

Cutting edge issues for south african boards of directors facing financial distress in 2019

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INTRODUCTION

Over the years, South African directors have, from time to time been faced with claims of malfeasance, reckless trading, fraud and negligent behaviour, all of which potentially cause damage to shareholders (loss of share value) and where damages are sustained by creditors who have supplied goods and services on credit to the company.

The basis of director liability in South African law is the imposition on directors of the duty of good faith and the practice of care and skill. This legal principle, which imposes personal liability on directors, is based on the proposition that the party that has suffered damages (shareholder or creditor) can "pierce the corporate veil" and hold directors personally liable when directors have been trading a company in the "zone of insolvency" and which results in losses/damages for certain stakeholders.

The United Nations Commission on International Trade Law ("UNCITRAL") set certain guidelines (in 2013), which dealt with the level of obligations that directors should consider when they are trading companies in the period approaching [insolvency](#).^[1] The principles set out by UNCITRAL reflect the world-wide view that there is a strong focus on the obligations of directors and management when they continue to incur credit when such a company is facing imminent insolvency or when insolvency clearly becomes unavoidable. The purpose of imposing such obligations, which only becomes enforceable once insolvency proceedings commence, is to protect the legitimate interests of creditors, shareholders and other stakeholders from sustaining damage/losses. The objective of such legislation is to provide creditors/shareholders with a mechanism to hold directors personally liable, and to further provide incentives for these creditors to bring timely action against such errant directors/managers, in order to minimise the effects of the financial distress experienced by the company.^[2]

Clearly, it is incumbent upon directors and management to ensure that when a company is facing imminent financial distress, that action is taken early and especially if directors wish to counter possible personal liability for trading a company recklessly and to the detriment of creditors, shareholders and other stakeholders.

South Africa, like other international jurisdictions, has sought to regulate directors' obligations in order to prevent reckless trading, which causes prejudice to suppliers of goods and services, employees and other trading parties involved with the financially distressed company. It is important, however, to understand that it is necessary to maintain a balance between the competing goals and interests of different stakeholders such as the directors who manage the company, and the creditors and shareholders who have a distinct and independent interest in the company's continued success. On the one hand, directors should be free to discharge their obligations and exercise their judgment in business matters appropriately and without fear of potential claims. There is a need to ensure that directors are encouraged to take risks, but at the same time not to get involved in wrongful conduct and excessive (and dangerous) risk taking positions. It is important to promote entrepreneurial activity and to encourage, at an early stage, if it is required, the refinancing or reorganisation of enterprises facing financial distress or insolvency.^[3]

INTERNATIONAL POSITION

It is important for legislation that impacts on directors' liability issues to be clear and consistent. If not, such legislation has the potential to undermine the benefits that an effective and efficient insolvency was intended to produce and certainly would exacerbate the financial difficulties that such legislation intends to address.^[4] Directors who trade their companies on the cusp/brink of insolvency in the so-called "Twilight Zone" would expose themselves to personal liability.^[5]

In international jurisdictions, the main categories of director liability for trading in insolvent circumstances are as follows:

- fraudulent trading – the intentional reckless incurring of debts when the director knows that there is no reasonable prospect of repayment;
- negligent trading – incurring debts when objectively there is no reasonable prospect of repaying them;
- compulsory stoppage on percentage loss of capital – a duty to take appropriate action when there has been a loss of capital, where the company is insolvent on its balance sheet or is unable to pay its debts as they fall due;
- business misjudgements leading to insolvency – for example, borrowing beyond the capacity of the company to repay, committing the company to risky business ventures, inadequate budgeting, inadequate financial monitoring or supervision, inadequate insurance, unfunded capital investments, excessive dividends or imprudent investment in high risk securities or having too many employees.^[6]

Most jurisdictions impose civil or criminal liability, or both for these violations of corporate law.

There are, of course, pros and cons in imposing personal liability on directors for the insolvency of the company. Positives would include:

- early stoppage before it is too late, with a view to protecting existing creditors from even greater losses and incoming creditors from becoming embroiled in such ongoing sustained losses/damages;
- controlling and disciplining management by the imposition of tough sanctions such as personal civil and criminal liability; and
- an incentive on management to obtain competent professional advice (at an early stage) when financial difficulties loom.^[7]

The negatives would include:

- the possibility of a premature closure of the company and the shut down of viable businesses which could have survived and contributed to the economy;
- such potential liability inhibits the pursuit of informal workouts, as directors are not willing to recognise the fact that the company is financially distressed and the need to trade out of its difficulties – in this case the policy emphasis is on encouraging the use of judicial rescue proceedings as self-protection to directors;
- the possibility of the personal liability of directors erodes the value of the company and weakens enterprise incentives;
- the risk of insolvent trading creates unpredictability by reason of the fact that the liability on directors depends on particular circumstances and also the attitudes of judicial officers presiding in the courts;
- the imposition of liability may increase the risk of unexpected liabilities for banks, financial institutions and others who are deemed to be "de facto" directors and by reason of their involvement in the informal workout of the company while it is in a period of financial distress.^[8]

The personal liability of directors is essentially a feature of what has been framed "the business judgment rule". The business judgment rule is a legal principle that makes officers, directors, managers and other agents of the company immune from liability to the company for loss incurred in corporate transactions that are within the authority and power to make, when sufficient evidence demonstrates that the transactions were made in good faith.^[9]

The business judgment rule seeks to protect and promote the ability of directors to the full and free exercise of the directors' managerial scope, which has the effect of insulating their business decisions from judicial review and shielding directors from the liability arising from those decisions, even if they subsequently turn out to be mistaken and which leads to insolvency. All that is required for a director to be able to rely on the business judgment rule is to show that such director acted honestly and with a view to what they thought was in the best interests of the company and its creditors.^[10]

In most countries, the bar for reckless and negligent trading has now been raised, and it is apparent that if a jurisdiction imposes liability for commercial mistakes, then almost invariably directors would be liable for the insolvency and business failure and the losses sustained as a result. Most insolvencies can be said to be attributable to some business mismanagement or misjudgement or lack of supervision, as opposed to a cataclysmic external event, which nobody could have foreseen or guarded against. It is often easy to pinpoint the mistake after the event when it would not have been made that obvious in the difficult environment in which the decision was made.

SOUTH AFRICAN POSITION

In South Africa, directors are obligated to report financial distress – failure to do so might result in personal liability.

The 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 continues to have 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.

RECKLESS TRADING

Reckless trading and conducting the company's business with the intention of defrauding creditors are dealt with in the new Act.

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.

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 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, (our emphasis)

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 the company 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).

KNOWINGLY A PARTY TO PROHIBITED CONDUCT

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.

Thus, those 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 would have a defence against claims. 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 has 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.

FURTHER DETERMINATIONS

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 scope of operations of the company; 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.

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.

FINANCIAL DISTRESS

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 ensuing six months; or
- it appears to be reasonably likely that the company will become insolvent within the immediately ensuing 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 decision.

Section 129(7) of the Act provides that:

"[I]f the board of a company has reasonable grounds to believe that the company is financially distressed, but the board has not adopted a resolution contemplated in this section, the board must deliver a written notice to each affected person, setting out the criteria referred to in section 128(1)(f) that are applicable to the company, and its reasons for not adopting a resolution contemplated in this section" (our emphasis).

With a section 129(7) notice, a company effectively publicises to the outside world (including creditors) that notwithstanding its inability to pay its debts in the ensuing six months or the possibility that it will become insolvent in the ensuing six months, it believes, for the reasons delineated in the notice, that it is not necessary to pass a resolution for the commencement of business rescue.

Careful consideration should be given when sending out this notice as it may give rise to unintended consequences (potentially an "Act of Insolvency"). A creditor receiving such a notification might itself apply to wind up the debtor company on the basis that such company cannot pay its debts and/or is insolvent on its' balance sheet.

Thus, if a board concludes that the company is "financially distressed", it will be obliged to either:

- adopt a resolution in accordance with the provisions of section 129(1) of Act to place the company under business rescue; or
- deliver a written notice to each affected person (in accordance with the provisions of section 129(7) of the Act) advising each affected person as to the reasons why the requisite resolution was not adopted.

URGENT DECISIONS NEED TO BE MADE

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 a reasonable business person 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 a business rescue or a liquidation filing depends on the factual circumstances of each case, and in particular the extent of the financial information available to such a 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.

BUSINESS-RESCUE READINESS

The test will always be that there will come a point in time when reasonable business persons would have no choice but to place the company into business rescue or wind up the company.

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 liquidator and creditors at insolvency enquiries concerned in terms of the 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 or marketing, he or she will not be expected to be privy to the same level of financial information as the financial director.

Section 214 renders a director (or any person) 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.

DELINQUENT DIRECTORS

Section 162 of the Act states that a director may be declared "delinquent" if such director grossly abuses the position of director 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

Like their international counterparts, South African directors have no choice but to take these provisions seriously. They need to be aware of the increased obligations set out in the Act; particularly in regard to their potential exposure to claims whilst sitting on boards of companies in South Africa.

The provisions of the Act require South African directors to make important decisions on company issues at board level and to report positions of financial distress to creditors and all affected parties.

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.

As appears above, 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.

[1] See *UNCITRAL Legislative Guide on Insolvency Law Part IV*, 2013 – "Directors obligations in the period approaching insolvency" at p. 1.

[2] Ibid at p. 1.

[3] Ibid at p. 8.

[4] Ibid at p. 8.

[5] See *Directors in the Twilight Zone IV* published by INSOL International (latest version – July 2013).

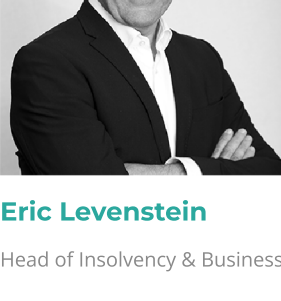
[6] Ibid at p. vi.

[7] Ibid at p. vi.

[8] Ibid at p. vi and p. vii.

[9] Ibid at p. vii.

[10] Ibid at p. vii.



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