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The delinquent director: No tolerance for errant directors

24 February 2013 *10 min read*

Errant company directors who fail to comply with the obligations set out in the Companies Act, 2008, will now face the prospect of being declared "delinquent" under certain circumstances.

Earlier this year the South Gauteng High Court declared a director to be delinquent for failing to discharge his duties and further granted leave to the companies involved to claim damages from such director for losses incurred as a result of such director's conduct.

As a consequence, South African directors must take cognisance of the impact of Section 162 of the Act (declaration of delinquent directors) and further take steps to ensure that they do not open themselves up to the possibility of being declared delinquent.

Section 162 of the new South African Companies Act 2008

In terms of Section 162 of the new South African Companies Act 2008 ("the Act"), a company, a shareholder, a director, company secretary or prescribed officer of the company, a registered trade union that represents employees of the company, or any other representative of the employees of the company, may apply to court for an order declaring a person (i.e. a director) delinquent or under probation if:

a. the person is a director of that company, or within 24 months immediately preceding the application, was a director of that company; and

b. such director has:

   i. consented to serve as a director whilst ineligible or disqualified under the Act or whilst under a probation order in terms of the Act or the Close Corporations Act and acted in a manner that contravened that order;

   ii. grossly abused the position of a director;

   iii. intentionally, or by gross negligence, inflicted harm upon the company or a subsidiary of the company, contrary to the provisions of the Act;

   iv. 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.

The Act provides that a director who uses his or her position or any information obtained while acting in the capacity of a director to:

- gain an advantage for him- or herself or for another person other than the company or a wholly owned subsidiary of the company; or
- knowingly cause harm to the company or a subsidiary of the company, may be declared delinquent.

Any organ of state responsible for the administration of any legislation may also apply to court for an order declaring a director delinquent if such director has repeatedly been personally subjected to a compliance notice or similar enforcement mechanism for substantially similar conduct in terms of any legislation.

A court will be obligated to declare a person to be a delinquent director if the person consented to serve as a director while ineligible or was disqualified. Such disqualifications are set out in Section 69 of the Act and include that such person:

- was an unrehabilitated insolvent; or
- is prohibited in terms of any public regulation to be a director; or

- has been removed from an office of trust on the grounds of misconduct involving dishonesty; or
- has been convicted in the Republic or elsewhere for theft, fraud, forgery or any conduct involving fraud, misrepresentation or dishonesty or offences involving various Statutes such as the Insolvency Act, the Close Corporation Act, the Competition Act, the Financial Intelligence Centre Act (FICA), the Securities Services Act, or the Prevention and Combating of Corrupt Activities Act.

Any person who has at least twice been personally convicted of an offence or subjected to an administrative fine or similar penalty in terms of any legislation could also be subject to an application for a declaration of delinquency.

Any declaration of delinquency will subsist for the lifetime of the person declared delinquent on account of having consented to serve as a director whilst ineligible or disqualified under the Act or whilst under a probation order in terms of the Act or the Close Corporations Act and acted in a manner that contravened that order.

Any declaration made by the court may be made subject to any conditions that the court considers appropriate, including conditions limiting the application of declaration to one or more particular categories of companies.

Furthermore, a court may make an order placing a person under probation. This would occur under circumstances where the court is satisfied that the declaration is justified having regard to the circumstances of the company's conduct and the person's conduct in relation to the management, business or property of the company at the time. Such order for probation (similar to a suspended sentence) will be made subject to conditions that the court considers appropriate and may subsist for a period not exceeding five years.

It is important to note that an order for probation applies to directors who were present at meetings of companies and failed to vote against a resolution despite the inability of the company to satisfy the solvency and liquidity test as set out in the Act. The solvency and liquidity test would apply to directors and any person who is obligated to consider whether, having regard to the reasonably foreseeable financial circumstances of the company at a particular point in time, that the assets of the company as fairly valued, equal or exceed the liabilities of the company.

Furthermore, any person may be placed under probation if he or she:

- acts in a manner materially inconsistent with the duties of a director; or
- acts in or supports a decision of a company to act in a manner which results in oppressive or prejudicial conduct; or
- on some basis acted in a manner which constituted an abuse of the separate juristic personality of such company.

The court may further make an order, placing a person under probation if, at any period of ten years after the effective date of the Act, the person has been a director of more than one company (irrespective whether concurrently, sequentially or at unrelated times) and during that time that the person was a director of each of such companies, two or more of those companies each failed to fully pay all of its creditors or meet all of its obligations, except in terms of a Business Rescue plan as contemplated by the Act or a compromise with creditors in terms of Section 155 of the Act.

Without limiting the powers of the court, a court may order as conditions applicable or ancillary to a declaration of delinquency or probation that the person concerned:

- undertakes a designated program of remedial education relevant to the nature of the person's conduct as director;
- carries out a designated programme of community service; or
- pays compensation to any person adversely affected by the person's conduct as a director to the extent that such a victim does not otherwise have a legal basis to claim compensation.

If a person is placed under probation he or she is to 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 of which that person is the sole shareholder.

Any person who has been declared delinquent or subject to an order of probation may apply to court to suspend the order of delinquency and substitute an order of probation, with or without conditions, at any time more than three years after the order of delinquency was made or to set aside an order of delinquency at any time more than two years after it was suspended or an order of probation at any time after such order was made.

This will not be available to a person declared delinquent on account of having consented to serve as a director whilst ineligible or disqualified under the Act or whilst under probation order in terms of the Act or the Close Corporations Act and acted in a manner that contravened that order.

Case of Kukama vs Lobelo

In the case of Kukama vs Lobelo, Peolwane Properties (Proprietary) Limited, Diphuka Construction (Proprietary) Limited and CIPC, South Gauteng High Court, Johannesburg, 12 April 2012, the Presiding Judge ruled that the director concerned had contravened section 22 (reckless trading) and section 76 (standards of directors conduct) of the Act.

The director in question had, inter alia, allowed funds (some R2.2 million) destined for the company to be paid into an alternative account to the detriment of the company, had failed to detect a fraud on SARS in the sum of R39 million and had further failed to alert his co-director and co-shareholder of such fraudulent transactions.

The court held that the conduct of such director did "not measure up to the standard required and expected of a director" and as a result found that he was in breach of his fiduciary duties to the company. Further, section 76(2)(b) of the Act created a duty on the part of a director to communicate at "the earliest practicable opportunity any information that comes to his attention to the board", which he failed to do.

The court held that the director's conduct was grossly negligent, constituted wilful misconduct, a breach of trust and a gross abuse of his position as a director. As a result, the court ruled that the director should be declared delinquent in terms of section 162 of the Act. The court did not order the director's removal, as such would occur automatically as a result of such declaration. The court further granted leave to the company that had suffered damages as a result of the director's conduct, to institute legal proceedings for such losses against the director personally.

Possibility of being declared delinquent

There is no doubt that directors of companies will have to carefully consider the manner in which they conduct the affairs of companies, particularly where there is the possibility of being declared delinquent. Directors who find themselves on the receiving end of such an order are highly unlikely to be nominated (never mind actually appointed) to any other boards of companies.

Furthermore, the word "delinquency" carries criminal connotations. The various dictionary definitions refer to "offender", "guilty of a crime or misdeed", "failing in one's duties" or "failing to perform an obligation", the most telling and damning being "a person guilty of serious antisocial or criminal conduct". In the initial draft of the Act, it was proposed that a "register of delinquent directors" be available to the general public. This appears to have fallen away.

Directors will need to understand whether or not they are complying with the provisions of the Act. In particular, a director is obligated to ensure that he or she is not trading his or her company in a position of financial distress which might push the company into a situation where it becomes insolvent and unable to pay its creditors.

Clearly, these provisions significantly increase the expected level of directors' duties to companies in South Africa and the standard of conduct required. Coupled with the provisions of King III, directors need to consider whether they are adhering to their duties carefully, or face an order of delinquency with all of its negative and unfortunate consequences.



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