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Rising above the flames – answers to directors' burning questions during times of financial crisis

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Often directors of companies that face financial difficulties have questions which they are too reluctant or embarrassed to ask. As a consequence, Rome is left to burn while the Roman Emperor Nero plays the lyre – that is, directors take little to no productive action during a crisis.

Fires destroy, but fires can also be a catalyst for renewal. We have therefore prepared this booklet with the aim of providing answers to directors' burning questions, so that directors have the legal tools to take the necessary action during times of crisis.

This booklet, in particular, provides insight into certain of the responsibilities, duties and liabilities of directors of South African companies facing financial difficulties, as set out in the new Companies Act 71 of 2008 (the Act).

1. **To whom do directors owe their obligations?**

   Every director owes a fiduciary duty to the company and must therefore use his or her particular skills, experience and intelligence to the advantage of the company. That director must therefore promote the success of the company in the collective best interest of all the shareholders.

   However, directors should be careful how they trade the business of their company, because they may incur personal liability towards third parties, as discussed more fully below.

2. **Can directors be held liable to their company for its obligations?**

   Section 77(3)(b) of the Act as read with section 22 of the Act penalises and holds directors personally liable to the company for any loss incurred through knowingly carrying in the business of the company recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose.

   For instance, any director who allows his company to receive goods on credit knowing full well that the company is not in a position to make payment for such goods (i.e. trading in insolvent circumstances) opens himself up to a personal liability claim. If the debtor company has more than one director, the company will have to pursue claims against all those directors that had knowledge of the company's financial situation.

3. **What are the potential claims which third party's might bring against directors?**

   A director can be held personally liable, based on sections 218(2), for any loss or damage to another person which resulted from any contravention of the Act.

   As such, in terms of section 218(2), as read with section 77(3) and section 22, the directors may be held liable for any loss sustained by a third party as a result of the directors knowingly carrying in the business of the company recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose.

   Directors can also be taken to task in other instances, for example in circumstances where the director's conduct is considered to be abusive or prejudicial.

4. **Can directors be liable for fraud?**

Section 22(1) of the Act states that a company must not carry on its business, *inter alia*, with intent to defraud any person, or for any fraudulent purpose. Section 77(3)(b) in turn states that any director of a company is liable for any loss, damages of costs sustained by the company as a direct or indirect consequence of the director having agreed to the carrying on of the company's business in a manner prohibited by section 22(1) of the Act; or being party to an act or omission was calculated to defraud a company creditor, employee or shareholder, or had another fraudulent purpose.

As such, the directors who were knowingly a party to a fraud by the company can be held personally liable.

5. **What other sanctions may be brought against directors?**

In terms of Section 162 of the Act a court may on application, if justified, make an order declaring a person to be delinquent where:

1. the person is a director of that company, or within 24 months immediately preceding the application, was a director of that company; and
2. such director has, inter alia:
    1. grossly abused the position of a director;
    2. took personal advantage of information or an opportunity for him- or herself or for another person other than the company or a wholly owned subsidiary of the company;
    3. intentionally, or by gross negligence, inflicted harm upon the company or a subsidiary of the company, contrary to the provisions of the Act;
    4. acted in any manner that amounts to gross negligence, wilful misconduct or breach of trust in relation to the performance of such director's duties; or
    5. acted in a manner contemplated in section 77(3).

A declaration of delinquency, following conduct described in paragraph 5.2 above, may be made subject to any conditions the court considers appropriate, and will subsist for a minimum of 7 years from the date of the order. In terms of section 69(8)(a) of the Act, a person who has been declared delinquent is disqualified from being a director of a company.

Also, a court may make an order placing a person under probation if the court is satisfied that the declaration is justified where such director, *inter alia*:

A declaration placing a person under probation may be made subject to any conditions the court considers appropriate, and will subsist for a period not exceeding 5 years from the date of the order. In terms of section 162(10)(d) the court may order that the person under probation be supervised by a mentor in any future participation as a director while the order remains in force, or be limited to serving as a director of a private company or of a company where that person is the sole shareholder.

It is important to mention that, if a director, while under an order of probation, acted in a manner that contravened that order, the court must make an order declaring that person to be a delinquent director, and that order will be unconditional and subsist for the director's lifetime.

When declaring a director to be delinquent or under probation, the court may also order:

Section 213 creates a new offence in respect of disclosure of confidential information if such information has been obtained by a person in the carrying out functions in terms of the Act or as a result of a complaint or proceedings under the Act. A "person" is not defined and includes anybody, including directors.

Section 214 of the Act provides for criminal liability if an act of fraud has been perpetrated by any person in relation to a company, its creditors or employees.

6. **What steps should directors take to minimise their risk of liability?**

In order to minimise their risk of liability, a director must perform his/her powers and functions in good faith and for a proper purpose; in the best interest of the company; and with the degree of care, skill and diligence that may be reasonably expected of a person carrying out the same functions in relation to the company as those carried out by that director; and having general knowledge, skill and experience of that director.

Section 76(4) of the Act states that, in respect of any particular matter arising in the exercise of the powers of the performance of the functions of a director, a particular director will have satisfied his/her obligations if that director has taken reasonably diligent steps to become informed about the matter, does not have a personal financial interest therein (or has declared such an interest to the board in

terms of section 75), and has a rational basis to believe that the decision was in the best interest of the company at the time. This goes to the degree of knowledge that a particular director would have as to the financial status of the company.

7. **Can directors rely on others' advice?**

   In terms of section 76(4) of the Act, a director must take reasonably diligent steps to become informed about the financial status, business and affairs of the company. In taking such steps, the directors are entitled to rely on information prepared by the employees of the company, accountants or any other professional person retained by the company. However, the director must reasonably believe that those duties falls within the particular person's professional or expert competence; or that the particular person merits confidence. Also, an unquestioning reliance on others by a director is not acceptable.

8. **Can directors' liability be limited?**

   Section 78(2) of the Act provides that any provision of an agreement, a company's Memorandum of Incorporation (MOI) or rules of a company, or a resolution adopted by a company, which directly or indirectly purports to relieve a director of any duty or liability, or negate, limit or restrict any legal consequences arising from an act or omission that constitutes wilful misconduct or wilful breach of trust on the part of the director, is void.

   However (and except to the extent that the MOI of a company provides otherwise), a company may, in terms of section 78(5) of the Act, indemnify a director in respect of any liability arising. This is except for a liability arising from wilful misconduct or wilful breach of trust on the part of the director; or where a fine has been imposed as a consequence of a director having been convicted of an offence; or where a director acted recklessly, or despite knowing he or she lacked authority, or with the intent to defraud creditors, or with any other fraudulent purpose.

   Furthermore, the company may, in terms of section 78(4) of the Act and subject to its MOI: advance expenses to a director to defend litigation in any proceedings arising out of the director's service to the company; and directly or indirectly indemnify a director for the expenses incurred, or to be incurred, for such litigation if such litigation is abandoned, or which exculpates the director, or which arises in respect of any liability for which the company may indemnify the director, as described above.

   Section 78(7) of the Act provides further, that a company may (subject to its MOI) purchase insurance to protect: a director against liability or expenses for which it is permitted to indemnify a director; and the company against any liability for which the company is permitted to indemnify a director, or any contingency including any expenses it is permitted to advance in respect of the defending of litigation by a director, or to indemnify a director for such expenses.

9. **What is the position of non-executive directors?**

   In *Howard v Herrigel* 1991 (2) SA 660 (A) the court held on appeal that:

   "*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, that person 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*."

   The statutory duties and liabilities of non-executive directors under the Act are therefore the same for executive and non-executive directors alike.

   However, the Act does sometimes delineate the responsibilities of executive and non-executive directors of public companies. For example, executive directors (i.e. directors who are involved in the day-to-day operations of the company), prescribed officers and a company employees may not, in terms of section 94(4) of the Act, be members of the company's audit committee.

   It is also worth mentioning that the Listing Requirements of the Johannesburg Stock Exchange (JSE) and the King Code differentiates between the responsibilities and duties of executive and non-executive directors. For example, the chairman must either be an independent non-executive director, or the issuer must appoint a lead independent director, in accordance with the King Code.

10. **What is the position of shadow directors?**

    Shadow directors would qualify as prescribed officers. A prescribed officer, as defined in the Act, includes every person, by whatever title the office is designated, that exercises, or regularly participates to a material degree in the exercise of, general executive control over and management of the business and activities of the company. This is relevant, as most of the provisions of the Act pertaining to directors apply equally to prescribed officers.

11. **Are there any different requirements and obligations for/on the directors of public companies in a pre-insolvency scenario?**

The Act does not distinguish between directors of public companies and directors of private companies. Therefore, the statutory requirements and obligations for/on directors of a public company are the same as those for/on directors of a private company.

However, directors of public companies listed on the JSE have additional duties and responsibilities, as the JSE Listing Requirements incorporates therein certain practices from the King Code which makes their implementation mandatory, even though implementation of those practices in the King Code is generally voluntary.

12. **What steps should a Board then undertake when it realises that a company is in financial difficulties?**

A company's board should carefully assess whether or not the company is facing financial difficulties which it may well be able to overcome (albeit with some difficulty), or is financially distressed.

A company is financially distressed within the meaning of the Act if it is reasonably unlikely that it will be able to pay all its debts as they fall due and payable within the immediately ensuing six months, or it is reasonably unlikely that the company's assets will continue to exceed its liabilities within the immediately ensuing six months.

When a company is facing financial difficulties it will be necessary for the board of directors to take the necessary steps to overcome those difficulties (e.g. restructure the company's business operations and/or its financial affairs) and to continually assess the company's financial status.

Should a company nevertheless become financially distressed, then the Board should either pass a resolution to place the company in business rescue, or deliver a statutory 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 such decision.

13. **What then is the role and obligations of directors of a company in business rescue?**

Once a company goes into business rescue, Chapter 6 of the Act sets out certain roles and obligations (in this changed environment) for directors.

Section 140(1)(a) and (b) states that *"[d]uring a company's business rescue proceedings, the practitioner, in addition to any other powers and duties set out in this Chapter- (a) has full management control of the company in substitution for its board and pre-existing management; (b) may delegate any power or function of the practitioner to a person who was part of the board or pre-existing management of the company*". However, notwithstanding any such delegation, the KwaZulu Natal Division of the South High Court, in the as yet unreported case of *Vengadesen v Standard Bank of South Africa Limited* with case number 8575/17P, held that ultimate responsibility rests with the business rescue practitioner.

As such, section 137(2)(b) of the Act provides that during a company's business rescue proceedings "*each director of the company has a duty to the company to exercise any management function within the company in accordance with the express instructions or direction of the practitioner, to the extent that it is reasonable to do so*". In fact, section 137(3) goes further and states that *"[d]uring a company's business rescue proceedings, each director of the company must attend to the requests of the practitioner at all times, and provide the practitioner with any information about the company's affairs as may reasonably be required*".

In addition, section 137(4) provides that if, during a company's business rescue proceedings, the board, or one or more directors of the company, purports to take any action on behalf of the company that requires the approval of the practitioner, that action is void unless approved by the practitioner.

For these reasons, section 137(2)(d) states that "*to the extent that the director acts in accordance with paragraphs (b)* [to act in accordance with the practitioner's express instructions] *and (c)* [requiring compliance with section 75 of the Act which concerns disclosure to the board of personal financial interests], *is relieved from the duties of a director as set out in section 76, and the liabilities set out in section 77, other than section 77(3)(a), (b) and (c)*" [our insertion for ease of reference].

If at any time during the business rescue proceedings, the director has:

then the practitioner may, in terms of section 137(5) of the Act, apply to a court for an order removing a director from office and may apply to have a director declared delinquent in terms of section 137(6) read with section 162 of the Act.

Moreover, if a director has acted in the manner set out in paragraphs 13.1 and 13.2 above, then section 218(2) provides that such director would be liable to any person who has suffered any loss or damage as a result thereof.

14. **What steps should a Board undertake when it realises that a company's insolvency is likely?**

If a company is trading in insolvent circumstances and there is no longer any prospect for business rescue to succeed, the Board should resolve to propose to the company's shareholders that a special resolution for the company's voluntary liquidation should be adopted. Alternatively, a director on the Board can apply to court for the liquidation of the company.

Either way, any such steps will have to be taken by the Board or its members in terms of Chapter 14 of the Companies Act 61 of 1973 (the 1973 Act), as read with item 9 of Schedule 5 of the Act.

Should the Board not proceed in this manner, and allow the company to continue to trade in insolvent circumstances, then the directors on the Board may be held personally liable in terms of section 77(3)(b) as read with section 22(1) of the Act, or section 424 of the 1973 Act.

15. **What is the ongoing role of directors once a company is in an insolvency process?**

Once an order for the liquidation of a company is granted, it will remain in existence; however, the directors cease to exercise control of its affairs. However, during liquidation proceedings, the directors have a duty to co-operate and provide any information is required from them.

The company is not divested of its assets but its assets are deemed to be in the custody and under the control the Master of the High Court at first, and eventually the liquidator. The company's assets will be sold (realised) and the proceeds will be used to satisfy the claims of creditors according to their order of preference. Any surplus remaining thereafter, will be distributed among the company's shareholders in accordance with their rights. The company will then be dissolved, and its corporate existence will come to an end.

16. **Conclusion**

It has been reported by National Geographic that Giant Sequoia trees (some of the oldest and tallest trees in the world, reaching up to 115m) require heat from fire to regenerate. The heat opens their seed cones in order for their seeds to be released, and the fires clear the earth for their germination. Sequoias are remarkably fire resistant, and while lesser trees blaze around them, the Giant Sequoias stand virtually unharmed.

Much like when a Sequoia faces raging fires, the mettle of a director is tested when the company faces financial difficulties.

However, even when faced with financial difficulties, a company can grow and flourish provided that action is taken before and during a crisis.

The lessons learned during such times of crisis will make directors and their companies more resilient.

And, even when financial difficulties turn into financial distress, and perhaps even insolvency, if the necessary action is taken timeously by directors, they may be protected from personal liability. Those directors will be able to rise above the flames.



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