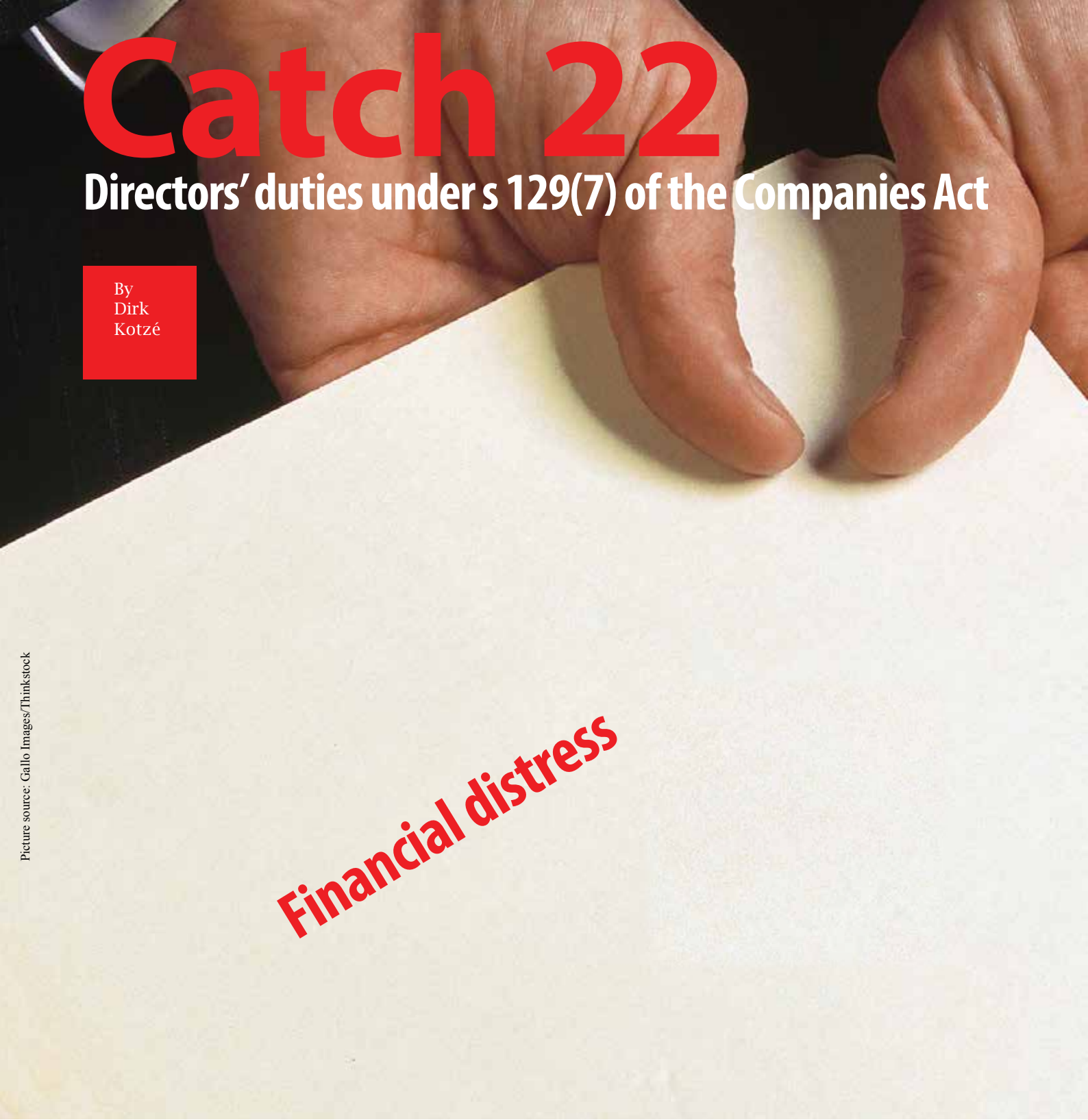
Catch 22

Directors' duties under s 129(7) of the Companies Act

By Dirk Kotzé



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Financial distress

It is trite that the ultimate fate of a financially distressed company that is unable to pay its creditors is liquidation.

Once in liquidation, and should creditors elect to proceed with an insolvency inquiry, the directors of the company might, in appropriate circumstances, be faced with uncomfortable questions, such as:

- Why did the board not inform the stakeholders and creditors timeously that the company was financially distressed?
- Why did the board not resolve to place the company under business rescue?

Positive duty to advise affected persons

The relevance of these questions is found in the duty imposed on the board of directors in s 129(7) of the Companies Act 71 of 2008 (the Act), which states: 'If 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.'

The resolution referred to is the one to begin business rescue proceedings. Simply stated, if a company is in financial distress and it has not filed for business rescue, there is a positive duty on its board of directors to advise the affected persons – creditors, shareholders and employees of the company – that the company is financially distressed, and to advance reasons why it has elected not to file for business rescue.

The language in this section is not directory, but peremptory, and it is sug-

gested that once the requirements set out in the definition of 'financial distress' in s 128 of the Act are met (*de facto* and commercial insolvency foreseen in the ensuing six months), the board has a positive duty to act.

Not only must it inform stakeholders that the company is in financial distress, but it must also advance reasons why it has not adopted a resolution and filed for business rescue.

Consequences for failing to comply

A further question that arises is whether a failure of the board to comply with this duty in terms of s 129(7) will have adverse consequences for the board, especially in circumstances where the company is eventually liquidated and creditors suffer huge losses as a result of unpaid claims, which could have been lessened if this duty had been met.

The answer to this question is by no means staightforward.

At the outset, s 129(7) does not contain any sanction if the board fails to comply with this duty, nor does the Act provide any specified time limits in which such compliance must occur. In my opinion, the main reason for the absence of a sanction is the fact that such notice to creditors will in all likelihood be tantamount to commercial suicide by a company, as its creditors may no longer be willing to supply goods and services on favourable credit terms, if any at all. Banks and financial institutions will, in all likelihood, withdraw all credit facilities or at least substantially reduce such facilities.

Does this mean that the board could simply ignore this duty if it has reason to believe that the company is financially distressed? In my view, the answer should definitely be 'no'.

Although I do not propose that a failure to comply with this duty will automatically lead to the directors being liable for losses suffered by creditors in a liquidation scenario, the following should be kept in mind:

- Firstly, s 218(2) of the Act makes it clear that '[a]ny 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'.

  Thus, for instance, an aggrieved shareholder (who continued to invest his money in a financially distressed company while not having been informed of its financially distressed status) and a creditor (who continues to supply goods and/or services to a financially distressed company while being unaware of its financially distressed status) might well choose to claim their losses from the directors of the company should the company end up in liquidation.
- Secondly, a failure to comply with this duty, in conjuction with other relevant evidence, may lead to a conclusion that the directors of the company acted recklessly and with gross negligence.

  Section 424 of the previous Companies Act 61 of 1973 (which still applies under the new company law regime) and the judicial pronouncements thereon (eg, *Philotex (Pty) Ltd and Others v Snyman and Others; Braitex (Pty) Ltd and Others v Snyman and Others* 1998 (2) SA 138 (SCA)) make it clear that directors will be held personally liable for the debts of a company if they traded recklessly.

  When the *Philotex* judgment was handed down, this duty did not exist and under the new company law regime it could well be argued that a failure to comply with this duty is an important factor from which an inference of 'recklessness' can be made in the event of a company continuing to trade and incur huge debts in a financially distressed scenario. Filing for busines rescue could certainly, in appropriate circumstances, be regarded as a reasonable step that a board could and should have taken to prevent the losses being incurred by creditors and shareholders.
- Thirdly, the failure to act in terms of s 129(7) of the Act could also lead to an inference that a director acquiesced in the carrying on of the company's business despite knowing that it was being conducted in a manner prohibited by s 22(1) of the Act (ie, recklessly, with gross negligence, with intent to defraud or for any fraudulent purpose). This may lead to personal liability for any loss, damage or costs sustained by the company (see s 77(3)(*b*) of the Act).

Conclusion

Taking into account the risks involved, directors should at least take note that a failure to comply with s 129(7) may, in appropriate circumstances, lead to personal liability for the debts of the company. The real challenge for the board, however, is that it faces difficult consequences whichever way it acts in this regard.

It will be interesting to see how the courts will interpret this provision, which, due to its possible adverse commercial consequences, is not likely to, in isolation, lead to personal liability, but will in appropriate circumstances be an important factor when considering reckless trading.

'[S]uch notice to creditors will in all likelihood be tantamount to commercial suicide.'

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