

The Delinquent Director in South Africa: No Tolerance for Errant Directors?

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The South African courts have declared directors, who have failed to discharge their duties under the South African Companies Act 71 of 2008 (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.

SECTION 162 – DELINQUENCY

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 his or her position or any information obtained while acting in the capacity of a director to:

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

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.¹

Any person who has at least twice been personally convicted of an offense 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.

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, 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.

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.

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.

Case Law

In the case of *Kukama vs Lobelo, Peolwane Properties (Proprietary) Limited, Diphuka Construction (Proprietary) Limited and CIPC*, South Gauteng High Court, Johannesburg, 12 April 2012, Kukama, the sole director of Diphuka Construction Proprietary Limited (Diphuka), allowed payments from the South African Revenue Services (SARS) in the amount of R22 million and R39 million destined for Peolwane Properties Proprietary Limited (Peolwane), of which he and Lobelo are directors, to be made to Diphuka. Kukama then utilised the two amounts for the benefit and interest of other companies to the detriment of Peolwane.

The Presiding Judge ruled that the director concerned had contravened section 22 (reckless trading) and section 76 (standards of director's conduct, including the duty to communicate to the board at the earliest practicable opportunity any information that comes to such director's attention) of the Companies Act. The court found that the director's conduct did "not measure up to the standard required and expected of a director" and as a result found that he was in breach of his fiduciary duties to the company.

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

Following the aforementioned decision in *Kukama*, in the case of *Cook v Hesber Impala (Pty) Limited and others* [2016] JOL 36194 (GJ), the applicant sought a declaration of delinquency on grounds which were not stipulated in section 162 of the Companies Act. 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 for the consequences of one's actions.²

SOUTH AFRICAN SUPREME COURT OF APPEAL – GIHWALA CASE

In the more recent judgment of the South African Supreme Court of Appeal (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 directors challenged the constitutionality of section 162 of the Companies Act on the following grounds:

- that the provisions of section 162(5) apply 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 May 1, 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 order 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 was 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 damage caused by the misconduct of delinquent directors. Section 162 of the Companies Act was therefore found to be Constitutional.

Lesson Learned for South African Directors?

There is no doubt that directors of South African companies will have to carefully consider the manner in which they conduct the affairs of companies, particularly where there is the possibility of being declared delinquent and incurring personal liability. Directors who find themselves on the receiving end of such an order will not be nominated and, in fact, cannot be appointed to any other boards of companies.

Furthermore, the word "delinquency" carries criminal connotations. The various dictionary definitions refer to "offender," "guilty of a crime or misdeed," "failing in one's

duties” or “failing to perform an obligation,” the most telling and damning being “a person guilty of serious antisocial or criminal conduct.” In this regard, directors who are declared to be delinquent may also be held criminally liable under section 214 of the Companies Act.

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

Clearly these provisions significantly increase the expected level of directors’ duties to companies in South Africa and the standard of conduct required. Coupled with the provisions of the King Code on Corporate Governance (King IV), directors need to carefully consider whether they are adhering to their duties as set out in section 75 and 76 of the Companies Act, or face an order of delinquency with all of its negative and unfortunate consequences. Once an order declaring a person to be a delinquent director is made, that person may also be held liable towards the company under section 77(5) or to any person under section 218 of the Companies Act, for any loss or damage suffered as a result of that person’s conduct.

Conclusion

Directors have no choice but to take these provisions seriously. They need to be aware of the increased obligations set out in the Companies Act; particularly in regard to their potential exposure to claims whilst sitting on boards of companies in South Africa.

The provisions of the Companies Act require South African directors to make important decisions on company issues at board level and to comply with the standards of conduct expected of them and as set out in the Companies Act.

Directors who allow companies to continue to trade in situations of financial distress or insolvent circumstances must recognise that such trading may result in a declaration of delinquency.

In current local and world financial markets, a frank and realistic review by directors of the manner in which their companies trade will be essential for survival and to avoid 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 companies at all times. Failure to maintain a particular level of knowledge of these issues can result in directors being severely criticised, being held liable for company debts as a result of reckless and negligent behaviour or being declared delinquent. ■

- Such disqualifications are set out in section 69 of the Companies Act and include that such person: (i) was an unrehabilitated insolvent; or (ii) is prohibited in terms of any public regulation to be a director; or (iii) has been removed from an office of trust on the grounds of misconduct involving dishonesty; or (iv) has been convicted in the Republic or elsewhere for theft, fraud, forgery or any conduct involving fraud, misrepresentation or dishonesty or offences involving various statutes such as the Insolvency Act, the Close Corporation Act, the Competition Act, the Financial Intelligence Centre Act (FICA), the Securities Services Act or the Prevention and Combating of Corrupt Activities Act.
- 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 Supreme Court of Appeal (“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”.



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