

CORPORATE GOVERNANCE AND PERSONAL LIABILITY IN TERMS OF SECTION 424(1) OF THE COMPANIES ACT OR SECTION 64(1) OF THE CLOSE CORPORATIONS ACT

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Abstract

The author poses the question: "In knowingly becoming a party to the conducting of corporate business, within which boundaries must I operate so as not to become personally liable for all or any of such debts or other liabilities of the corporation as the Court may direct in terms of section 424(1) of the Companies Act 61 of 1973 or section 64(1) of the Close Corporations Act 69 of 1984?"

The answer to this question may prove to be of paramount importance to members of the scientific and engineering fraternity who become involved in corporate governance, whether in a technology advisory capacity, in a managerial capacity, or otherwise.

Opsomming

Die outeur stel die volgende vraag: "Indien ek wetens as 'n party betrokke raak by die bedryf van 'n maatskappy, binne welke grense moet ek optree om persoonlike aanspreeklikheid te vermy vir al of enige van die skulde of ander verpligtinge van die maatskappy soos die Hof mag gelas ingevolge artikel 424(1) van die Maatskappywet, No. 61 van 1973 of artikel 64(1) van die Wet op Beslote Korporasies, No. 69 van 1984?"

Die antwoord op hierdie vraag mag van groot belang wees vir lede van die wetenskap- en ingenieursberoep wat op die een of ander manier betrokke raak by die bedryf van 'n maatskappy, hetsy in 'n tegnologiese-adviserende hoedanigheid, in 'n bestuurshoedanigheid of andersins.

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1. Introduction

Many members of the scientific and engineering fraternity become involved in corporate governance, whether in a technology advisory capacity, in moving up the managerial ladder, or by other means. Members may serve on a company's board of directors as an "executive" or "non-executive" director. Some may start up their own company or Close Corporation and become a director or member. There is a concerted drive in South Africa to create a culture of self-employment and to enhance the growth of small, medium and micro enterprises (so-called SMMEs).

Company shareholders and potential shareholders, company creditors and potential creditors and even company employees are increasingly focusing on the level of good governance practised by the board of directors of companies. The reason is straightforward: Companies are seen as the workshops for wealth creation and the effectiveness of the company depends to a large extent on the level of good governance [1]. Corporate governance refers to the system by which companies are directed and controlled [2].

This article elaborates on those risks to be managed when one is becoming knowingly involved in corporate governance so as not to be found personally liable for recklessly conducting corporate business.

2. Section 424(1) of the Companies Act and section 64(1) of the Close Corporations Act

Section 424(1) of the Companies Act 61 of 1973 states:

"When it appears, whether it be in a winding-up, judicial management or otherwise, that any business of the company was or is being carried on recklessly or with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court may, on the application of the Master [of the Court], the liquidator, the judicial manager, any creditor or member or contributory of the company, declare that ANY PERSON who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be personally responsible, without any limitation of liability, for all or any of the debts or liabilities of the company as the Court may direct." [My emphasis by using capital lettering and underlining.]

On the other hand, section 64(1) of the Close Corporations Act 69 of 1984 reads as follows:

"If at any time it appears that any business of a corporation was or is being carried on recklessly, with gross negligence or with intent to defraud any person or for any fraudulent purpose, a Court may on the application of the Master [of the Court], or any creditor, member or liquidator of the corporation, declare that ANY PERSON who was knowingly a party to the carrying on of the business in any such manner, shall be personally liable for all or any of such debts or other liabilities of the corporation as the Court may direct, and the Court may give such further orders as it considers proper for the purpose of giving effect to the declaration and enforcing that liability." [My emphasis by using capital lettering and underlining.]

3. Problem statement

Luiz [3] neatly captures the risks to which directors and controlling stakeholders are exposed when undertaking business:

“The concepts of limited liability and separate legal personality of the company give rise to endless opportunities for abuse by the directors and controlling shareholders of a company. Most people would agree that a director should be held accountable when he uses the company as a vehicle to commit fraud. Difficulties arise, however, when the person concerned has acted not fraudulently but recklessly. Entrepreneurial spirit must not be completely curbed. A director is entitled, indeed expected, to take calculated business risks. But where does one draw the line between calculated risks and reckless mismanagement?” [My emphasis by underlining.]

For the purpose of this article, I phrase the problem statement as follows:

“In becoming knowingly a party to the carrying on of corporate business, within which boundaries must I operate so as not to become personally liable for all or any of such debts or other liabilities of the corporation as the Court may direct in terms of section 424(1) of the Companies Act 61 of 1973?” The same question can be posed for the case of Close Corporations.

This question equally applies to members of the scientific and engineering fraternity that in one way or another become involved in corporate governance, as shareholders, directors, executive directors and non-executive directors.

The solution to the problem is complicated by the fact that directors of companies and those persons knowingly a party to the carrying on of the business, may have different types and levels of education and training, and may govern corporate businesses of varying size and deliver products (services implicitly included) of varying complexity. Many private companies are incorporated with a minimum authorised share capital and depend to a large extent on financial credit. Furthermore, the question arises as to whether and under which circumstances trading in technically insolvent situations implies reckless mismanagement.

4. Interpreting section 424(1) of the Companies Act of 1973 in the light of the Supreme Court of Appeal’s decision in *Philotex (Pty) Ltd and Others v J R Snyman and Others* [4] in curbing reckless mismanagement

Wolnit Ltd, a small company involved in the manufacture of clothing, was placed in voluntary liquidation on 20 November 1989. Former concurrent creditors of Wolnit instituted action in the Transvaal Provincial Division against the persons (respondents) that were at all material times the directors of Wolnit Ltd. The appellants made the allegation that the respondents had from 1 July 1987 recklessly carried on Wolnit’s business. A crucial question was whether the respondents were

liable in terms of section 424(1) of the Companies Act of 1973. The respondents denied this allegation. Judge Van Dijkhorst dismissed the appellants' claim on the ground that the appellants did not prove recklessness. The appellants appealed against this Court decision and the Supreme Court of Appeal had to decide whether the appellants did indeed prove recklessness in the lower Court.

The Supreme Court of Appeal held that the appellants proved on a balance of probabilities that Wolnit's business was carried out recklessly during the 1989 calendar year. Eight of the respondents (defendants), all directors of Wolnit Ltd, were held liable in terms of section 424(1). The decision in the Transvaal Provincial Division was reversed.

Judge Appellate Howie pointed out (at 142H) that the precursor of section 424, namely section 185*bis* of the previous Companies Act 46 of 1926 did not address reckless trading. The legislature's intent with section 424 was, amongst others, to address reckless trading and to make provision for remedies "*by means of which a restraining influence can be exercised on 'over-sanguine directors'*".

Personal liability in terms of section 424(1) revolves to a large extent around two issues that the plaintiff needs to prove, namely a) that the person accused of reckless management was **knowingly a party** to the carrying on of the business, and b) that such person was a party to the carrying on of the business **recklessly**. This equally applies to section 64(1) of the Close Corporations Act 69 of 1984. Being a civil proceeding, the onus is on the plaintiff to prove recklessness on a balance of probabilities.

4.1 Being "knowingly a party" to the carrying on of the business

Judge Appellate Howie confirmed (at 143B) the definition of "knowingly" as set out in *Howard v Herringel and Another NNO* [5], namely that it means "*having 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 recklessly*". The party need not even be conscious of the recklessness or have knowledge of the legal consequences relating to those facts.

Of great importance is that Judge Appellate Howie also confirmed (at 143C) the view in *Howard v Herringel and Another NNO* that by "*being a party to the conduct of the company's business does not have to involve the taking of positive steps in the carrying on of the business; it may be enough to support or concur in the conduct of the business*".

4.2 The definitions of "recklessly" and "recklessness"

Judge Appellate Howie came to the conclusion (at 143F) that the ordinary meaning of "recklessly" includes gross negligence, with or without consciousness of risk-taking. The Court then confirmed the view taken in *S v Dhlamini* [6], namely that gross negligence includes "*an attitude or state of*

mind characterised by ‘an entire failure to give consideration to the consequences of one’s actions, in other words, an attitude of reckless disregard of such consequences’.

4.3 The test for recklessness

Confirming the view held in *S v Van As* [7], the Supreme Court of Appeal held (at 143G - I) that:

“The test for recklessness is objective insofar as the defendant’s actions are measured against the standard of conduct of the notional reasonable person and it is subjective insofar as one has to postulate that notional being as belonging to the same group or class as the defendant, moving in the same spheres and having the same knowledge or means to knowledge.”

Once more referring to the *S v Van As* decision, Judge Appellate Howie (at 148E – H) elaborated on the situation of the notional reasonable person having the same knowledge or means to knowledge as the defendant. Judge Appellate Howie highlighted the example where director A, being a farmer, did not know of certain relevant facts, which facts were within the knowledge of his co-director B by reason of his qualifications or experience. Then A’s ignorance will be blameworthy if he **ought reasonably to have sought B’s** advice in B’s capacity as a co-director having that extra knowledge. [My emphasis by using bold lettering.] Judge Appellate Howie: *“The enquiry will therefore be: what would the reasonable businessman having that additional knowledge, or having access to that knowledge, have done in the circumstances?”*

Referring to *Fisheries Development Corporation of SA Ltd v Jorgensen and Another* [8], the Supreme Court of Appeal stated (at 144B) that in applying the recklessness test, a Court will take into account amongst others *“the scope of the operations of such company, the role, functions and powers of the directors, the amount of debts of the company, the extent of the company’s financial difficulties and the prospects, if any, of recovery.”*

This test for recklessness must be welcomed. Subjective considerations such as the “honest beliefs” on the side of the party accused of reckless mismanagement, do not figure in the test.

4.4 Entrepreneurial risks, reckless mismanagement and incurring company debts

The Supreme Court of Appeal took the stance that section 424 is also aimed at those persons who subject third parties or creditors to grossly unreasonable risks when incurring debts for such persons’ company.

In formulating an objective test for reckless mismanagement relating to the incurring of company debts, Judge Appellate Howie confirmed (at 145I) the approach in *Ozinsky NO v Lloyd and Others* [9] by stating:

"If a company continues to carry on business and to incur debts when, 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 is being carried on recklessly." [My emphasis by underlining.]

It should be noted that the statement does not read that "... there would be no reasonable prospect of the creditors ever receiving payment."

How does the "honest belief" on the side of the director as to the prospects of payment figure in the enquiry as to recklessness in incurring company debts? Judge Appellate Howie stated (at 147D) that "honest belief" will be an irrelevant factor if a reasonable person doing business in the same circumstances would not have held that belief.

The reader's attention is drawn to the finding of the Judge in *Body Corporate of Greenwood Scheme v 75/2 Sandown (Pty) Ltd and Others* [10] that section 424 is not limited solely to the financial affairs of the company, but that the section's reference to the business of the company which is being carried on recklessly, has a wider connotation. The Court also held that a director could be held liable in terms of this section even in instances where the company is in a sound financial position. Judge Wepener (at 487H): *"The result is that, even if it was not necessary for the company to be in a winding-up or to be under judicial management, the persons referred to in s 424 (usually directors) are still liable in terms of that section if they acted recklessly."* [My emphasis by underlining.]

In *Body Corporate of Greenwood Scheme v 75/2 Sandown (Pty) Ltd and Others* the plaintiff, a body corporate, instituted action against the sole director of a building company. The plaintiff alleged that the director had knowingly been a party to the company performing the building activities in a reckless manner and consequently should be personally liable in terms of section 424(1).

5. Personal liability of the director and non-executive director in terms of section 424(1) of the Companies Act and section 64(1) of the Close Corporations Act

The scientific and engineering fraternity is familiar with what it entails to be a professional engineer, a professional technologist, a professional natural scientist or a professional science technologist. A professional engineer, a professional technologist (engineering), a certified engineer or an engineering technician means a person registered in terms of the Engineering Profession of South Africa Act, No. 114 of 1990. A professional natural scientist or professional science technologist means a person registered in terms of the Natural Scientific Act, No. 106 of 1993. However, is there a profession such as a "professional director", a "professional executive director" or even, for that matter, a "professional non-executive director"? And if so, to what standards or code of conduct must their actions comply? What training should they undergo to qualify for registration?

In general any individual can become a company director, excluding those disqualified in terms of section 218 of the Companies Act 61 of 1973. Furthermore, this Act and our common law do not lay down any qualifications that one must meet to become a director.

In terms of our common law, a director has a fiduciary duty to act in utmost loyalty and good faith in the interest of the company as a whole and in doing so to exercise reasonable skill and diligence. According to Havenga [11] this duty is a so-called open-ended standard, *“the interpretation of which depends on policy considerations. The standards of good faith required from a director must be gauged in the light of the boni mores or legal convictions of the community as reflected in the Bill of Rights.”*

The question of personal liability for reckless management becomes complicated where, for instance, one director takes an active role in the day-to-day management of the company and the other takes on the passive role by being a so-called non-executive director.

In the appellate case of *Howard v Herringel and Another NNO* Judge Appellate Goldstone stated (at 678A-D):

“In my opinion it is unhelpful and even misleading to classify company directors as ‘executive’ or ‘non-executive’ for purposes of ascertaining their duties to the company or when any specific or affirmative action is required of them. No such distinction is to be found in any statute. At common law, once a person accepts an appointment as a director, he becomes a fiduciary in relation to the company and is obliged to display the utmost good faith towards the company in his dealings on its behalf. That is the general rule and its application to any particular incumbent of the office of director must necessarily depend on the facts and the circumstances of each case. One of the circumstances may be whether he is engaged full-time in the affairs of the company. However, it is not helpful to say of a particular director that, because he was not an ‘executive director’, his duties were less onerous than they would have been if he were an executive director. Whether the inquiry be one in relation to negligence, reckless conduct or fraud, the legal rules are the same for all directors.”

Luiz [3] rightfully points out that the Court’s decision in *Cronje v Stone en ’n Ander* [12] should be seen as a warning to those who invest money in a company and take up a position as a non-executive director to protect their investment and then simply sit back and make no attempt to take an active part in the management of the company.

Suppose that a director has an opinion different from those of his co-directors on what business risks to take and how the business should be managed, but that he was part of the unanimous decision-making process taken by the board of directors. How will the test for recklessness operate in this case?

In *Philotex (Pty) Ltd and Others v Snyman and Others*, Judge Appellate Howie pointed out (at 148H-J) that where crucial decisions were made by unanimous decision by the board of directors, then those decisions will be the decisions that will be subjected to the objective test for recklessness in the case where a director is a defendant accused of reckless mismanagement.

Gower [13] is of the opinion that the English common law duties of care, skill, and diligence are admittedly lax, but this, according to him, is inevitable unless and until company directorship is recognised as a profession with professional standards.

Botha and Jooste [14] point out that the “*South African law places a deplorable low standard of care and skill on directors, so much so that a successful action against a director for breach of duty of care and skill is highly unlikely.*”

The question may rightly be asked whether it is advisable to pass legislation to provide for the establishment of a South African Council for Professional Company Directors; for the registration of professional company directors; the prohibition of performance of work of a corporate business nature by unregistered persons and matters pertaining to the training of directors and the setting of standards. South Africa as a developing country focuses on job creation and export for wealth creation. Applying the Pareto principle, to my mind our common law and existing corporate legislation sufficiently spells out the boundaries within which the corporate director must operate. We should guard against over-regulation.

Judge Margo stated in *Fisheries Development Corporation* (at 165G-166A):

“The extent of a director’s duty of care and skill depends to a considerable degree on the nature of the company’s business and on any particular obligations assumed by or assigned to him. ... Nowhere are his duties and qualifications listed as being equal to those of an auditor or accountant. Nor is he required to have special business acumen or expertise, or singular ability or intelligence, or even experience in the business of the company. He is nevertheless expected to exercise the care which can reasonably be expected of a person with his knowledge and experience.”

It is my view that section 424(1) of the Companies Act and section 64(1) of the Close Corporations Act, as seen against the background of the decision in *Philotex (Pty) Ltd and Others v Snyman and Others*, is available to the Master of the Court, any creditor, member or liquidator of the corporation to act against a director or non-executive director or other person who was/is knowingly a party to the carrying on of the business in a reckless manner. The onus is on them to use this tool if need be.

6. The company secretary and the director’s personal liability for reckless mismanagement

In terms of the Companies Amendment Act No. 37 of 1999 it is now mandatory that the directors of any public companies having a share capital, excluding a share block company, appoint a company secretary who, **in the opinion of the directors, has the requisite knowledge and experience to carry out the duties of a secretary of a public company.** The duties of the secretary include, amongst others, a) to provide the directors of the company collectively and individually with guidance as to their duties, responsibilities and powers; and b) to make the directors aware of all law and legislation relevant to or affecting the company and reporting at any meetings of the shareholders of the company or of the company’s directors, any failure to comply with such law or legislation. [My emphasis by using bold lettering.]

The question may similarly be asked whether it is advisable to pass legislation to provide for the establishment of a Council for Professional Company Secretaries; for the registration of professional company secretaries; the prohibition of performance of work of a corporate secretarial nature applicable to public companies having a share capital, by unregistered persons and matters pertaining to the training of corporate secretaries and the setting of standards.

Noteworthy is that the new section 297 now contains for the first time the definitions of an executive director and a non-executive director.

How will the appointment of the secretary and the way he conducts his functions, affect the personal liability of the director and other persons being knowingly a party to the reckless management of the business of the company?

The dictum in *Fisheries Development Corporation v Jorgensen* should give us an indication of the Court's approach. In this decision Judge Margo said (at 166B/C):

"In respect of all duties that may be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly. He is entitled to accept and rely on the judgement, information and advice of the management, unless there are proper reasons for querying such. Similarly, he is not bound to examine entries in the company's books." Furthermore, at 166D/E: *"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 judgement in the light thereof. ... Nor may he shelter behind culpable ignorance or failure to understand the company's affairs."*

I believe that the reckless mismanagement test as set out in *Philotex (Pty) Ltd and Others v Snyman and Others* can be applied unaltered. There seems to be no indications to the contrary. The director or other persons that are knowingly a party to the reckless mismanagement of the business of the company will not be able to hide behind the company secretary's deeds.

7. Conclusion

In becoming knowingly a party to the carrying on of corporate business, one must consciously ask oneself: "What would a reasonable person, belonging to the same group or class as myself and moving in the same spheres and having the same knowledge or means to knowledge have done in carrying on this business that I am involved in? Would he have taken these business risks or would he have considered the taking of the risks as unreasonable? Would he have incurred debts for the company, knowing that there would be no reasonable prospect of the creditors receiving payment when due?"

The boundaries within which one must operate so as not to become personally liable for all or any of such debts or other liabilities of the corporation as the Court may direct in terms of section 424(1) of the Companies Act 61 of 1973 or section 64(1) of the Close Corporations Act 69 of 1984, are set by the standard of the reasonable businessman.

The clear interpretation of section 424(1) of the Companies Act and implicitly section 64(1) of the Close Corporations Act by the Supreme Court of Appeal in *Philotex (Pty) Ltd and Others v J R Snyman and Others* is to be welcomed. The boundaries within which one must operate so as not to

become personally liable for all or any of such debts or other liabilities of the corporation as the Court may direct in terms of section 424(1) of the Companies Act 61 of 1973 or section 64(1) of the Close Corporations Act 69 of 1984, are now clearly spelled out.

8. Acknowledgement

The author wishes to thank Ms Ilse Lombard from CSIR Legal Services for her valuable advice and peer review.

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