The new Companies Act, No. 71 of 2008 – reckless trading and the personal liability of directors

By Eric Levenstein, Director

The prestige of holding numerous non-executive directorships is being overshadowed by the increased personal vulnerability to which it exposes directors, particularly those who lack the requisite experience or time to fulfil their fiduciary obligations to companies on whose boards they sit.

The personal liability of South African directors is an emotive and important issue. The topic has gained momentum with the coming into effect of the new Companies Act, and general concerns about incurring personal liability.

Directors need to be aware of the circumstances in which they can be held personally liable for the debts of a company should it be placed into liquidation. It is incumbent upon directors to ensure that when the warning signs become evident, they immediately take legal and financial advice and, if necessary, place their companies either into business rescue or liquidation or to cease trading.

The question to be considered is whether or not insolvency is in fact a real possibility and whether the telltale signs of trading in insolvent circumstances are evident to directors. It is at this stage that directors are obligated to place their companies into business rescue or liquidation.

The Companies Act, No. 71 of 2008

The new Companies Act No. 71 of 2008 (the Act) was signed into law on 8 April 2009 and became effective on 1 May 2011. The Act has a significant impact on directors’ liability in corporate South Africa.

Section 424(1) of the old Companies Act has been replaced by section 77 which, while worded differently, retains the essence of the old section 424. Section 77, as read with section 22 of the Act, penalises and holds directors personally liable for any loss incurred through knowingly carrying on the business of the company recklessly or with the intent to defraud creditors and other stakeholders. Section 214 creates criminal liability for those directors trading a company in a manner which is calculated to defraud a creditor.

Standard of director’s conduct

Section 76 addresses the standard of conduct expected from directors. Section 76(3) states that a director of a company, when acting in that capacity, must exercise the powers and perform the functions of a director:

- in good faith and for a proper purpose;
- in the best interests of the company; and
- with the degree of care, skill and diligence that may reasonably be expected of a person;

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carrying out the same functions in relation to the company as those carried out by that director; and
having the general knowledge, skill and experience of that director.

Section 76(4) states that in respect of any particular matter arising in the exercise of the powers or the performance of the functions of a director, a particular company director will have satisfied the obligations set out in section 76(3), if the director has taken reasonably diligent steps to become informed about the matter.

What would constitute “reasonably diligent steps?” In these circumstances, a director would be entitled to rely on the performance and information provided by persons who have received delegated powers or authority to perform one or more of the board’s functions that are capable of delegation under applicable law. This includes the ability to rely on the veracity of the information provided, including financial statements and other financial data prepared by the employees of the company, accountants or any other professional person retained by the company, the board, or any committee constituted by the company.

Also included would be matters involving skills or expertise that the director could reasonably believe a particular person to have or to be within that person’s professional competence. For instance, if a director receives financial information from departmental managers, he or she would be entitled to rely on the veracity of such information provided such reliance is “reasonable” in the circumstances and when one considers the specific expertise of that particular manager. For example, the marketing director would not have the same level of insight into a set of management accounts as would the financial director.

Furthermore, in terms of section 76(4) of the Act, a director would have satisfied the obligations of section 76(3), if the director made a decision, or supported the decision of a committee or the board, with regard to that matter, and the director had a rational basis for believing, and did believe, that the decision was in the best interests of the company.

In terms of section 77(2)(a), a director of a company may be held liable in accordance with the principles of the common law relating to the breach of a fiduciary duty, for any loss, damages or costs sustained by the company as a consequence of any breach by the director of duties contemplated, inter alia, in section 76.

**Reckless trading: when does one place a company into business rescue or apply for the company’s liquidation due to trading in insolvent circumstances?**

Reckless trading and conducting the company’s business with the intention of defrauding a creditor are also covered by the new Act.

Section 77(3)(b) states that any director of a company is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director:

- having acquiesced to the carrying on of the company’s business despite knowing that it was being conducted in a manner prohibited by section 22(1) of the Act; or
- being party to an act or omission by the company despite knowing that the act or omission was calculated to defraud a company creditor, employee or shareholder, or had another fraudulent purpose.

Section 22(1) states that a company must not carry on its business recklessly, with gross negligence, with intent to defraud any person, or for any fraudulent purpose.

Consequently a director would have a duty to pass a resolution for a company’s business rescue or alternatively resolve to wind up or liquidate as soon as he or she becomes knowingly aware that the company is either financially distressed or is trading in insolvent circumstances (both factually, in that its liabilities exceed its assets, or commercially, in that it cannot pay its debts to creditors as and when they fall due).

The definition of financial distress in reference to a particular company at any particular time, means that:

- it appears to be reasonably unlikely that the company will be able to pay all of its debts as they fall due and payable within the immediately ensuring six months; or
- it appears to be reasonably likely that the company will become insolvent within the immediately ensuring six months.

If a company is financially distressed and directors decide not to place it into business rescue, directors will be under a statutory obligation, in terms of section 129(7), to deliver a written notice to each affected person, confirming that the company is financially distressed and is not being placed into business rescue and providing reasons for this.

The decision by a board to pass a resolution for business rescue needs to be done urgently to enable the business rescue practitioner to take control for the purposes of having a business rescue plan approved and thereafter implemented.

If a company is trading in insolvent circumstances and there is no prospect for business rescue, the directors are obligated to file for liquidation on an urgent basis. In South African law, a company need not be placed in liquidation merely on the basis that it has an “insolvent” balance sheet (i.e. it is factually insolvent). Many start-up companies commence trading on this basis and might remain “insolvent” for a substantial period of time. It is only when the company becomes commercially insolvent (i.e. it cannot pay its debts to creditors as and when they fall due) that directors face an obligation to apply for liquidation. This is not the case where the company is not currently trading and is not incurring credit with creditors. Any insolvent liquidation would still have to be dealt with in terms of the old Act (the new Act only deals with the winding up of solvent companies).

If a company continues to incur debts, where, in the opinion of reasonable businessmen standing in the shoes of the company directors, there would be no reasonable prospect of the creditors receiving payment when due, it can be inferred that the business of the company is being carried on recklessly or negligently as contemplated by section 22(1) of the Act.

The timing of such a liquidation filing depends on the factual circumstances of each case, and in particular the extent of the financial information available to such director at the relevant time. But, should a director not proceed in this manner, he or she might be held personally liable in terms of section 77(3)(b) as read with section 22(1) of the Act.

The test will always be that there will come a point in time when reasonable businessmen would wind up his or her company and pay creditors in full, unless he or she has access to further capital which can revitalise the company with some appropriate form of capital reconstruction.

Incurring credit when a director knows that the company will not be able to meet its liabilities when they fall due, will be tested by the court in order to substantiate the argument that the director should have placed the company into business rescue or liquidation, at that time, and should not have continued to do business knowing full well that such company would never be able to satisfy its creditors.

The detail of financial information available to a director, together with the veracity of such information, will be taken into account when the personal liability of such director is examined in terms of section 77 of the Act. Obviously if a director is in charge of operations, he or she will not be expected to be privy to the same level of financial information as the financial director.

Section 214 now renders a director (or any person) guilty of a criminal offence if such director or person was knowingly a party to an act or omission by a company calculated to defraud a creditor, employee, or a holder of the company’s securities (shareholder), or with another fraudulent purpose.

Thus carrying out the business of the company knowing full well that such company is not able to pay its creditors, now constitutes a criminal offence.
Defences available to directors

The Act does make provision for directors to raise “honest or reasonable” behaviour on their part to be a defence in these circumstances. Section 77(9) states that in any proceedings against a director, other than for wilful misconduct or wilful breach of trust, the court may relieve the director, either wholly or in part, from any liability set out in this section, or on any terms the court considers just, if it appears to the court that the director has acted honestly and reasonably, or having regard to all the circumstances of the case, including those connected with the appointment of the director, it would be fair to excuse the director. This is the equivalent of the Business Judgment test.

It is important to note that the Act does not limit the application of section 77 only to directors as such. It applies to a director, an alternate director, a prescribed officer (as designated by the Minister), a person who is a member of a committee of a board of a company, or a member of the audit committee of a company irrespective of whether or not the person is also a member of the company’s board.

Knowing a party to prohibited conduct?

Furthermore the Act defines what is meant by a person “knowing” of such prohibited conduct. “Knowing” is defined as a person either having actual knowledge, a person who has investigated the matter to an extent that would have provided the person with actual knowledge; or a person who has taken other measures which, if taken, would reasonably be expected to have provided the person with actual knowledge of the matter.

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The intended effect of sections 76 and 77 in the Act is to protect directors who, in carrying on the business of the company, have shown a genuine concern for the prosperity of the company and whose decisions have been made in the company’s interests. Directors should note that any enquiry into the conduct of the affairs of a company will always involve an evidential investigation. To the extent that a director has fulfilled his or her fiduciary duties and conducted the affairs of the company in accordance with sound business practices that fall within the parameters of these expectations, the evidence should speak for itself. Compliance with what can be reasonably expected of a director when faced with similar circumstances will therefore, in appropriate and objective circumstances, constitute a defence to any action launched in terms of section 77. “Reasonable behaviour” will differ from case to case and will be considered having regard to the peculiar circumstances of the issues facing a particular director.

As in all cases involving negligence, the test in South African law is essentially an objective one, in that it postulates the standard of conduct of the notionally reasonable director. It is subjective insofar as the said notional director is envisaged as conducting himself or herself with the same knowledge and access to financial information as the relevant director would have had in the circumstances. In this regard the court will have regard to, inter alia, the role, functions and powers of the directors; the amount of the corporate debt; the extent of the company's financial difficulties; and the prospect, if any, of recovery.

Delinquent directors

Section 162 of the Act states that a director may be declared “delinquent” if such director grossly abuses the position of director or intentionally or by gross negligence, inflicts harm upon the company or a subsidiary of the company contrary to section 76 or acts in a manner that amounts to gross negligence, wilful misconduct or breach of trust in relation to the performance of the director’s functions within, and duties to, the company or as contemplated in section 77 of the Act.

Summary

Directors will have to “up their game”. They need to be aware of the increased obligations in the Act, particularly in regard to the potential exposure to directors’ liability whilst sitting on boards of companies in South Africa.

The new provisions of the Act require South African directors to make important decisions on company issues at board level.

Directors who allow companies to continue to trade in situations of financial distress or insolvent circumstances must recognise that such trading may be the subject of examination either by the business rescue practitioner or, if the company is placed into liquidation, at insolvency enquiries in the post liquidation period.

In current local and world financial markets, a frank and realistic review by directors of the manner in which their companies trade will be essential for survival and to avoid personal liability.

Worldwide, there is an expectation that directors’ duties to their companies be elevated to ensure that the correct decisions are made for the financial benefit of the companies at all times. Failure to maintain a particular level of knowledge of these issues can result in directors being severely criticised or being held liable for company debts as a result of reckless and negligent behaviour.
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