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Companies Act No. 71 of 2008
Duties and Liabilities of Directors 2021

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The position as set out in the Companies Act and the King IV Report on Corporate Governance for South Africa.

Introduction

Worldwide, the role of directors and their duties towards their companies are coming into increased focus. One of the reasons why is to ensure that proper decisions are made by and for companies at all times. Given that the business and affairs of a company are managed by or under the direction of its board of directors, it comes as no surprise that a failure on the part of a board of directors, or its individual directors, to be adequately appraised of their obligations and duties may result in such directors being, at best, severely criticised, and at worst, being held personally liable for losses sustained by the company.

Following the introduction of the King IV Report on Corporate Governance for South Africa 2016 ("King IV Report"), there has been an increased emphasis on ensuring that a company and its board have access to professional and independent advice on not only corporate governance principles, but also on their legal duties. This is based on the understanding that, one of the principal ways in which to achieve ethical and effective corporate governance is to ensure that all directors are fully aware of their legal obligations, duties and liabilities.

The Companies Act 71 of 2008 ("Companies Act"), amongst other things, sets out the rules relating to the appointment of directors, the grounds for ineligibility and disqualification of persons to be directors, the removal of directors, the procedures relative to declaring directors delinquent, the steps directors are to take when a company faces financial distress, and directors' responsibilities, duties and liabilities. Accordingly, a proper understanding of the relevant provisions of the Companies Act is critical, especially in view of the increased obligations and potential exposure to liability as set out in the Companies Act.

As such, this booklet seeks to provide some insight into certain of the responsibilities and duties of boards of directors of South African companies, in terms of the Companies Act, with reference to the King IV Report.

Background to the King IV Report

The King IV Report is a voluntary code or guide which sets out various principles and best practices that governance structures of companies in South Africa striving to achieve good governance should follow.

Corporate governance, for purposes of the King IV Report is defined as the exercise of ethical and effective leadership by governing bodies, aimed at the achievement of certain governance outcomes, such as ethical culture, good performance, effective control and legitimacy.

The King IV Report sets out 17 key principles, each linked to very distinct outcomes, and ultimately aims to achieve ethical behaviour and good governance. An important feature of the King IV Report is its emphasis on the mindful application of corporate governance principles, as opposed to mindless compliance, i.e. adopting the "tick box" mind set. The outcome-based approach, coupled with the "apply and explain" application regime encourages organisations to achieve the principles, rather than simply following a set of rules. This allows organisations a degree of flexibility as it recognises that each organisation operates in its own environment. The principles therefore inform what should be achieved as opposed to prescribing certain actions.

Some of these important principles are –

> The governing body should lead ethically and effectively and establish an ethical culture

This means that an organisation should implement policies, codes of conduct and performance evaluations by which members of the governing body are held to account for ethical and effective leadership. This includes but is not limited to –

> A Social & Ethics Committee mandated with responsibility for monitoring and reporting on ethics;

> A formal Code of Ethics;

> The requirement for the board to declare outside interests;

> Gift registers;

> An ethics awareness programme; and

> A "whistleblowing" framework.

> The governing body should ensure that the evaluation of its own performance and that of its committees, its chair and its individual members, support continued improvement in its performance and effectiveness

This means that performance evaluations of the board, its sub-committees, individual directors, chairman, CEO and company secretary are formally done on an annual basis. The results of the evaluations are discussed with individual board members, where remedial action is required and the overall results of the evaluations reported to the board.

> The governing body should govern compliance with applicable laws and adopted, non-binding rules, codes and standards in a way that supports the organisation being ethical and a good corporate citizen

A Social and Ethics committee should monitor the various areas of applicable laws, rules, codes and standards and report the areas reviewed and its findings in the financial year in its report included in the integrated report.

Who is a "Director"?

The Companies Act defines a director as a member of the board of a company, as contemplated in section 66 of the Companies Act, or an alternate director, by whatever name designated. This definition is critical, as being identified as such comes with all the associated responsibilities, and the legal duty to manage the affairs of the company.

Section 66 of the Companies Act provides that the business and affairs of a company must be managed by or under the direction of its board of directors, which has the authority to exercise all of the powers and perform all of the functions of the company, except to the extent that the Companies Act or the company's Memorandum of Incorporation ("MOI") provide otherwise.

Section 66 of the Companies Act further stipulates that –

> the board of a private or personal liability company must comprise of at least one director, in addition to the minimum number of directors that the company must have to satisfy any requirement to appoint an audit committee, or a social and ethics committee;

> the board of a public or non-profit company must comprise of at least three directors, in addition to the minimum number of directors that the company must have to satisfy any requirement to appoint an audit committee, or a social and ethics committee; and

> the company's MOI may specify a higher minimum number of directors.

A company's MOI may also –

> specifically authorise one or more named persons to appoint and remove one or more directors;

> provide for one or more persons to be ex officio directors of the company; and

> provide for the appointment or election of one or more persons as alternate directors of the company.

In the case of a profit company (other than a state owned company), the MOI must provide for the election by shareholders of at least 50% of the directors and 50% of any alternate directors.

How are directors appointed and removed in terms of the Companies Act?

The appointment of directors of a company is prescribed in section 68 of the Companies Act. This section stipulates that each director of a company must be elected by the persons entitled to exercise voting rights in such an election. Furthermore, each director should be elected to serve for an indefinite term or for a term as set out in the MOI of the company. In addition, and unless the MOI provides otherwise, the election of directors is to be conducted as a series of votes, each of which is on the candidacy of a single individual to fill a single vacancy, with the series of votes continuing until all vacancies on the board have been filled.

Each voting right entitled to be exercised may only be exercised once, and the vacancy may only be filled if a majority of the voting rights exercised, support the candidate. Section 68(3) allows the board, unless the MOI of the company provides otherwise, to appoint a person satisfying the requirements for election as a director to fill any vacancy and to serve as a director of the company on a temporary basis until the vacancy has been filled by election.

Section 71 of the Companies Act prescribes the removal of directors. Section 71(1) provides that a director shall be removed by an ordinary resolution (more than 50% of the voting rights exercised on the resolution or such higher percentage as determined in the relevant MOI) adopted at a shareholders meeting by the persons entitled to exercise voting rights in an election of that director. However, prior to such resolution being passed, the director concerned must be given notice (at least equivalent to the time which a shareholder is entitled to receive such notice) of the meeting and the resolution, and the director must be afforded reasonable opportunity to make a presentation, in person or through a representative, to the meeting, before such resolution is put to a vote.

Section 71(3) of the Companies Act provides further that where a company has more than two directors and it is alleged that a director has –

> become ineligible or disqualified or incapacitated to the extent that he or she is unable to perform the functions of a director, and is unlikely to regain that capacity within a reasonable time; or

> neglected, or been derelict in the performance of or the functions of director, then the board, other than the director concerned, must determine the matter by resolution and may remove a director deemed to be so ineligible or disqualified, incapacitated, negligent or derelict, as the case may be.

Before such resolution may be considered by the board, however, the director concerned must be given –

> notice of the meeting, including a copy of the proposed resolution and a statement setting out reasons for the resolution;

> a reasonable opportunity to make a presentation, in person or through a representative, to the meeting before the resolution is put to a vote.

If the board determines that the director concerned is ineligible or disqualified, incapacitated, negligent or derelict, as the case may be, he or she, or a person who appointed such director, may apply within 20 business days to a court to review the determination of the board.

If it is determined by the board that the director concerned is not ineligible or disqualified, incapacitated, negligent or derelict, as the case may be, any director who voted otherwise on the resolution, or any holder of voting rights entitled to be exercised in the election of that director, may apply to a court to review the determination. The court may either confirm the determination of the board, or remove the director from office.

Section 71(3) of the Companies Act will not apply to a company with fewer than three directors. Any director or shareholder of such a company may apply to the Companies Tribunal to make a determination contemplated in section 71(3) of the Companies Act.

The quorum for (and voting at) a directors' meeting

Section 73(1) of the Companies Act provides that a director who is authorised by the board may call a meeting at any time and that such person must call a meeting if required to do so by at least 25% of the directors (in the case of a board that has at least 12 members) or two directors in any other case.

The Companies Act provides further in section 73(5)(b) that a majority of the directors must be present at a meeting before a vote may be called at the meeting. However the company's MOI may set out a different quorum for meetings of the directors of the company.

In a similar manner, Section 73(5) of the Companies Act provides that, unless the company's MOI provides otherwise, each director has one vote at any meeting of the board and board resolutions are passed by simple majority decisions.

What are the duties of directors in terms of the Companies Act?

Before the promulgation of the Companies Act, the duties of company directors were governed by South African common law. The common law dictates that directors must act in the utmost good faith and in the best interests of their companies and includes the need to exercise care, skill and diligence so as to promote company success through independent judgment.

These common law duties and principles were examined by the court in the case of *Fisheries Development Corporation of SA Limited v. Jorgensen* 1980 (4) SA 156 (W), where it was stated:

"The extent of a director's duty of care and skill depend to a considerable degree on the nature of the company's business and on any particular obligations assumed by or assigned to him. … He is … expected to exercise the care which can reasonably be expected of a person with his knowledge and experience. … Obviously, a director exercising reasonable care would not accept information and advice blindly. He would accept it, and he would be entitled to rely on it, but he would give it due consideration and exercise his own judgment in the light thereof. … A director may not be indifferent or a mere dummy. Nor may he shelter behind culpable ignorance or failure to understand the company's affairs."

The Companies Act now codifies the common law position and makes a few notable additions (which do not alter the common law position significantly). The Companies Act extends the duties of directors and increases the accountability of directors to the shareholders of the company. However, common law duties and principles still apply where they have not been expressly altered by, or are not in conflict with, the Companies Act.

Sections 75 and 76 of the Companies Act address, to a large extent, the standard of conduct expected from directors:

Section 75

Section 75 primarily deals with conflicts of interest and requires the disclosure of personal financial interests in respect of matters relating to the company. It provides that if a director of a company [other than a company where a sole shareholder owns the company with one director on the board (subsection (2)(b)) or where a person is the only director of a company, but does not hold all of the beneficial interests of all of the issued securities of the company, unless the agreement or determination is approved by an ordinary resolution of the shareholders after the director has disclosed the nature and extent of that interest to the shareholders (subsection (3))], has a personal financial interest in respect of a matter to be considered at a meeting of the board, or knows that a related person has a personal financial interest in the matter, the director must –

> disclose the interest and its general nature before the matter is considered at the meeting;

> must disclose to the meeting any material information relating to the matter, and known to the director;

> may disclose any observations or pertinent insights relating to the matter if requested to do so by the other directors;

> if present at the meeting, must leave the meeting immediately after making any disclosure as contemplated above; and

> must not take part in the consideration of the matter, except to the extent contemplated in the above paragraphs.

Section 76

Section 76 of the Companies Act, on the other hand, addresses the standard of conduct expected from directors and extends it beyond the common law duty of directors by compelling them to act honestly, in good faith and in a manner they reasonably believe to be in the best interests of, and for the benefit of, their companies.

Section 76(3) of the Companies Act 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 carried out by that director, and having the general knowledge, skill and experience of that director.

Section 76(4) of the Companies Act states that in respect of any matter arising in the exercise of the powers or the performance of the functions of a director, a director will have satisfied the obligations in section 76(3) of the Companies Act, if the director –

> has taken reasonably diligent steps to become informed about the matter;

> has made a decision, or supported the decision of a committee or the board with regard to that matter; and

> had a rational basis for believing, and did believe, that the decision was in the best interests of the company.

In further compliance with this section, the director is required to communicate to the board, at the earliest practicable opportunity, any material information that comes to his or her attention, unless he or she –

> reasonably believes that the information is publicly available or known to the other directors; or

> is bound by a legal or ethical obligation of confidentiality.

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.

Section 76 also provides that a director of a company must not use the position of director, or any information obtained while acting in the capacity of a director to gain an advantage for the director, or for another person other than the company or a wholly-owned subsidiary of the company, or to knowingly cause harm to the company or a subsidiary of the company.

This means that a director has the duty not to misappropriate corporate opportunities, to account for secret profits and not to improperly compete with the company.

It is important to note that the duties set out sections 75 and 76 of the Companies Act, as well as the liabilities set out in section 77 of the Companies Act (which we deal with below), extend to "Prescribed Officers" and the members of a company's audit and board committees. In this regard, "Prescribed Officers" is defined in Regulation 38 of the Companies Regulations, 2011 and refers to persons who exercise or regularly participate to a material degree in the exercise of general executive control over and management of the whole of, or a significant portion of the business of a company; for example, chief executive officers, chief financial officers, general counsel and the like.

As such, any reference to "director" or "directors" below, includes Prescribed Officers. In addition, in terms of the judgment in *Howard v Herrigel and Another NNO 1991 (2) SA 660 (A)*, it is accepted that there is no distinction between executive and non-executive directors when determining directors' duties towards a company. Accordingly, executive and non-executive directors have the same responsibilities, duties and liabilities as set out below.

Section 72 of the Companies Act is also important in relation to committees established as it entitles companies to appoint board committees and delegate to any committee any authority of the board. Such committees may include people who are not directors of the company, but they may not be ineligible or disqualified to be a company director and may not vote on any matter to be decided by the committee. Board committees have the full authority of the board in respect of matters referred to them and may consult with or receive advice from any person. However, the creation of any committee and the delegation of any power do not by themselves satisfy or constitute compliance by a director with his or her duties as a director.

Can directors be held personally liable?

Section 77 of the Companies Act provides that a director (as well as an alternate director, de facto directors, a prescribed officer, and committee members irrespective of whether or not they are also directors on the company's board) may be held personally liable to the company for any loss, damage or costs arising as a direct or indirect consequence of that director, amongst others –

> breaching a fiduciary duty, or any other duty contemplated in sections 75 and 76 or any other section of the Companies Act or the company's MOI; and

> being a party to an act or omission by the company despite knowing that it was calculated to defraud a creditor, employee or shareholder of the company, or had another fraudulent purpose.

A director of a company will, in addition, be held liable where that director –

> purports to bind the company or authorise the taking of any action by or on behalf of the company without the requisite authority;

> acts in the name of the company in a way that is false or misleading; or

> knowingly or recklessly signs or consents to the publication of a financial statement which is false or misleading in a material respect.

In terms of section 77, a director is held personally liable to the company and to any other affected person for any consequential loss suffered by the company or such person. The liability of a director is, in terms of section 77(6) of the Companies Act, joint and several with any other person who is or may be held liable for the same act (which means that a single director can be held liable for the totality of damages suffered by a third party as a result of the breach of fiduciary duties).

It is worth noting that in terms of section 77(7) of the Companies Act, proceedings to recover any loss, damages or costs for which a person is or may be held liable in terms of section 77 of the Companies Act may not be commenced more than three years after the act or omission that gave rise to that liability. Furthermore, in terms of section 78(2) of the Companies Act, any action taken that directly or indirectly purports to relieve a director of liability under section 77 is considered void.

Liability for reckless trading in terms of Section 22 of the Companies Act and Section 424 of the Companies Act 61 of 1973

The Companies Act further provides for the liability of directors, where they trade recklessly or conduct the company's business with the intention of defrauding a creditor. Sub-sections 77(3)(b) and (c) of the Companies Act state 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 Companies Act; or

> being 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.

In this context, it was found by the Appeal Court in *Howard v Herrigel 1991 (2) SA 660 (A)* that "knowingly" means, and a potential litigant must be able to prove, that:

"on a balance of probabilities, that the person sought to be held liable had knowledge of the facts from which the conclusion is properly to be drawn that the business of the company was or is being carried on [in any of such ways]. It would not be necessary to go further and prove that the person also had actual knowledge of the legal consequences of those facts."

Section 22(1) of the Companies 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. Therefore, 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 (i.e. commercial insolvency), it will in general be a proper inference that the company's business is being carried on recklessly or negligently as contemplated by section 22(1) of

the Companies Act.

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

There have been several court decisions prior to the commencement of the Companies Act in which the meaning of "recklessly" has been interpreted. In the case of *Philotex (Proprietary) Limited & Others v Snyman & Others* 1998 (2) SA 138 (SCA), the Supreme Court of Appeal ("SCA") held that, "recklessly" must be given its ordinary meaning. It therefore does not mean mere negligence, but at the very least, gross negligence.

In *Fourie v Newton* 2010 JDR 1437 (SCA) the SCA stated that –

"[a]cting 'recklessly' consists of 'an entire failure to give consideration to the consequences of one's actions, in other words, an attitude of reckless disregard of such consequences."

In *Saincic v Industro-Clean (Pty) Ltd 2009* (1) SA 538 (SCA), the SCA held that in order to hold directors personally liable for the debts of a company there must also be evidence of the company's inability to pay. This judgment accordingly approved of the conclusion reached by it in the case of *L&P Plant Hire BK v Bosch 2002* (2) SA 662 (SCA) where the SCA held that notwithstanding any reckless or grossly negligent conduct, if the company is nevertheless able to meet a creditor's claim, that creditor is not entitled to proceed against the directors in terms of section 424 of the previous Companies Act 61 of 1973 ("the 1973 Act") (which section is comparable to section 77(3)(b) of the Companies Act, as read with sections 22 and 218).

However, it is important to note that, unlike the relevant sections in Companies Act - which require that causation be proved - section 424 of the 1973 Act provides that where a creditor is able to prove that the debtor company's directors acted recklessly generally and that the debtor company is unable to pay its debts, the debtor company's directors can be held personally liable for any debt/loss, and the creditor will not be required to prove that the directors' reckless conduct caused the creditor's particular debt/loss. In this regard, section 424 of the 1973 Act continues to be in force to the extent that the Companies Act provides at item 9 of Schedule 5 that Chapter 14 of the 1973 Act remains extant in respect of the winding up and liquidation of insolvent companies.

There have been a number of important judgments handed down by the courts in regard to section 424 of the 1973 Act. What is clear from these decisions is 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. Causation need not be proved.

Conversely, section 218(2) of the Companies Act requires a causal link between the offending conduct on the one hand and the loss suffered on the other hand, by providing that –

"any person who contravenes any provision of this Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention."

Accordingly, section 218 of the Companies Act, read together with sections 77 and 22 (discussed above), will allow a creditor to hold the directors personally liable for the debts or losses of the company if the business of that company was knowingly carried on recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose, provided a causal link between the contravention of the Companies Act and the loss suffered can be demonstrated.

The need for a causal link between the contravention of the provisions of the Companies Act and the loss suffered, was confirmed by the SCA in *Hlumisa Investment Holdings (RF) Ltd and Another v Kirkinis and Others* [2020] ZASCA 83 (03 July 2020).

The effects of Covid-19 on Section 22 of the Companies Act

The Companies and Intellectual Property Commission of South Africa published a Notice dated 24 March 2021 implementing a moratorium on the enforcement of section 22 of the Companies Act (*reckless trading*).

In terms of the Notice, the CIPC has stated that whilst the declaration of a national disaster remains in place, the CIPC will not invoke its powers in terms of section 22 of the Companies Act "*in the case of a company which is temporarily insolvent and which is still carrying on business or trading*". This is an important statement in the context of directors of companies who are trading the business of their companies "*recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose*".

The moratorium will lapse 60 days after the declaration of a national disaster has been lifted.

From a proper reading of section 22, this can only be applicable in the context of sections 22(2) and (3) of the Companies Act.

The moratorium imposed by CIPC not invoking the provisions of section 22 during the lockdown period, does not however prohibit any third party (including a creditor), who believes that a company is trading in contravention of section 22(1), from instituting a claim against the company and against its directors for damages resulting from a breach of that section.

Directors of financially distressed companies must take the above into account in the ongoing conduct of their companies whilst the declaration of the state of national disaster remains in place.

What are the defences available to directors to escape personal liability?

The Companies Act has adopted the business judgment rule, as section 76(4) of the Companies Act provides that a director will escape personal liability if that director –

> has taken reasonably diligent steps to become informed about the matter at hand;

> does not have a personal financial interest therein (or has declared such an interest to the board in terms of section 75 of the Companies Act); and

> has a rational basis to believe that the decision was in the best interest of the company at the time.

The first requirement for the application of the business judgment rule is that the decision must be an informed one, and in taking reasonably diligent steps in becoming so informed, directors are entitled to rely on information prepared by the employees of the company, accountants or any other professional person retained by the company.

The second requirement is self-explanatory, and insofar as the third requirement is concerned it must be noted that the test of rationality is objective. The belief must be one that a reasonable person in the position of the director would hold. An objectively irrational decision is not protected.

Also, in terms of section 77(9) of the Companies Act, 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 partly, from any liability set out in section 77 of the Companies Act, 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 supplemented by section 77(10) of the Companies Act which enables a director, who has reason to apprehend that a claim may be made against him or her personally, to lodge an anticipatory application to a court for relief. Section 77(10), like section 77(9), does not apply to wilful misconduct or a wilful breach of trust.

The intended effect of sections 76(4) and 77(9)-(10) of the Companies Act is to protect directors who, in carrying on the business of a company, have shown a genuine concern for its prosperity and have made decisions in its best interest. Directors should note that any inquiry 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 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 constitute a defence to any action launched in terms of section 77 of the Companies Act. “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 South African law is essentially an objective one, in that it postulates the standard of conduct of the notionally reasonable director. However, the test is subjective insofar as the notional director is seen 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 consider *inter alia*, the –

> scope of operations of the company;

> role, functions and powers of the directors;

> amount of the corporate debt;

> extent of the company’s financial difficulties;

> and the prospect, if any, of recovery.

Limitation of liability, indemnification and directors’ insurance

Notwithstanding the aforegoing, section 78(2) of the Companies Act provides that any provision of an agreement, the 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 Companies Act, indemnify a director in respect of any liability. This however does not apply to any 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.

In addition to the above, the company may, in terms of section 78(4) of the Companies 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 Companies 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.

Directors' duties when a company faces financial difficulties

Section 129(1) of the Companies Act provides that –

the board of a company may resolve that the company voluntarily begin business rescue proceedings and place the company under supervision, if the board ***has reasonable grounds to believe*** *that (a) the company is* ***financially distressed****; and (b) there appears to be a* ***reasonable prospect of rescuing the company*** *(our emphasis)*

In terms of section 128(1)(f) of the Companies Act, the words "*financially distressed*" mean that –

(1). *it appears to be reasonably unlikely that the company will be able to pay all of its debts as they become due and payable within the immediately ensuing six months; or*

(ii) *it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months.*

Consequently, there are two instances in which a company may be held to be "*financially distressed*". In order to determine whether or not either instance has occurred, the following tests must be performed –

- a cash flow test, which pertains to the so called "commercial insolvency" where a company cannot pay its debts as and when they fall due for payment (section 128(1)(f)(i)); or

- a balance sheet test, which relates to the so called "factual or technical insolvency" where a company's liabilities exceeds its assets (section 128(1)(f)(ii)).

In both instances, the word "reasonably" is used. Accordingly, the test for financial distress is objective, it being whether or not a reasonable director, in the same position as the directors of the company, would have come to the same conclusions regarding the company's financial position had they had to make the same decision.

The Companies Act is silent on when it should be concluded that the company will be unable to pay all its debts as they fall due in the immediately ensuing six months, or how it is to be decided that that company is likely to become insolvent during the same period. It is recommended that the board of directors should, inter alia, continuously monitor whether the company is able to pay its debts as they fall due and payable in the ensuing six months or if the company is likely to become insolvent.

In addition to the aforegoing, 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).

Accordingly, if the board of directors of the company concludes that the company is financially distressed at any particular point in time, it will be obliged to either (i) adopt a resolution in accordance with the provisions of section 129(1) of Companies Act to place the company under business rescue; or (ii) deliver a written notice to each affected person (in accordance with the provisions of section 129(7) of the Companies Act) advising why the requisite resolution was not adopted.

If the directors make a decision not to place a company under business rescue at a certain point in time on the basis that they do not believe that the company is financially distressed at that point in time,

and if the financial position of the company changes at a later point in time, we are of the view that the directors will need to reconvene and re consider the test for financial distress.

The decision to either place a company in business rescue, or to send out a "section 129(7) notice" should be carefully considered, particularly the latter, which may give rise to unintended consequences.

It is also important to note that, in the event that a company is considered to be financially distressed and as a result, business rescue proceedings have commenced, the Companies Act, in section 142, imposes additional responsibilities on company directors. In terms of section 142(1) and (2) of the Companies Act, each director must deliver to the business rescue practitioner, all books and records relating to the affairs of the company which are in such director's possession, or must inform the business rescue practitioner of the whereabouts, if known, of such books and records. Moreover, the directors must, in terms of section 142(3) of the Companies Act, provide the business rescue practitioner, within five business days after business rescue proceedings begin, with a statement of affairs of the company, containing, at a minimum, the particulars set out in section 142(3). Section 142 of the Companies Act therefore imposes further duties and liabilities on company directors.

Delinquent directors – Section 162 of the Companies Act

Errant company directors who fail to comply with the obligations set out in the Companies Act face the prospect of being declared "delinquent" under certain circumstances. Our courts have declared directors, who have failed to discharge their duties under the Companies Act to be delinquent, and have granted leave to the companies involved to claim damages from such director for losses incurred as a result of such director's conduct.

It is therefore incumbent on South African directors to take cognisance of the impact of section 162 of the Companies Act (declaration of delinquent directors) and to take steps to ensure that they do not open themselves up to the possibility of being declared delinquent.

In terms of section 162 of the Companies 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 delinquent or under probation if:

- the person is a director of that company, or within 24 months immediately preceding the application, was a director of that company; and
- amongst other things such director has –
  - whilst under a probation order in terms of the Companies Act or the Close Corporations Act, acted in a manner that contravened that order;
  - grossly abused the position of a director;
  - intentionally, or by gross negligence, inflicted harm upon the company or a subsidiary of the company, contrary to the provisions of the Companies Act;
  - 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.

Furthermore, the Companies Act provides that a director may be declared delinquent if he or she uses their position or any information obtained while acting in the capacity of a director to –

- gain an advantage for himself 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.

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 disqualified. Such disqualifications are set out in section 69 of the Companies 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 Financial Markets 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 Companies Act, or whilst under a probation order in terms of the Companies Act that person acted in a manner that contravened the probation order.

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

The Companies Act further states that if any person was a director of more than one company (irrespective of whether concurrently, sequentially or at unrelated times) and where two or more of those companies each failed to pay all of their creditors or meet all of their obligations (except in terms of a business rescue plan resulting from a board resolution or a compromise with creditors in terms of the Companies Act), that person could be subject to a declaration of delinquency.

As an alternative to a declaration of delinquency, a court may make an order placing a person under probation instead. 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 section 4 of the Companies 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 are fairly valued, are equal to or exceed the liabilities of the company, and it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of 12 months thereafter.

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 Companies Act, the person has been a director of more than one company (irrespective whether concurrently, sequentially or at unrelated times) and during the 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 in Chapter 6 of the Companies Act or a compromise with creditors in terms of section 155 of the Companies Act.

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 Companies Act or whilst under probation in terms of the Companies Act or the Close Corporations Act and acted in a manner that contravened that order.

Important case law in relation to delinquent directors

- In the case of *Cook v Hesber Impala (Pty) Limited and others* [2016] JOL 36194 (GJ), the High Court warned that a declaration of delinquency can only be made in relation to one of the legislated grounds stipulated in section 162 of the Companies Act, and that there must be clear "evidence" of any conduct that warrants a director being declared delinquent. With this in mind, if such "evidence" is available, then the directors can also be held personally liable under section 218 of the Companies Act for the losses incurred by any person as a result of the directors' delinquent conduct.

- In the case of *Companies and Intellectual Property Commission v Cresswell and Others* (921092/2015) [2017] ZAWCHC 38, the Western Cape High Court expanded upon the meaning to be ascribed to the words "gross negligence" or "wilful misconduct" within the prescripts of section 165(5)(c)(iv)(aa). In this case, a director of a company allowed the company to carry on trading while knowing that the company was insolvent. The director inter alia made withdrawals from the company's bank account and also received payments from the company's bank account into his personal account. In finding that the director's conduct constituted gross negligence or wilful misconduct, the court referred to the case of *S v Dhlamini 1998* (2) SA 302 (A), where the Appellate Division indicated that gross negligence is characterised by an attitude of reckless consideration of the consequences of one's actions. The Western Cape High Court further indicated that the concept of gross negligence was developed in a number of cases such as *Transnet Ltd t/a Portnet v Owners of the MV "Stella Tingas" and another* 2003 (2) SA 473 (SCA).In this case, the SCA indicated that for conduct to qualify as gross negligence, "... it must demonstrate, where there is found to be conscious risk taking, a complete obtuseness of mind or, where there is no conscious risk taking, a total failure to take care".

- *Gihwala v Grancy Property Limited* 2017 (2) SA 337 (SCA)

  In the more recent judgment of the SCA in the case of *Gihwala v Grancy Property Limited* 2017 (2) SA 337 (SCA), the constitutionality of section 162 of the Companies Act was called into question. The constitutional challenge was brought on appeal by Mr Gihwala and Mr Manala (who were the directors of Grancy Property Limited ("Grancy").

The directors challenged the constitutionality of section 162 of the Companies Act on the following grounds:

- that the provisions of section 162(5) applies retrospectively. In support of this argument, the directors indicated that the events relied upon by the court a quo to justify the order of delinquency occurred before the commencement of the Companies Act on 1 May 2011;
- that after consideration of the provisions of section 162(5)(c) as read with section 162(6)(b)(ii), the aforementioned provisions vested no discretion on the courts to make an order of delinquency which subsist for a period less than 7 years; and
- that the provisions of section 162(5) infringes upon their right to choose a trade and occupation or profession, their right to access courts and their right to dignity.

The SCA took the view that in assessing the directors' arguments, it is the purpose and intent of section 162 which had to be examined. The court found that the purpose of section 162 is to protect the investing public against the type of conduct that leads to an order of delinquency, and also to protect those who deal with companies against the misconduct of delinquent directors.

In rejecting the argument of retrospectivity, the SCA relied on a principle established in the case of *R v St Mary, Whitechapel (Inhabitants)* 116 E.R. 811 (1848) 12 QB 120 that a statute is not retrospective merely "*because a part of the requisites for its action is drawn from time antecedent to its passing*".

In sofar as the duration of delinquency is concerned, the SCA found that the courts' discretion to reduce the subsistence of a delinquency period was catered for in terms of section 162(11)(a), which confers upon the courts the power to relax the full effect of the delinquency once the delinquent has demonstrated that it is appropriate to do so.

Further, and in relation to the right to trade occupation, the SCA found that it was never suggested by the directors that section 162(5) is capricious or arbitrary and, on that ground alone, that constitutional challenge had to fail.

With regard to the directors' challenge relating to the alleged infringement of their right to access to court, the SCA dismissed this contention and found that before an order of delinquency is made, the errant directors had been given a fair hearing before a court.

Lastly, the court found that in order to challenge the constitutionality of section 162 on the basis that it infringes their dignity, the SCA found that an attack on this ground can only be pursued by attacking the rationality of the provision. The SCA noted that the attack on section 162 was not on the ground that the particular provision was irrational. The court held that it is a constitutional requirement that all legislation must serve a rational purpose – and section 162 passes this test. The directors' appeal therefore had to fail.

> *Organisation Undoing Tax Abuse and another v DC Myeni & others* [2020] 3 All SA 578 (GP)

In this case, former SAA Chair, Dudu Myeni, was declared a delinquent director in terms of the Companies Act. The court found that Ms Myeni had comprehensively failed to fulfil her duties as a director and ordered that she be declared a delinquent director for life, and she was further ordered to pay punitive costs. The Judge also referred the judgment and evidence to the National Prosecuting Authority for investigation regarding possible criminal conduct.

The court's far-reaching judgment is timely for a number of reasons - it finally tests in court the Institute of Directors of Southern Africa's long-standing contention that directors must inform themselves properly about the nature and extent of their duties towards the organisation, or put themselves in peril. It is also clear from the evidence led that the courts will rely not only on legislation but also the King Reports on Corporate Governance. Together, these provide a sound framework to guide directors in fulfilling their duties satisfactorily. Directors have a critical role to play, and they can only do it if they are fully conversant with what their legal and fiduciary obligations entail.

The judgment also made the important point that directors cannot use collective decision-making as a way to evade individual responsibility and liability, and further illustrates the importance of not only appointing suitably qualified people to boards of companies, but also ensuring that they keep up to date with the latest thinking and are regularly appraised with the relevant principles of corporate governance.

As stated by the Court, "*to serve on a board of an SOE should not be a privilege of the politically connected. Government has, as custodian of the common good, an obligation to ensure that suitably qualified people, with integrity are appointed in these positions.*"

Dudu Myeni's application for leave to appeal against this judgment was dismissed by the SCA, on the grounds that there was no reasonable prospect of success in an appeal and that there was no compelling reason why an appeal should be heard. As such, the findings in this High Court judgment (including those set out above) have been solidified as important benchmarks as to the standard of conduct required of directors.

Lessons to be learnt

Directors 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 and incurring personal liability. Directors must ensure that they guard against falling foul of the provisions of the Companies Act set out above. In addition, directors must also consider whether they are trading recklessly when the company is experiencing financial distress, and whether to place the company into business rescue. Failure to do so may result in their conduct being the subject of scrutiny either by a business rescue practitioner or, if the company is subsequently placed into liquidation, at insolvency inquiries in the post liquidation period.

In view of the case law set out above, directors must also guard against finding themselves on the receiving end of a delinquency order, as any director subject to such an order will not be nominated and, in fact, cannot be appointed to any other boards of companies. The word "delinquency" also 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 this regard, directors who are declared to be delinquent may also be held criminally liable under section 214 of the Companies Act.

Accordingly, it is critical for directors to be aware of the relevant provisions of the Companies Act. These provisions, coupled with the corporate governance principles set out in the King IV Report, must serve as a guide for boards of directors when managing the business and affairs of a company, as failure to adhere to the significantly increased standard of conduct required of directors may give rise to negative and unfortunate consequences.

In general, directors should therefore undertake a frank and realistic review of the manner in which their companies operate. This is essential in avoiding personal liability. Worldwide, directors' duties towards their companies are coming into increased focus, to ensure that correct decisions are made. Failure to maintain the requisite level of knowledge on the issues dealt with in this booklet may result in directors being, at best, severely criticised or, at worst, being held liable for company debts as a result of reckless and negligent behaviour.

Summary

Directors need to be aware of the increased obligations and potential exposure to liability as set out in the Companies Act. Directors should also consider the level of insurance required to provide cover for potential claims.

The provisions of the Act require South African directors to make important decisions on company issues at board level.

Directors who allow companies to trade in breach of their newly constituted duties of good faith, or in situations of financial distress, or in insolvent circumstances, must recognise that such trading may be the subject of examination either by a business rescue practitioner or, if the company is placed into liquidation, at insolvency inquiries in the post liquidation period.

Directors should therefore undertake a frank and realistic review of the manner in which their companies trade. This will be essential to avoid personal liability.

Worldwide, directors' duties to their companies are being elevated to ensure that correct decisions are made for the financial benefit of 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.

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About us

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