COMPANY DIRECTORSHIP-DECLARING DIRECTORS DELINQUENT WHEN TRADING A COMPANY IN INSOLVENT CIRCUMSTANCES

By Dr Eric Levenstein, Director

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In these turbulent economic times, and particularly with overt pressure on the Rand and with the recent downgrade of South Africa to "junk status", directors of South African companies need to be fully aware of the reckless trading provisions applicable to them in terms of the 2008 Companies Act ("the Act").

INTRODUCTION

Reckless trading and conducting the company's business with the intention of defrauding creditors who supply the company with goods and services on credit, may result in creditors pursuing claims against directors who continue to accept the provision of credit knowing full well that such credit obligations cannot be met by the company.

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.

Directors need to be aware of a situation where, due to increased economic pressures on the company, the company becomes financially distressed in a sense that it cannot pay its debts in the next six month period or where it might become insolvent in the next six month period. If that is the case, directors have a duty to pass a resolution for a company's business rescue, or alternatively resolve to wind up or liquidate the company.

DIRECTOR ACCOUNTABILITY

In years gone by, there was a time when company directorships were valued for prestige and director fees. In recent years, South African company directors have become more and more accountable in respect of their obligations to the company and where they are expected to act in the best interests of the company. Section 77(3)(b) of the Act is clear. It states that any director of a company will be liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the directors:

- 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
- 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.

Gone are the days where directors can rely on the principle of limited liability for incorporated companies. In the 1997 case of *Philotex*, the court stated clearly that when a company traded recklessly, with intent

to defraud creditors, any person who was a party to such trading could be held personally liable for all the debts of the company. In overseas jurisdictions, law reform bodies have become convinced that the leniency shown towards directors of insolvent companies, who act to the detriment of creditors and shareholders, must cease. International laws have been introduced to discourage errant behaviour on the part of directors while accepting at the same time that directors need to be encouraged to sit on boards and to grow their company's businesses, despite inevitable risks posed to creditors.

South African directors that fail to take action when trading a company in insolvent circumstances can, in terms of section 214 of the Act, render a director guilty of a criminal offence and be liable to a fine or imprisonment for a period not exceeding 10 years or to both a fine and imprisonment. Further, in terms of section 218 of the Act, a director can be held civilly liable for damages caused to any person as a result of any contravention of the Act. Since the financial crisis in 2008, and in more recent times, company directors have no doubt felt increased pressure and noted the demands being placed on directors and the manner in which they conduct the business of their companies. The challenge for these directors is to remain focused on doing what they believe is in the company's best interest and, in particular, to maintain a sufficient understanding of shareholder sensitivities.

Furthermore, section 162 of the Act makes provision for the directors to be declared delinquent if a director grossly abuses the position of a director or intentionally or by gross negligence inflicts harm upon the company contrary to the provisions of the Act. Again, the threat of possibly being declared a delinquent director ups the ante in respect of the accepted level of director behaviour on boards on companies. The recent case of the *Companies and Intellectual Property Commission v Cresswell, Basson and Wienand* (27 March 2017) supports the notion that our courts are very much alive to the possibility of declaring directors delinquent that "act in a manner that amounts to gross negligence, wilful misconduct or breach of trust". In this case, one of the directors was declared delinquent and to remain so for a period of seven years as a result of him having traded the company in "insolvent" circumstances. The provisions of the Act have set the bar fairly high for directors in respect of their compliance with their fiduciary duty obligations and where creditors will, in time, readily hold errant directors of companies personally liable for the debts of such companies.

CONCLUSION

Directorships are clearly not for the faint-hearted. In these tough economic times, more and more companies are going to face financial stress and distress. It will be up to these directors to be aware of their fiduciary obligations and prohibitions applicable to them trading companies in insolvent circumstances.

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Dr Eric Levenstein has been a director at Werksmans Attorneys since 1993 and is currently the head of the firm's Business Rescue, Insolvency & Restructuring Practice. He specialises in Litigation and Dispute Resolution with a particular focus on Business Rescue, Insolvency and Restructuring. In addition, Eric specialises in Banking and Finance, Corporate/Commercial Recoveries of Debt, Shareholder/Director Disputes, Corporate Governance (Director's Liability) Issues and Intellectual Property. He regularly delivers seminars and writes for various publications on these topics among others.

He is a member of the South African Restructuring and Insolvency Practitioners Association (SARIPA) and sits on the National Board of SARIPA. In addition, Eric is a member of INSOL, a worldwide group of insolvency practitioners and attorneys. Eric also sits on SARIPA's Restructuring, Business Rescue and Government Liaison Committees.

Eric has been ranked as a highly recommended lawyer in Dispute Resolution (Business Rescue) in *Legal 500*, 2012-2017. He has also been named as a recommended lawyer in Restructuring and Insolvency by *PLC Which Lawyer* 2013. Eric is also named as a leading Insolvency and Restructuring lawyer by *Who's Who Legal*, 2014, 2016 and 2017 and by Chambers Global in 2017. Eric has given numerous presentations on Insolvency, Business Rescue and Director's Liability. He is a regular contributor to the media on the effect of Business Rescue on companies and creditors, Consumer Protection Law, Insolvency and Director's Liability.

He has BCom and LLB degrees, higher diplomas in Company Law and Tax, and a diploma in Insolvency Law. He recently received an LLD (Doctorate of Laws) in Business Rescue from the University of Pretoria.

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