WERKSMANS
ATTORNEYS

INSOLVENCY & BUSINESS RESCUE

Reporting obligations of directors in terms of the Companies Act, No. 71 of 2008 – reckless trading and personal liability

3 October 2018 *11 min read*

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 Section 424(1) of the old Companies Act has been replaced by section 77 which, while worded differently, retains the essence of the old section 424.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 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. (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 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 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 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) guilty of a criminal offence if such a 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

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.

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.



Eric Levenstein

Head of Insolvency & Business Rescue

View Profile