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Putting Directors on Notice! – Section 129(7) of the Companies Act

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Section 129(7) of the Companies Act

The often "overlooked" Section and its meaning for directors of financially distressed companies

by Eric Levenstein, Director, and Head of Insolvency, Business Rescue & Restructuring, and Malachizodok Mpolokeng, Candidate Attorney

Business rescue has been an integral part of the South African legal and restructuring landscape for more than a decade, and has, since its inception, served as an effective means through which financially distressed companies may be rehabilitated and restructured, by way of a formal restructuring process.

Section 129(1) of the Companies Act 71 of 2008

Section 129(1) of the Companies Act 71 of 2008 (the "**Companies Act**") provides that a company's board of directors may voluntarily commence business rescue proceedings if it has reasonable grounds to believe that the company concerned is financially distressed and that there appears to be a reasonable prospect of rescuing the company.

For purposes of the Companies Act, a company will be deemed to be "financially distressed" if it appears to be reasonably unlikely that the company will be able to pay all of its debts as they become due and payable within the immediately ensuing six months (commercial insolvency), or alternatively, if it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months (factual insolvency).

Accordingly, the test for financial distress is simple and comprises a six-month "forward looking" test that contemplates either commercial insolvency or factual insolvency. For a number of reasons, boards of companies experiencing financial difficulties often decide not to file for business rescue proceedings and allow the companies concerned to continue to operate under financially distressed circumstances – outside of the formal business rescue process and much to their peril!

The question that should immediately arise, in such instances, but which is often neglected or ignored by boards of directors is simply: "what does the law say?"

Put differently, is it appropriate for boards of directors to allow the company to continue trading whilst in financial distress? Alternatively, what are the duties placed on directors in circumstances where a company is financially distressed, but where its board nevertheless opts not to file for business rescue? The answers to these questions are discussed below.

Resolution for the voluntary commencement of business rescue proceedings

Section 129(7) of the Companies Act provides that if a board of a company has reasonable grounds to believe that the company is financially distressed, but opts not to adopt a resolution for the voluntary commencement of business rescue proceedings, the board must deliver a written notice to each affected person (i.e. its shareholders, creditors, and employees) detailing the company's financial distress, as well as the board's reasons for not adopting a resolution initiating business rescue proceedings.

The rationale behind section 129(7) notices, is to place all affected persons (particularly creditors) on notice that the company in question may be financially distressed, and that it has not been placed into business rescue for certain reasons (which must be set out in the notice).

Given their nature and prescribed content, several unfavourable outcomes may (as a necessary consequence) flow from the issuance of section 129(7) notices to affected persons. Liquidation applications, compulsory business rescue applications, and creditor enforcement processes readily come to mind. For these reasons, it comes as no surprise that very few boards of directors comply with the statutory prescripts of section 129(7).

Certainly from our experience, we have seen boards of directors being very reluctant to issue section 129(7) notices, even in instances where the companies in question are clearly financially distressed! It is safe to say that section 129(7) has been overlooked, neglected, or simply thought away, by numerous boards of directors of financially distressed companies.

Hesitancy in sending out section 129(7) notices

Whilst one can understand the rationale behind boards of directors' hesitancy in sending out section 129(7) notices, it must be accepted that the provisions of the Companies Act cannot be deliberately ignored or circumvented simply because one wishes to avoid certain adverse consequences that may result from compliance with the section. Boards of directors must be aware that the mere fact that section 129(7) does not expressly provide for a sanction or penalty for non compliance, does not necessarily mean that they cannot be held personally liable.

Section 218(2) of the Companies Act

Directors of financially distressed companies must bear in mind that, in terms of section 22(1) of the Companies Act, a company must not "carry on its business recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose", and in this regard, section 77(3)(b) of the Companies Act provides that a director may be held liable for any loss, damage or costs sustained by the company as a direct or indirect consequence of the director having acquiesced in the carrying on of the company's business, despite knowing that it was being conducted recklessly.

Additionally, in terms of section 218(2) of the Companies Act, any person, including a director, who contravenes any provision of the Companies Act is liable to any other person for any loss or damage suffered by that person, as a result of such contravention.

With the above in mind, the scope for personal liability (both to the company itself and to third parties), as a result of non compliance with the provisions of section 129(7) of the Companies Act, very much exists. Therefore, boards of directors are encouraged to take appropriate steps (and take legal advice) to ensure that they do not leave themselves open to such liability.

When the provisions of the Companies Act (as discussed above) are considered in totality, the legal position is simply that where a company is financially distressed, the board of directors must adopt a resolution commencing business rescue proceedings.

Alternatively, if the board decides not to file for rescue, it will be obligated to issue a section 129(7) notice – clearly setting out that there are reasonable grounds to believe that the company is financially distressed and that there are cogent reasons for not filing for business rescue. These statutorily prescribed steps must not be neglected or overlooked by directors, as non compliance may leave them exposed to the risk of personal liability.

Read more on The Basics of Business Rescue here

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Eric Levenstein

Head of Insolvency & Business Rescue

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