

Director's Trading in Insolvent Circumstances

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Legal Brief

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Introduction

The personal liability of directors is becoming an emotive and important issue for directors sitting on boards in South Africa. The topic has gained momentum amid the recent submission of the King 3 report, the new Companies Act and general concerns on the part of directors in respect of them incurring personal liability.

The prestige of holding numerous non-executive directorships is being overshadowed by the increased personal vulnerability to which it exposes directors, particularly those who lack the requisite experience or time to fulfill their fiduciary obligations to companies on whose boards they sit.

Directors need to be aware of the circumstances in which they can be held personally liable for the debts of the company should such company be placed into liquidation. It is incumbent upon directors to ensure that when the warning signs become self evident, they immediately take legal and financial advice and, if necessary, place their companies into liquidation or cease trading.

The question to be considered is whether or not insolvency is in fact a real possibility and whether the telltale signs of a pending liquidation are evident to the directors. It is at this stage that a director would be obligated to place his company into liquidation.

The Companies Act, No 71 of 2008

The new Companies Act no 71 of 2008 ("the Act") was signed into law on 8 April 2009 and appeared in the Government Gazette of 9 April 2009. The Act is due to become operative in July 2010. The Act has a significant impact on directors' liability in corporate South Africa. Section 424(1) of the old Companies Act will be replaced by section 77 which, while worded differently, has retained the essence of the old Section 424. As before, 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.

Standard of Director's Conduct

Section 76 addresses 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 –

- a) in good faith and for a proper purpose;
- b) in the best interests of the company; and
- c) with the degree of care, skill and diligence that may reasonably be expected of a person –
 - i) carrying out the same functions in relation to the company as those carried out by that director; and
 - ii) 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 director of a company will have satisfied the obligations set out in Section 76(3), if the director has taken reasonably diligent steps to become informed about the matter.

What would constitute "reasonable diligent steps?" In these circumstances, a director would 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 that are capable of delegation under applicable law. This includes reliance by the director on the veracity of the information provided to such directors. This would also include 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 directors reasonably believe are within the particular person's professional expert competence or as to which the particular person merits confidence. For instance, if a director receives financial information from departmental managers, he 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 director. 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.

In terms of Section 77(2)(a), 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, 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.

Reckless Trading...When Does One Wind Up the Company When Trading in Insolvent Circumstances?

Reckless trading, conducting the company's business in insolvent circumstances or with the intention of defrauding a creditor are also covered by the new Act. 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 in 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 has been a party to an act or omission by the company despite knowing that the act or omission was calculated to defraud a creditor, employee or shareholder of the company or had another fraudulent purpose.

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; or trade under insolvent circumstances.

In South African Law, a director would have a duty to apply for a company's winding up/liquidation ("liquidation") as soon as he/she is knowingly aware that the company is trading in insolvent circumstances (both factually in that its liabilities exceed its assets, or commercially in that the company cannot pay its debts to creditors as and when they fall due). Consequently, if a company is trading in insolvent circumstances, the directors of the company would be obligated to file for the company's liquidation on an urgent basis. For instance, if a company continues to incur debts, where, in the opinion of reasonable businessmen standing in the shoes of the directors, there would be no reasonable prospect of the creditors receiving payment when due, it will in general be a proper inference 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 such 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/she might be held personally liable in terms of Section 77(3)(b) as read with Section 22(1) of the Act.

The test will always be that there will come a point in time when reasonable businessmen would wind up their company and pay creditors in full, unless they have access to further capital which can revitalise their company with some appropriate form of capital reconstruction.

The incurring of credit at a time where directors know that the company will not be able to meet its liabilities when they fall due will be tested by the court in order to substantiate that a director should have placed the company into liquidation at that time and not 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, he will not be expected to be privy to the same level of financial information as the financial director.

Defences Available to Directors

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 willful misconduct or willful 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.

It is important to note that the Act does not limit the application of Section 77 only to directors as such. It would apply 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 of the audit committee of a company irrespective of whether or not the person is also a member of the company's board.

Knowingly a Party to Prohibited Conduct?

Furthermore 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.

The intended effect of Sections 76 and 77 in the Act is to protect 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. 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/her fiduciary duties and conducted the affairs of the company in accordance with sound business practices that fall within the parameters of these expectations, the evidence should, in such circumstances, 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. What is "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.

As in all cases involving negligence, the test in our 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 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.

Delinquent Directors

It should also be noted that Section 162 of the Act states that a director may be declared "delinquent" if such director grossly abused the position of director or intentionally or by gross negligence, inflicted harm upon the company or a subsidiary of the company contrary to Section 76 or acted in a manner that amounted 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 should be made aware of the current developments in our law in regard to directors' liability whilst sitting on boards of companies in South Africa.

The new provisions of the Act will up the ante when it comes to directors making important decisions on company issues at board level.

Directors who allow companies to continue to trade in insolvent circumstances must recognise that such trading may be the subject matter of examination 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 companies trade will be essential to survival and for the avoidance of 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 company at all times. Failure to maintain a particular level of knowledge of these issues can result in directors being severely criticised or, alternatively, being held liable for the debts of the company for reckless and negligent behaviour.

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Eric Levenstein has been with the firm since 1987. He specialises in consumer law; insolvency; liquidations and business recovery; debtor and insolvency recovery actions; structuring of offers of compromise and arrangements; and cross border recognition of judgements. In 2005 he researched the National Credit Act. He was invited to the Parliamentary Hearings on the Bill and also gave submissions to Parliament in this regard. He is a member of the Association of Insolvency Practitioners of South Africa (AIPSA) and the Worldwide Group of Insolvency Practitioners (INSOL). Eric is also on the International Membership Development Committee of INSOL International and is a member of the editorial board of INSOL World, the quarterly journal of INSOL International.

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