese dan voortduur."

The stock figure in the 1989 balance sheet was R4,95m. The July management report gave it as R4,85m. No August figures are contained in the record but the September stock value was R4,3m and in October it was down to R3,4m. How much the monthly figures were augmented by continuing production one does not know but having regard to the actual sales reflected in the September and October figures, totalling just under R2m, it is a necessary inference from that alone that a very large segment was ex-stock. The gross loss for those two months was approximately R650 000. It will be recalled that in his July management report Hollis indicated that a sale

ex-stock of about R4m could entail a loss of about R1m. The gross loss actually sustained was therefore not far out of proportion to Hollis's assessment. Moreover, he said at the September meeting that immediate ex-stock sales would result in a loss of about R700 000.

On the evidence, therefore, the inescapable conclusion is that the gross losses of September and October, which were predominantly responsible for precipitating liquidation, were attributable to sales ex-stock, about the inevitability of which Hollis had warned.

On the strength of figures agreed upon between the parties and expressed in round thousands, Wolnit owed trade creditors as at July 1989 a total of R655 000. In the ensuing four months the company incurred credit in the further amount of R1 775 000, leading to a total owing to trade creditors at liquidation of R2,43m.

In closing this survey of relevant events and related

documentation, it is appropriate to refer to a passage in the Rentbel annual report for the 1989 financial year. It was written by Vermooten but it is not clear when. It reads, with regard to the subsidiary, Wolnit –

> "The capital structure of Wolnit was strengthened during the year. In spite of incurred losses the operating results showed marked improvement during the year".

The issues

The evidence reviewed thus far gives rise to a number of major issues considered by the trial Court and debated by counsel on appeal. They may conveniently be grouped as follows: A FACTUAL INSOLVENCY –

1. The 1986 entries and notes
2. Directors' own valuations

B COMMERCIAL INSOLVENCY –

3. The auditor's qualification

4. The financial support given

5. The financial support required

C WHETHER WOLNIT's CARRYING ON BUSINESS IN 1989 WAS RECKLESS —

6. Attitude to creditors' interests

7. Attitude to group reputation

8. Optimism expressed in management reports

9. The new fashion ranges and attendant increase in costs

10. Incurring credit of Rl,7m during August - November 1989

11. Reason for liquidating eventually

I shall discuss those issues in the tabulated order.

A FACTUAL INSOLVENCY

1. The 1986 entries and notes

As already mentioned, R 1,55m was shown as a profit when it was the capital component of a loan and thus, with the interest

component, in reality a liability. And an amount of R329 694 was shown as an asset in the form of pre-paid rental when it was not an asset at all. In cross-examination of Wainer, in examination of Vermooten and in his heads of argument, counsel for respondents (who appeared on trial and appeal) advanced detailed propositions and figures either to support those entries or to attempt to establish alternative ways in which the entries concerned could, acceptably, from an accounting point of view, have been shown and described in the financial statements. In evidence Vermooten sought to lay appropriate foundations for counsel's efforts. Apart from the fact that certain of the propositions offered by Vermooten in evidence were not put to Wainer for comment the answer to all these suggestions and submissions is simply this. Warner's evidence was emphatic that the 1986 entries and notes were plainly incorrect and unjustified on the facts. He disposed convincingly of the alternative possibilities that were put to him. The trial Court did not record its impressions of the

witnesses but did say that in so far as Wainer and Oosthuizen differed with regard to definitions and auditing practice Warner's evidence was to be preferred. By inference the trial Judge also preferred Warner's evidence to the various suggestions and submissions offered by counsel and Vermooten in the Court below as he labelled the 1986 entries and notes as "blatant verkeerd", "misleidend" and " 'n afkeurenswaardige stuk rekenmeestersverdoeseling". Those descriptions are undoubtedly warranted. The falsity was that the annual accounts over the crucial period misrepresented the value of the shareholders' interest. As Wainer explained, the shareholders' interest is, in effect, the litmus test for factual insolvency. (One could refer to "actual" or "technical" insolvency but, regarding them as synonymous, I shall continue to refer to factual insolvency.) Simply by removing the false profit and the false asset, the positive shareholders' interest in the 1986 financial year would have been

drastically reduced. What is of greater importance is that the shareholders' interest in later years, leaving all other figures in the financial statements as they are, would have been negative, and substantially so. In round figures, and with brackets indicating a negative, the relevant figures would have been these:

1987	(702 000)	
1988	(R1 774 000)	
1989	(R1 472 000)	(Without capitalisation of Rl,lm of the Trebbob loan this figure would have been approximately R2,6m.)

(On paper, as already mentioned, liabilities on liquidation exceeded assets by R 1,871m.) It is possible that the extent of these negative shareholders' interest figures may have been somewhat ameliorated had respondents put forward what the correct figures should have been instead of continuing to assert the correctness of the false figures. In short, therefore, the financial statements falsely conveyed that the company was solvent when in the last three-and-a-half years of its

trading existence it was factually insolvent.

Of the implications of the 1986 entries and notes the trial Court had this to say:

> "(Hulle was) niks meer as agtergrondsgeskiedenis om aan te toon dat Wolnit se finansiele toestand slegter was as wat die state voorgegee het. Die direksie het egter geweet wat die finansiele posisie van Wolnit was en die vraag of hul roekeloos was kan op basis van die werklike finansiele feite beoordeel word. Myns insiens was die verkeerde state bedoel om die finansiele posisie van die groep beter te laat lyk. Dit het geen invloed gehad op die krediteure in die tersaaklike tyd nie en dit was nie op hulle gemik nie. Hoewel dit nie geignoreer kan word nie moet daarteen gewaak word dat daaraan buite verhouding gewig verleen word by die beoordeling of roekeloos skuld gemaak is".

The conclusion that the directors (by whom the learned Judge presumably also meant respondents) knew the true state of affairs and intended the financial statements to convey a false picture is not only justified by the evidence but is an extremely serious

finding. No reasonable person in respondents' position would have done the same. No excuse or explanation was offered by Vermooten for this conduct and none suggest themselves other than that respondents intended to mislead anyone whose task or business interest it was to read the financial statements. Wolnit was a public company. Anyone concerned to know the contents of the annual accounts was entitled to access to them (s 9(1) of the Act; Henochsberg on the Companies Act, vol 1, 36). Copies were furnished annually to Credit Guarantee and that, in effect, was communication of the contents to most trade creditors. Whether the directors had the additional intention to prejudice anyone is irrelevant in the light of appellants' reliance only on recklessness. But the conclusion is unavoidable that the false picture was projected regardless of the consequences. Far from the 1986 entries being mere background, they constituted concealment of a very material fact; a deception which was

maintained from then on. That such concealment is an important consideration in the case is unquestionable. It is indicative of a disregard of trade creditors' interests. Consequently I disagree that the misrepresentation had no influence upon creditors and was not aimed at them. It is difficult to fathom who else had as much interest in knowing the truth. Power was not asked what his reaction would have been had he known of Wolnit's factual insolvency (as distinct from its inability to pay its debts) but if he thought, as he did, that registration of the bond went against the grain of the letter of comfort, it is only logical to infer that he would have thought the same thing had he known of the false concealment perpetuated by each year's audited statements. And he would have been justified had he so thought.

2. The directors' own valuations

In so far as Vermooten proffered in evidence various

suggested revaluations of Wolnit's assets in an endeavour to show factual solvency, the trial Court accepted Warner's reasons for rejecting them when they were put to him in cross-examination and nothing more need be said about them.

The other valuations which it is necessary to mention were two valuations arrived at by the Wolnit directors themselves in determining the value of the Wolnit shares, firstly, as at 30 September 1988, and secondly (for the purposes of the part-capitalisation of the Trebbob loan debt) as at 31 March 1989. The trial Court remarked in this connection that sight should not be lost of the fact that the directors achieved a positive shareholders' interest in both valuations. Whether the Judge meant that the directors were therefore entitled to think that Wolnit was factually solvent on those dates is not clear. If he did, that would run counter to the finding, already discussed, that they knew of the false representation contained in the annual financial

statements. At all events, Wainer criticised the first of those valuations as wrongly taking into account the pre-paid rental already discussed and also the company's assessed loss. The latter consideration, he said, was irrelevant in this type of valuation. Accordingly, instead of a positive figure of R313 023 the unexceptionable facts and amounts in the document concerned actually present a negative figure of R526 602. The other valuation he was not referred to but as it reached a slightly lower positive figure than the first and was flawed in the same respects, it is plain that it, too, ought to have portrayed a substantially negative shareholders' interest. The conclusion I reach in the present connection, therefore, is that Wolnit was at all relevant times factually insolvent and that respondents knew it.

B. COMMERCIAL INSOLVENCY 3.

The auditor's qualification.

Hoek and Wiehahn warned the Wolnit board early in 1987 of the possibility of a "going concern" qualification and asked what would be planned to rectify the problem. No answer was given. The qualification was imposed by their successors in both the 1988 and 1989 financial statements. Wainer stressed the "red light" signal this conveyed and that in auditing terms it meant that if a company was not a going concern its assets had to be valued as if on liquidation. Vermooten was dismissive of this and testified that the Wolnit board knew full well in any case that the future of the company was entirely dependent on support from the group. Wessels, in his evidence, emphasised that to render a limping company a going concern there had to be structured planning and effective action.

Wolnit's inability to trade and pay its debts without group

support would in my view have prompted reasonable businessmen standing in the shoes of respondents and their co-directors to obtain clarity on certain basic questions before deciding against liquidation and in favour of incurring the credit necessary for the continued operation of the business. Those questions would have been: (a) What financial support will the group provide? (b) For how long will that support be available? Without clarity and the group's commitment on those crucial enquiries it was neither responsible nor reasonable for the Wolnit board to have taken the risk, knowingly or not, that trade creditors might not be paid. 4. The financial support given

The trial Court found that the group intended to provide sufficient financing to keep Wolnit going; that that approach was founded on the bona fide conviction that Wolnit would be able to become viable; and that the group implemented its intention in 1987,

1988 and 1989 by substantial loans to Wolnit and by paying considerable sums to creditors, and in 1989 by issuing guarantees to Volkskas, Rand Merchant Bank and third appellant and by capitalising R1,1m of the Trebbob loan.

There is no doubt that these steps were taken and that except for the capitalisation they were intended to help Wolnit stay in business. What is important, however, is the trial Court's premise that the funding was intended to be sufficient. To that aspect I shall revert. It is important to note, first, that the Court's summary of the financial support given is not factually correct. From the evidence summarised earlier it is clear that the Rand Merchant Bank guarantee pre-dated 1989 and that the guarantee to third appellant was an existing one switched from the Frame Group. No direct payments to creditors were made in 1989. Nor were considerable sums lent in that year. R70 000 was advanced for a very short term ending on 27

April 1989, and a mere R30 000 was lent in August 1989. Considering the enormity of the financial gap that had to be bridged, those two sums were neither here nor there. The last major cash loan and the last direct payment to creditors occurred in the period August - September 1988. As for the capitalisation, it is difficult to see how this assisted in extricating Wolnit from its predicament. The learned Judge had already found, and correctly so, that capitalisation was effected to avoid the group's financial statements showing that Rentmeester had an insolvent subsidiary, not to help Wolnit, and that if the intention had indeed been to assist Wolnit the whole loan could have been capitalised.

The real reason for the capitalisation, the fact that only enough of the debt was capitalised to restore ostensible "paper" solvency and that this was not a case of an infusion of operating capital, all combine to render Vermooten's statement in the Rentbel

1989 annual report, that the capital structure of Wolnit was strengthened, a remarkably cynical half-truth.

As regards interest on the Trebbob loan, the trial Court remarked that the interest debt was of no significance in determining commercial insolvency because it was a mere book entry, with no interest payments being made or insisted upon. I respectfully disagree. The Rentmeester minutes regularly recorded that Wolnit was not paying interest and as long as the interest debt was seriously taken, as indeed it was, it affected what on Warner's evidence is the vital figure illustrative of profitability and the ability to pay one's debts, namely, profit or loss after interest. It was obviously the mounting interest liability which compelled the conclusion reached by the Rentmeester directors in November 1988 that Rentmeester would not get its money back even if Wolnit became profitable. That implied that even with interest payments being made the capital would

remain unpaid or not totally paid. And, of course, as long as capital remained unpaid interest would keep accruing. In these circumstances, quite apart from the imbalance to the Wolnit shareholding ratio which a fresh capital infusion by Rentmeester would have caused, it was, at least partly, the interest factor which persuaded the group not to fund Wolnit more than it did. That in turn, as I shall show, removed the only basis for Wolnifs commercial solvency.

As to Wolnit's viability the trial Court made the following finding:

> "Hier het ons die getuienis van mnr Vermooten dat die groep se direksie van oordeel was dat Wolnit lewensvatbaar was. Dit moet aanvaar word in die lig van die feit van die voortgesette steun oor 'n lang tyd."

I do not think that these findings are justified. They fail to take into account that the really substantial support ended in 1988. What was offered after that, apart from the small loans of R70 000 and

R30 000 were the Volkskas guarantees. But all that the guarantees meant in practical terms was this. The evidence is that the ordinary limit of the overdraft was taken as being R941 000. (Why in that particular sum, was not explained.) In about April - May 1989 management stated a need for an increase in the limit to R 1,441 000, hence the two June guarantees from Rentbel totalling R500 000. But from overdraft figures taken from Wolnit's cash book (and agreed upon by the parties) it is plain that by April - May 1989 Wolnit was already overdrawn in the amount of just under R1,4m. The guarantees therefore did not serve to provide any significant operating cash. And they only extended to the end of June 1989, just less than a month. By then the overdrawn account stood at Rl,67m. From June to September there was a guarantee for only R300 000. In other words the secured overdraft limit was effectively down to R1 241 000 in those three months. Yet in July the overdraft went up

to Rl,86m; in August it was R1,75m; in September Rl,7m; and in October R1,63m.

Vermooten was referred in cross-examination to the fact that Wolnit incurred R1,7m in credit from August to November 1989 and asked how that debt could ever have been paid in the circumstances. He said the group ("ons") would have provided guarantees. Asked whether for as much as Rl,7m, he said:

> "As Wolnit nog 'n lewensvatbare bedryf was, dan sou ons dit waarskynlik gegee het. . . ons sou Wolnit ondersteun vir solank ons gedink het hy is 'n lewensvatbare bedryf."

In the light of those answers and the absence of any guarantee other than for R300 000 in September 1989, which was wholly inadequate, the conclusion is a necessary one that Wolnit's directors were extraordinarily negligent in not appealing for that help or that the group had, by April - May 1989, decided that Wolnit was not viable

after all and that token assistance was as much as it was prepared to advance. If the latter was indeed the group's stance, the Wolnit board, with so many of its directors involved in group directorates or management, must, by inference, have been aware of it. Either way, the Wolnit board let the company continue in business after April-May 1989 without sufficient support from the group and without such support Wolnit was commercially insolvent. That is not to say that it was not commercially insolvent earlier. I merely refer to April - May because that was the period in which the subject of the Volkskas guarantees arose. If those guarantees, plus the respective loans of R70 000 and R30 000 constituted inadequate support, and together they comprised the only financial assistance provided by the group since Rentmeester's final payment to creditors in September 1988 then, logically, commercial insolvency dated from as early as October 1988.

The significance of the above-mentioned comment at the Rentmeester meeting on 23 November 1988 - that Rentmeester would not get its money back even if Wolnit became profitable - was considered by the trial Court merely to mean that the Trebbob loan was converted into a long term loan. This seems to me to constitute an uncritical, unquestioning repetition of Vermooten's evidence. To my mind the comment in question provides strong support for the inference that the group had indeed concluded that Wolnit was not viable. Moreover, it was made in the context of discussion concerning the sale of Wolnit and a possible management buy-out. Vermooten's evidence was conspicuously lame and unconvincing in its attempt to downplay the remark's importance which, quite patently, he realised. In evidence-in-chief, when dealing with the failure of the del credere arrangement and the minutes of the Wolnit meeting on 16 August 1988 he said that it was clear "dat ons nie die geld sal

terugkry nie . . . (en) het ons eintlik gese dat ons sal 'n langer termyn lening gee". As already pointed out, those minutes are relatively full and contain no reference to a long term loan or Trebbob's not getting its money back in the sense Vermooten meant. Then, led as regards the Womit meeting on 29 November 1988, where Botha remarked that it seemed as if no repayment would be made to Trebbob and that interest had been underprovided for, Vermooten said this conveyed that the board had already come to regard the loan as permanent. Asked what that meant, he said "dit gaan nie terugbetaal word nie . . dit verander dit net na 'n meer permanente aard . . . 'n vaste tipe van versekerde vaste belegging."

What is noteworthy is the resort by Vermooten to the phraseology used in the Rentmeester minute and the attempt to attach to it the meaning - which I confess to finding laboured and obscure - of a long term loan. What is also remarkable is that although

Vermooten's evidence-in-chief was carefully led and dealt with the documentary evidence in chronological order, it omitted altogether to deal with the Rentmeester minute.

When he was referred to it in cross-examination he said it was not important because it simply meant that the group would not get its money for a very long time and that in turn meant the loan was permanent.

Consistent with the way he had led the evidence-in-chief, respondents' counsel argued that the comment in the Rentmeester minute really related to the absence of any repayments under the del credere arrangement and to the consequent need to replace it with the bond. That is as unconvincing as Vermooten's evidence. Vermooten allegedly did envisage repayment, albeit far into the future. The view at the Rentmeester meeting, however, was that there would be no repayment, not even if Wolnit became profitable. The doom in that

forecast is unmistakable. So is the attempt by Vermooten to transpose the Rentmeester comment to a different context and to remove its sting.

Of course, if the directors of Rentbel and Rentmeester did hold a negative view of Wolnit's prospects it would have been irresponsible and unreasonable towards their own companies to inject any more operating capital into Wolnit.

5. The financial support required

The factual insolvency in this case was not such that the proceeds of sale of even some of Wolnit's assets would have enabled it to continue in business. Its factual insolvency brought about, concomitantly, its commercial insolvency. Rescue from the latter necessitated group financial support. The company had made losses, and ended with a liquidation deficit, in amounts which Wainer described as very large indeed for a company of its size. The fact

that it was undercapitalised all along is frequently referred to in the documentary evidence surveyed above. One could justifiably say it was hopelessly undercapitalised. Because of that, and the stock problem, its cash flow ailment was persistently chronic and eventually fatal. Wainer referred in his evidence to the many features showing that the stock was overvalued and that this problem was of long standing and never overcome. There was the discussion paper presented to Rentbel in March 1988 showing that stock was conceivably overvalued by 50%. There was Vermooten's comment to the Rentmeester meeting in October 1988 that Wolnit had about R4m worth of stock "wat moeilik gerealiseer gaan word". According to Wainer it was this factor which made it difficult to sell the company. Very telling was Hollis's attitude that the stock was worth only 30% of its value. Allowing for a certain degree of "sales pitch" on his part, it is nevertheless significant that on liquidation the stock -

valued at R4,4m - fetched only a quarter of that amount. In these respects, and in regard to the upward valuation of finished stock in May 1988, Wainer stressed that inflated values would distort the trading results and apart from stock over-valuation, the levels of stock were unacceptably high.

The management reports repeatedly drew attention to the need for funding that would enable the business to operate to its potential. There can have been no mistaking the management's plea from late 1988 onwards as being one for a substantial injection of operating capital and nothing less. It was never forthcoming. Management was left with no alternative but to embark on the eventually destructive course of selling ex-stock in order to obtain some cash flow. The resulting gross losses at last prompted the realisation that the shop should be shut. In my opinion reasonable businessmen in respondents' position would have come to that

realisation during the last quarter of 1988 and, consequently, would not have allowed Wolnit to trade during 1989 in a state of commercial insolvency.

> The trial Court observed that the Wolnit directorate was really just an extension of the controlling group. To my mind that is one of the features of this case that was fundamental to the problem. Had there been an arm's length relationship between Wolnit and its financial supporter it might have appeared more clearly to respondents what their responsibilities were. That is to say, looking at the matter subjectively. However, respondents and their fellow Wolnit directors were called upon to apply reasonable standards in their conduct of the company's affairs and in observing their duty to members. They were also required, in my view, to have reasonable regard for the interests of trade creditors once it was manifest, as it must have been to the Wolnit directors, that only sufficient holding company support could

keep Wolnit from commercial insolvency and liquidation. Reasonable businessmen would have realised that directors of a subsidiary in such parlous circumstances were obliged to consider the matter of holding company support as if the latter were an independent entity at arm's length and having that perspective, they would have obtained a commitment from the group as to what financial support was available and for how long. Instead of doing that, respondents and their colleagues on the Wolnit board left those questions not only unresolved but unasked, with the result that culpably inadequate attention was given to ascertaining what more support Wolnit could count on.

C WHETHER WOLNIT'S CARRYING ON BUSINESS IN 1989 WAS RECKLESS

6. Attitude to creditors' interests

Apart from the Wolnit directors' attitude to creditors' interests as evinced by the 1986 entries, there are a number of other

features which bear on the present subject. First, there is the failure by Wolnit to inform Power of the Trebbob bond. Power had written to Read requesting either capitalisation or subordination. The Wolnit board can have been under no misapprehension as to the concern which Power felt, and expressed, to be kept abreast of developments at Wolnit or as to the fact that Credit Guarantee's interests were, in effect, synonymous with the insured creditors' interests. Power's letter of 8 November 1988 was consistent with that concern. It elicited a response from Read that capitalisation was being considered and that Power would be kept informed of developments. Without the latter hearing anything more the bond was registered and nothing was done or said about subordination.

The trial Court considered that the registration of the bond was just normal commercial practice and remarked that appellants and Credit Guarantee had no objection to the Volkskas

bond, regarding that as an ordinary business transaction. The Court also said that if Wolnit had wanted to it could have subjected the whole loan to the bond.

The distinction between Volkskas and Trebbob, however, lies in the identity of the creditors in question coupled with the preceding relationship and communication between Wolnit and Credit Guarantee and, of course, the sentiments expressed in the letters of comfort. Volkskas was Wolnit's banker and the bond in its favour was certainly within the bounds of standard commercial practice. Trebbob, it need hardly be stressed, was a member of the group. It is not just that it sought to place itself ahead of trade creditors in the liquidation queue that is important but the attitude to Credit Guarantee which its conduct manifested. The relevant background consists, firstly, in the commitment conveyed, in my view, by the letters of comfort that the group had the interests of Wolnit's creditors

at heart. Secondly, there is Power's request in the discussion with Botha and Read in April 1988 that subordination be considered and the repetition of that suggestion in his November letter. Wolnit never responded but it nonetheless reacted. Without a word to Power, it adopted a course which was the very opposite to subordination. The fact that in the end Trebbob also did not get paid in the liquidation is presently irrelevant. So is the fact that registration of the bond was a requirement imposed by Rentmeester. Power spoke in his evidence of business morality. It is unnecessary for present purposes to attempt a definition of that concept. The criterion we have to apply in the present appeal is the objective standard of reasonable business people in the position of the respondents. The bond subjected trade creditors to greater exposure than before but, more importantly from Power and trade creditors' point of view, here was the Rentmeester group taking steps to protect itself instead of subordinating its claim, with all the

attendant signs that that conveyed of an inability on Wolnit's part to pay its debts. Power had, to the knowledge of the Wolnit directors, a legitimate interest in discerning and reacting to such signs by warning his insured. The likely, or at least very possible, result of such a warning was that they would stop supplies and so bring Wolnit's business to a halt. Even if there was no legal duty on Wolnit to communicate with Power concerning the bond, I am sure that the failure to apprise Power of the intention to register the bond, or of the registration itself, was, in the particular circumstances, an omission of which reasonable businessmen would not have been guilty. Wolnit's silence in this instance smacks of an intention to carry on business in disregard of creditors' interests.

As far as the trial Court's observation is concerned that the whole Trebbob loan could have been subjected to the bond had there been any untoward intention on the part of Wolnit's directors, the

short answer is that there was no need to do that. It was protection enough to secure the loan for R1,1m. The reasons are these. If regard be had to the 1988 financial statements the fixed assets were, but for an insignificant proportion, encumbered. The book debts were ceded to Volkskas. The bank also had a first general notarial bond over the stock in the sum of R500 000. Looking at the matter as in 1988, the Trebbob loan could only have been met out of the proceeds of the remainder of the stock. In the 1988 financial statements the loan debt was stated as being R3,lm (that was after capitalisation of R1,1m) and the stock value was R3,8m. As already mentioned, however, the stock valuation was too high, possibly by more than 50% but realistically at least that. If, therefore, the stock was, on a non-liquidation basis, worth less than R2m, and if, as was likely, it would fetch even less on a liquidation sale, Trebbob could not have expected much more than Rl,lm to be left over after

satisfaction of the Volkskas bond.

Counsel for respondents contended that Power at the time thought that there was nothing amiss in Wolnit's continuing in business after 1988 and that in reality the decision to go on was one which Wolnit made jointly with trade creditors as represented by Credit Guarantee. The answer to that argument is simply that Power and trade creditors knew nothing of the misrepresentations contained in the 1986 and subsequent annual financial statements or of Wolnit's factual insolvency or of the Trebbob bond or of the insufficiency of such group support as was essential to enable Wolnit to make payment to creditors when due.

7. Attitude to group reputation

Apart from management's optimistic comments from time to time, which I shall deal with in due course, it is difficult to understand what motivation drove Wolnit's directors to persist in

carrying on business into 1989. With the lack of sufficient capital initially, the group's omission to put in sufficient fresh capital, the cash flow problem, the very big losses and the constant failures, by a long way, to meet budgets, reasonable businessmen on the board of a company such as this would have asked themselves what possible justification there was for going on. The fact that from late 1988

amalgamation, management buy-out and selling Wolnit were seriously considered all confirm that Wolnit was not worth keeping. It rang entirely hollow for Vermooten to say that respondents thought Wolnit had very good potential. The group is apparently a large, successful and prominent one. One may assume, I am sure, that it had the financial resources to advance sufficient fresh capital if the potential was as good as that. The fact that it did not, compels the inference, as the most plausible one, that there was no real confidence in Wolnit's viability. The only other motive for carrying on - and again I leave

the management's optimistic remarks to one side - was the hope, against all reasonable odds, in my view, that Wolnit might pull through or amalgamate with another company or be sold or be bought out by management and so save the group the embarrassment of having a subsidiary go into liquidation. It would not avail respondents to say that if that had been the motive the group could simply have put in more money, for the inevitable question would have been: for how long? The inference to be drawn, I think, is that the group was in a "catch-22" situation of its own. It did not consider it worthwhile to invest more in Wolnit but it did not want the company to succumb to liquidation and sully the group's reputation. Apart from the fact that the partial capitalisation was aimed at preventing insolvency appearing on Wolnit's 1989 financial statements there is the reference to Rentbel credibility contained in the discussion paper presented at the Rentbel meeting of 29 March 1988 and the

likelihood that Rentmeester, as an insurer, would be particularly sensitive to the implications of being seen to have a failed subsidiary. An insurer's bad investment would be less understood by the public than a trader's bad luck.

To have continued Wolnit's business into 1989 in order to attempt somehow to avoid there being a liquidated subsidiary in the group would patently have been most unreasonable vis-a-vis trade creditors, essentially at whose expense that attempt would have been made. Whether the inference is warranted that that was the motivation is a question I shall return to.

8. Optimism expressed in management reports

The trial Court considered that the opinion of the group's directors that Wolnit was viable, was supported by the optimistic contents of the management reports. However, assuming the absence of the motivation discussed in heading 7 above, it is only realistic to

bear in mind, firstly, that if Hollis and Combrink had always reported entirely candidly they would have risked talking themselves out of their jobs. For Hollis as a new appointee to the top managerial position brutal frankness about Wolnit's dismal state would not have been easy to express. More importantly, management obviously never knew what the Wolnit or group directorates intended to do about adequate funding. They were not told. Probably they were not told because the directors did not want to reveal the paucity of their planning or their lack of faith in Wolnit. Management requested adequate capital infusion but they only ever learnt of any financial assistance when it was actually given, and then given only on virtually a hand to mouth basis. If Hollis had known that substantial operating capital would never ensue, it is, to judge from his reports, more than probable he would have told the Wolnit board that the company could not carry on. On the other hand if he hoped, as he obviously did, that

sufficient funding might eventually be provided, it made sense to encourage the board by sounding optimistic notes. It would not have helped his case to be totally negative despite Wolnit's very bad state. Therefore, without in any way suggesting intentional misrepresentation, it is not altogether surprising to find optimistic comment. Reasonable businessmen in respondents' position would have borne that in mind and not taken such comment at face value.

The second point is that it is significant how often one finds in the reports that improvement was expected the following month only for that forecast to be wrong, and substantially wrong. Allied to that was the regularity with which after-interest loss occurred. Of the last eight months of 1988 (the calendar year) substantial losses occurred in six.

Thirdly, the optimistic comment was either general or

related to matters which did not bear sufficiently, or at all, on the problems of capitalisation, cash flow, excess stock and overvaluation of stock. Those difficulties were highlighted ad nauseam. The thrust of what management was really saying was that the company had good potential and could become successful provided the group infused sufficient fresh capital. Here, again, it is highly relevant that the group failed or refused to inject such capital and that Rentmeester was very readily considering selling Wolnit or management's buying it out. Those facts belie the positive and optimistic outlook which Vermooten professed to have had and which he said was shared by the Rentbel board.

Another feature which runs strongly counter to the alleged optimistic view of Wolnit's future is the unanimous view at the Rentmeester board meeting of 23 November 1988 that Rentmeester-Trebbob would not get their money back even if Wolnit became

profitable. This aspect and Vermooten's evidence concerning it, have been discussed under heading 4 above. They are equally relevant under the present one. The trial Judge made no credibility findings regarding Vennooten but it does seem implied in the judgment that the Court accepted his evidence on this question of optimism as to Wolnit's future. However, when Vermooten's evidence in that regard is carefully studied in the light of the continuing major unresolved problems of Wolnit and the group's persistent failure to capitalise it properly the conclusion must be, in my assessment, that his evidence in that regard was not only improbable but, in instances such as "dat Wolnit 'n uitstekende winsgewende bedryf sal raak", profoundly so.

Essentially, the alleged optimism was founded on the mere ipse dixit of the management and the fact that gross profits were consistently made in the 1989 financial year. This attaches undue importance to

gross profits. Apart from the fact that the gross profits made in that

year were, in eight of the twelve months, under budget, the achievement of gross profit was nothing unusual even in Wolnit's bad years. All that one can really say in respondent's favour in this regard is that without gross profit there could be no net profit but that is as far as it goes. Wainer testified that the acid test is profit after interest and in that respect, as I have just said, there were losses after interest in six of the last eight months of the 1988 calendar year. There were also such losses in four of the first six months of the 1989 calendar year. And one need hardly even mention the disastrous results in the final five months before liquidation. Moreover, as Wainer also said, if stock is overvalued, the gross profit will be misleading. In so far as Vermooten sought encouragement in a full order book through to 1990, that feature alone was not the key to the company's survival. Profit and cash flow still depended not only on sales but, more especially, the cost of sales and the collection of

debts resulting from sales.

In these circumstances I cannot accept that the Wolnit board, or the relevant group boards for that matter, with their conspicuously well qualified and experienced businessmen simply relied on the optimistic contents of the management reports and the gross profits. The inference that they did is just too implausible. On the other hand, if they did, and respondents among them, their doing so constituted a gross departure from the standard of reasonable businessmen, especially people with their collective qualifications, knowledge and experience.

9. The new fashion rangesand attendant increase in costs

It was decided that in the 1989 financial year Wolnit would venture into the fashion market. That decision was implemented. It had the advantage of placing the business more on an order basis, rather than the hitherto restricting tender basis, but it

involved a number of risks and disadvantages. Such disadvantages included the higher price of material and higher production, the latter involving bigger and more expensive stock levels. Inevitably, therefore, the question ought to have arisen during the last months of 1988: how was the new venture to be funded, and more particularly, how were creditors going to be paid? Once again it is relevant to note the absence of adequate capital funding despite management's pleas. This brings me to the next heading.

10 The incurring of credit of R1,7m during August - November 1989

During the period April-May 1989 Hollis enlisted Vermooten's help in making a submission to Rentbel aimed at obtaining urgent funding in the sum of R500 000. The Volkskas guarantees resulted. As already pointed out in the factual survey above, the bank account was already overdrawn almost to the full

extent of the extra facilities which the guarantees were meant to cover. Thereafter the overdraft increased while, from June to September, the cover afforded by guarantee decreased. It was in those circumstances, with no further financial aid forthcoming from the group, or asked for, that Wolnit proceeded, after July 1989, to incur additional credit in an amount of R1,7m. Vermooten said in evidence that he did not investigate either in July or thereafter whether Wolnit was capable of paying debts of that order. Ordinarily one would not expect a director to make or to have to make such enquiries. But the fact that funding in the sum of only R500 000 was asked for and that the extra facilities were already virtually taken up when the request was made, seen against the events leading up to that stage, reveal a complete lack of the sort of structured financial planning that was necessary, in the light of the going concern qualification, to keep Wolnit from commercial insolvency. Blame for

that failure cannot be laid at the door of management alone. Indeed, the primary obligation for proper planning lay upon the Wolnit board. The threat to close Wolnit if the overdraft was not reduced as required by Rentbel would have prompted reasonable directors in respondents' position to keep a particularly close watch on the overdraft level, the prospects of the required reduction and the incurring of substantial credit. There were no such prospects and there was no such watch.

11. Reason for liquidating eventually The trial Judge found:

> "Die getuienis van mnr Vermooten dat 'n deur die bestuur onverklaarde en vir die direksie onverwagte ineenstorting van die bedryfsresultate van Wolnit in September en Oktober (1989) die likwidasie veroorsaak het, moet aanvaar word."

That the results in those two months precipitated the decision to

liquidate is clear. But I disagree, with respect, that Vermooten's evidence as to a sudden, unexplained collapse must be accepted or is acceptable at all. A detailed analysis of the facts outlined above demonstrates that management repeatedly warned the Wolnit board in clear terms that without proper funding - meaning, by implication, fresh operating capital, not just overdraft guarantees - the cash flow crisis would continue, and that if the only way to achieve some cash flow was to sell from the abundance of overvalued stock then major losses would result. True to that warning, which the board failed to heed, such losses did indeed result. In my view the board's failure in that regard constituted at least gross negligence.

Conclusion

Although several of the features discussed in the preceding section might fairly be said, each on its own, to be decisive of the question of recklessness, I prefer to focus on the

cumulative impact of them all in answering the question whether reckless trading was proved.

The trial Judge considered that a court would not lightly find that the directors of a large organisation such as the Rentmeester group which has so much expertise at its disposal

> "roekeloos besluite neem wanneer hy besluit om sy filiaal waarin hy miljoene bele het verder finansieel te ondersteun . . .".

It may be, speaking generally, that a company that is well endowed with resources and expertise is inherently less likely to trade recklessly than a company existing on the financial edge and run by directors with more modest attributes. And no court should ever lightly find recklessness no matter who alleges it or against whom it is alleged. But if the evidence of recklessness is there, the identity of the particular defendant becomes irrelevant. The trial Court also found

> "(hier) is nie gedobbel met die kapitaal van andere sonder om self enige risiko te loop nie".

However, as long as the financial support forthcoming from the group was inadequate to maintain Wolnit's commercial solvency its board was very much gambling with trade creditors' money. As indicated, that occurred, in my opinion, at least from the end of 1988.

In summary, the 1986 entries demonstrate an attitude of such disregard for the fair, frank and reasonable dealing with outsiders which Wolnit's insolvent circumstances demanded that, in my view, it was reckless. To that foundational consideration must be added the attitude to creditors' interests as evinced by the failure to inform Power of the impending bond; the refusal to subordinate; the reason for part capitalisation being nothing more than to prevent documentary revelation of insolvency; the Rentmeester directors' conviction, of which the Wolnit directors must, by inference, have

been aware, that they would not get their already committed capital back and therefore would not put more in; the continuation of trade in 1989 when respondents knew, or ought to have known, that there were no reasonable grounds for management's optimism; that the company was undercapitalised, terminally short of cash and possessed of a surfeit of overvalued stock such as made a landslide of gross losses inevitable; and, finally, the incurrring of R1,7m worth of debt in the final four months without any or adequate prior assessment of the prospects of all that debt being paid.

Not only was there in all these circumstances no reasonable prospect of payment of all Wolnit's debts when due but the most acceptable inference is that there was on the part of Wolnit's directors, including respondents, an awareness that trade creditors' money was being unreasonably risked and, because of their wish to prevent Rentbel's having a liquidated subsidiary, a wilful disregard of

the consequences to trade creditors.

It follows that in my judgment appellants proved on a balance of probabilities that Wolnit's business was carried on recklessly during the 1989 calendar year.

Nowhere in his evidence did Vermooten seek to protest that he was at any relevant stage not knowingly a party to the carrying on of Wolnit's business and no other respondent testified. The evidence establishes clearly enough that all the respondents were knowingly such parties to the proved reckless trading.

The appeal must consequently succeed.

As to the relief to be granted, counsel for appellants asked in the main for an order declaring respondents liable for all the debts of Wolnit incurred after 1 July 1988 and, in the alternative, for an order in favour of appellants in the sum of the respective debts owing to each at the date of liquidation. The amounts constituting those

debts were agreed between the parties. The evidence shows that they were incurred during the period in which the reckless trading occurred. It seems to me that the alternative form of relief is the one that should, in the exercise of the Court's discretion, be made. It makes for greater certainty as regards the parties' respective rights and obligations flowing from the Court's order. I should also mention that we were informed during argument that other creditors had issued summonses and that the decision on liability in this appeal would apply to their cases. Certain items of ancillary relief and costs which were agreed upon between the parties, or at any rate not in contention, will be included in the order below.

Before concluding, it is necessary to draw attention to a flagrant shortcoming in the record. It comprises 6283 pages. The exhibits start at p 1597, run to p 4595, resume at p 5224 and end at p 6274. This thicket of 4048 pages lacks an index. A few

descriptions of a most general character are put forward in place of an index. For instance, thousands of pages are described simply as "Wolnit Internal Documentation". This is quite unacceptable. As a result, considerable judicial time has been wasted simply in finding the relevant documents. The situation was aggravated by appellant's counsel not presenting a chronology with their heads of argument. This is a particularly bad instance of a breach of Rule 5 (11) of this Court, which requires that a record "shall contain a correct and complete index ... of all the documents and exhibits in the case, the nature of the exhibits being briefly stated in the index". Attorneys responsible for the preparation of records should take note that they stand in danger, in cases of such a flagrant disregard of the rule, of having their clients' records rejected, or of themselves paying costs de bonis propriis if a record should mistakenly be accepted by the Registrar, followed by a postponement at the instance of the Court.

The order of this Court is as follows:

1. The appeal is allowed, with costs, such costs to include the costs of two counsel.

2. The order of the Court a quo is set aside. Substituted for it is the following order:

"1. The defendants (excluding first, eighth and eleventh defendants) are ordered, jointly and severally, to pay In case no 4608/91

(a) First Plaintiff R178 366,52;

(b) Second Plaintiff R45 364,00;

(c) Third Plaintiff R433 349,70

In Case No 15656/91

(d) Fourth Plaintiff R20 119,06

(e) Sixth Plaintiff R180 252,07

(f) Ninth Plaintiff R124 355,56

(g) Eleventh Plaintiff R94 174,96.

2. Subject to par 3 below, the said Defendants are ordered, jointly and severally, to pay costs of suit, such costs to include the costs of two counsel and the qualifying fees

of Mr H E Wainer.

3. The costs wasted in connection with the hearing on 9 March 1992 are to be paid by the above-mentioned plaintiffs jointly and severally, such costs to include the costs of two counsel."

CT HOWIE

EKSTEEN JA) MARAIS
JA) SCHUTZ JA) CONCUR
VAN COLLER AJA)