CLAIMS AGAINST DIRECTORS IN TERMS OF THE COMPANIES ACT, 2008
INTRODUCTION

The principles of good leadership have become a huge money-spinner for business schools, consultants, and trainers and there is fierce competition amongst organisations to be seen as a highly ranked employer of choice.

But for all the noise, company performance often remains mediocre and largely disappointing; and today, companies – and their leaders – fail faster than ever. Failure on directorship level may ultimately result in the ruin of a company with aggrieved and unpaid creditors attempting to recover damages suffered and losses incurred.

Fortunately, the new Companies Act No. 71 of 2008 ("the Act") that came into effect on 1 May 2011, has a significant impact on directors' liability in corporate South Africa. The provisions of the Act set the bar for competent directors at much higher levels than we have seen in the past.

This booklet provides insight into how creditors may hold errant directors of companies personally liable for the debts of their companies, in terms of the Act.
STANDARD OF DIRECTOR’S CONDUCT

The fiduciary duties of directors are derived from our common law, which is created through the precedents set by our courts. While the Act attempts to codify many of these common law duties, it is a partial codification of the common law. In the circumstances, to the extent that the Act does not deal with a specific duty, or the consequence thereof, the common law will apply or will supplement such duty.

Section 76 addresses, to a very large extent, the standard of conduct expected from directors. Section 76(3) states that a director of a company, when acting in that capacity, must exercise the powers and perform the functions of a director -

- in good faith and for a proper purpose;
- in the best interests of the company; and
- with the degree of care, skill and diligence that may reasonably be expected of a person -
  - carrying out the same functions in relation to the company as those carried out by that director; and
  - having the general knowledge, skill and experience of that director.

Section 76(4) states that, in respect of any particular matter arising in the exercise of the powers or the performance of the functions of a director, a particular company director will have satisfied the obligations set out in section 76(3), if that director has taken reasonably diligent steps to become informed about the matter. This goes to the degree of knowledge that a particular director would have as to the financial status of the company.

A director would therefore be entitled to rely on the performance and information provided by persons who have received delegated powers or authority to perform one or more of the board’s functions. This includes the ability to rely on the veracity of the information provided, including financial statements and other financial data prepared by the employees of the company, accountants or any other professional person retained by the company, the board, or any committee constituted by the company.

Also included would be matters involving skills or expertise that the director could reasonably believe a particular person to have or to be within that person's professional competence. For instance, if a director receives financial information from departmental managers, he or she would be entitled to rely on the veracity of such information provided such reliance is reasonable in the circumstances and when one considers the specific expertise of that particular manager. For example, the marketing director would not have the same level of insight into a set of management accounts as would the financial director.

Furthermore, in terms of section 76(4) of the Act, a director would have satisfied the obligations of section 76(3), if the director made a decision, or supported the decision of a committee or the board, with regard to that matter, and the director had a rational basis for believing, and did believe, that the decision was in the best interests of the company.

However, 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.
Section 22(1) of the Act 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) in turn 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 agreed 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.

Therefore, 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.

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 it 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).

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 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).

Should a director not proceed in this manner, he or she may be held personally liable in terms of section 77(3)(b) as read with section 22(1) of the Act, subject of course to the court’s discretion to excuse such a director in terms of section 77(9) of the Act. In this regard, 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. If a director is, however, 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.

**DIRECTORS WHO ARE KNOWINGLY A PARTY TO PROHIBITED CONDUCT**

Furthermore, the Act defines what is meant by a person “knowing” of such prohibited conduct. “Knowing” when used with respect to a person, and in relation to a particular matter, means that the person either had actual knowledge, or such person reasonably ought to have had actual knowledge or acquired it by having investigated the matter or by having taken other measures which would reasonably be expected to have provided the person with actual knowledge of the matter.

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 extent of the company’s corporate debt; the amount of the corporate debt; and the prospect, if any, of recovery.
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 on the business of the company recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose.

Any director, who allows his company (the debtor company) to receive goods on credit from a creditor, knowing full well that the company is not in a position to make payment for such goods, opens himself/herself up to a personal liability claim. Such conduct would constitute reckless behaviour on the part of the director and may also include an intent to defraud the creditor who had supplied goods to the company on credit.

If the debtor company has more than one director, the company will have to pursue claims against all of those directors that had knowledge of the financial position of the debtor company, particularly to the fact that the debtor company, at the time that the company received the goods on credit, would be unable to pay for such goods as and when payment for such goods became due and payable (albeit due to lack of liquidity or because the company’s liabilities exceeded its assets). Knowledge is therefore an important element to prove and the onus will be on the company to prove such knowledge on the part of the director.

If the director indeed had such knowledge, the Act will allow the debtor company to pursue a civil claim for loss/damages against the relevant director.

Additionally, in terms of section 77(2), a director of a company may be held liable in accordance with the principles of the common law relating to the breach of a fiduciary duty and relating to delict, for any loss, damages or costs sustained by the company as a consequence of any breach by the director of duties contemplated, inter alia, in section 76 discussed above.

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.

Section 77(6) states that –

“The liability of a person in terms of this section is joint and several with any other person who is or may be held liable for the same act”.

Section 77(6) thus allows the company to claim against more than one director and against any person who contravened the provisions of the Act.

As set out above, the standards of conduct, and liability of directors under the Act are dealt with principally in sections 76 and 77. However, nowhere in those sections or anywhere else in the Act are there provisions identical to sections 423 and 424 of the 1973 Act, which gave creditors rights as against directors of debtor companies.

Schedule 5 of the Act delineates the transitional arrangements. That is, those provisions of the 1973 Act which continue to apply despite the repeal of the 1973 Act.

Item 9 of Schedule 5 of the Act provides that despite the repeal of the 1973 Act, Chapter 14 of the 1973 Act continues to apply with respect to the winding-up and liquidation of companies under the Act.

In light of item 9(1) of Schedule 5, it would therefore appear that sections 423 and 424 of the 1973 Act (which are part of Chapter 14) will continue to be used by aggrieved creditors (whose claims arose either before or after 1 May 2011) against directors of companies in circumstances where such companies have been wound up or liquidated, and when such conduct has caused losses to creditors. Whether or not the reference to “winding-up and liquidation” in item 9 is limited to purely procedural aspects of this process, and thus not to matters related therewith, is something that will need to be deliberated on by our courts.

That being said, as a result of item 11(1) of Schedule 5, if the debtor company has not been wound up, the rights enjoyed by aggrieved creditor, in respect of claims that arose prior to the effective date of the Act, in terms of section 424 of the 1973 Act will, in all likelihood, remain valid subject to section 218(2) of the Act, if the provisions of section 22 (which provides that a company must not carry on its business recklessly, with gross negligence, with the intent to defraud creditors or for any fraudulent purpose) and section 77(3) of the Act were contravened.

Section 424 of the 1973 Act reads as follows –

“When it appears, whether it be in a winding–up, judicial management or otherwise, that any business of the company was or is being carried on recklessly or with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court may, on the application of the Master, the liquidator, the judicial manager, any creditor or creditor or contributory of the company, declare that any person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be personally responsible, without any limitation of liability, for all or any of the debts of other liabilities of the company as the Court may direct.”

Whilst section 424(1) does not specifically refer to directors, it is clear that directors who acted in the manner referred to in section 424(1) are targets for aggrieved creditors in terms of that subsection. Moreover, section 424 of the 1973 Act can be applied in conjunction with section 423 of the 1973 Act, which gives creditors a right against directors of companies whose conduct had caused loss to creditors. Section 423 reads as follows –

“(1) Where in the course of the winding-up or judicial management of a company it appears that any person who has taken part in the formation or promotion of the company, or any past or present director or any officer of the company has misapplied or retained or become liable or accountable for any money or property of the company or has been guilty of any breach of faith or trust in relation to the company the Court may, on the application of the Master or of the liquidator or of any creditor or creditor or contributory of the company, enquire into the conduct of the promoter, director or officer concerned and may order him at such rate as the Court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retention, breach of faith or trust as the Court thinks just.”

There were a significant number of important decisions of our High Courts in regard to section 424 of the 1973 Act. Amongst these were –

- Gordon N O and Rennie N O v Standard Merchant Bank Limited and others 1984 (2) SA 519 C;
- Ex Parte Lebowa Development Corporation Limited 1989 (3) SA 71T;
- Howard v Hemigel and Another NNO 1991 (2) SA 660 (A); and
- Philotex (Pty) Limited and Others v Snyman and Others; Braitex (Proprietary) Limited and Others v Snyman and Others 1998 (2) SA 138 (SCA).

These decisions discussed and interpreted various provisions of section 424 of the 1973 Act. What was, however, clear under section 424 of the 1973 Act (and section 423 of that Act) and the decisions pertaining to those sections, was that a creditor of a company who has sustained losses enjoyed rights to claim compensation for such losses directly against a director of a company who had participated in, or was responsible for, the company conducting its business recklessly or fraudulently and which had resulted in a loss to the creditor.

It must also be said that, sections 22, 77(3) and 218(2) may be relied upon to impute personal liability on directors if the claims of creditors of solvent debtor companies arose after the effective date of the Act.
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.

Additionally, in terms of section 34 of the Prevention and Combating of Corrupt Activities Act 12 of 2004 ("POCA"), any person who holds a position of authority and who knows or ought reasonably to have known or (reasonably) suspects that any other person has committed fraud involving an amount of R100,000 or more must report such knowledge or suspicion or cause such knowledge or suspicion to be reported to any police official. A failure to do so is a criminal offence.

Accordingly, if a creditor (or fellow director) suspects that the business of a company is being carried on with the intent to defraud any person or for any fraudulent purpose, then such creditor (or fellow director) is under a statutory obligation to report his/her suspicions to the police.

As a result, the directors of debtor companies may not only be held personally liable towards to the company and its creditors for losses incurred, but may also be charged criminally.

In order to advance a criminal investigation, it may be advisable to assist the police by deposing to a detailed affidavit, in support of a complaint for the purpose of a criminal investigation. Such affidavit will assist the police in their investigations, and may be the foundation for the successful prosecution of a criminal offence, in circumstances where proof must be established "beyond reasonable doubt".

In terms of section 162 of Act, the Companies and Intellectual Property Commission ("the Commission") or the Panel set up by the Act, may apply to a court for an order declaring a director delinquent (or under probation) if such a director continues to grossly abuse his/her position, or acted in a manner which constituted a contravention of section 77(3)(b) of the Act. Such contravention would occur as a result of a director acquiescing in the carrying on of a company's business despite knowing it was being conducted in a manner prohibited by section 22(1).

Further, a director may be declared to be a delinquent, if he/she has been a party to an act or omission by a company despite knowing that the act or omission was calculated to defraud a creditor of the company or had another fraudulent purpose.

A director may also be declared a delinquent, in terms of section 162(7)(b)(ii) of the Act, if during the time that he/she was a director of more than two companies, and such companies failed to pay all of its creditors in full or meet all of its obligations (except in terms of a Business Rescue Plan resulting from a resolution of the board in terms of section 129 or a compromise of creditors in terms of section 155). Therefore if a director consistently allowed his/her companies to be placed into liquidation resulting in creditors not being paid in full, an application may be made to court via the Commission or the Panel to declare such person to be delinquent.

Where a declaration of delinquency occurs, the director concerned may be ordered to pay compensation to any person adversely affected by that person's conduct as a director, even if such a victim does not otherwise have a legal basis to claim compensation or in the case of an order of probation (similar to a suspended sentence) be forced to be supervised by a mentor in any future participation as a director while the order remains in force or be limited to serve as a director of a private company or of a company of which that person is a sole shareholder.

CHARGING DIRECTORS CRIMINALLY

DELINQUENT DIRECTORS
Creditors are often faced with the unfortunate consequence of having supplied goods and/or services to a debtor company on credit and where such debtor company refuses or is unable to pay for such goods.

What would happen in the ordinary course is that creditors either issue summons for recovery of the debt due or such amounts are written off. This of course is costly and may contribute to deficiencies in the company’s bottom line.

Creditors should, in the light of the issues considered in this booklet, consider the following options –

- if a creditor believes that a director has failed in any of the statutory obligations (and has evidence of this) set out in the Act, such creditor could institute an action/summons for any loss/damage caused to such creditor in terms of section 218(2) of the Act;
- in the event that a creditor does not have any or sufficient evidence to make out a cause of action against a director in terms of section 218(2) of the Act, such creditor should apply to the High Court to wind up the debtor company on the basis that the debtor company is commercially insolvent in that it is unable to pay its debts;
- thereafter the creditor should convene an insolvency enquiry in terms of section 417 of the 1973 Act (still applicable) and proceed to interrogate the directors of the debtor company in respect of the trade, dealings and affairs of the debtor company. During such enquiry, the creditor would seek to establish knowledge on the part of the director/s and any other person in respect of the commercial insolvency position of the debtor company whilst trading with suppliers and creditors. The objective would be to obtain evidence of this factual position so that creditors are able to pursue personal liability claims (in terms of sections 423 and 424 of the 1973 Act) against such persons;
- the creditor would thereafter have to proceed to issue a summons against such persons in the High Court for recovery of the amounts due to such creditor and as a result of such damage/loss caused to the creditor by such persons.

Creditors should always be aware of their reporting obligations under POCA and the consequences of failing to report fraud to the relevant authorities.

In conclusion, creditors can take comfort in the fact that they remain able, under the Act, to pursue delinquent directors of debtor companies civilly for losses incurred, and also to bring criminal charges against them in the appropriate circumstances.
Eric has been a director of Werksmans Attorneys since 1993 and is currently the joint head of the firm’s Insolvency, Business Rescue & Restructuring Practice.

He specialises in litigation and dispute resolution with a particular focus on banking and finance, forensics and intellectual property in addition to business recovery, insolvency and restructuring. His expertise extends to consumer protection and director liability. He regularly delivers seminars and writes for various publications on these topics among others.

He is a member of the Association of Insolvency Practitioners of South Africa (AIPSA) and of INSOL, a worldwide group of insolvency practitioners and attorneys who specialise in insolvency and restructuring matters. He also currently sits on the editorial committee of INSOL World.

He is named as a recommended lawyer in restructuring and insolvency by PLC Which Lawyer and has BCom and LLB degrees, Higher Diplomas in Company Law and Tax and a Diploma in Insolvency Law.

Nastascha van Vuuren is currently a senior associate in Werksmans Attorneys Insolvency, Business Rescue & Restructuring Practice. She specialises in insolvency matters, and received an award in academic excellence for achieving in 2011 the highest results for the Association of Insolvency Practitioners of Southern Africa’s Diploma in Insolvency Law and Practice. She also undertakes general litigation, in both the High and Magistrate’s Courts, on behalf of a variety of clients.

Nastascha has a BSc (Hons) in Chemistry & Biochemistry from Rand Afrikaans University and an LLB, which she was awarded cum laude, from the University of Johannesburg. She also received an award for best law clinic student at the University of Johannesburg’s law clinic. As a student, Nastascha tutored Introduction to Legal Studies at the University of Johannesburg; was secretary of the Law Student’s Counsel from 2005 to 2006; and was a member of the University of Johannesburg’s Chapter of the Golden Key Honour Society.

She was recognized at the Association of Insolvency Practitioners (AIPSA) certification ceremony, where she achieved the highest mark in the AIPSA Insolvency Diploma examination written by 75 students in South Africa, Namibia and the Caymen Islands.