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PERSONAL LIABILITY FOR DIRECTORS WHO TRADE RECKLESSLY DURING THE COVID-19 PANDEMIC

The Covid-19 pandemic and the lockdown imposed by the South African government, in order to slow down the spread of the virus, have accumulatively placed unprecedented financial strain on companies. Some companies may find themselves in a temporary insolvent position which affects their ability to pay their creditors such as banks or suppliers.

With the inability to pay debts comes an increased risk of liability for reckless trading, not only for companies but also their directors. Section 22 of the Companies Act, 2008 contains provisions pertaining to reckless trading and spells out the powers and responsibilities of the CIPC to deal with companies who engage in this type of behaviour.

The meaning of "reckless" is not defined in the Companies Act, however, the common law provides much needed clarity on the matter. South African courts have found that:

- to carry on business recklessly or grossly negligent is to carry on business by conduct which evinces a lack of any genuine concern for its prosperity, which conduct has an adverse effect on the creditors' claims against the company; and

- 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.

What can be inferred from the common law is that if directors continue to trade and incur further debts on behalf of a company, while knowing fully well that the company is unable to pay its debts as they fall due, such conduct may constitute reckless trading. But can directors be held personally liable in these circumstances?

Although the Companies Act contains a number of sections which could potentially be applied to impose personal liability on directors, the approach taken by the legislature in section 77 as read with section 22 of the Companies Act is as follows: Directors can be held personally liable to a company for any losses or damages sustained by the company as a consequence of the directors acquiescing in the carrying on of the company's business recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose.

However, the directors may in those circumstances avoid personal liability if they are able to prove that they took reasonably diligent steps to become informed about the matter and had a rational basis for believing, and did believe, that their decisions were in the best interests of the company. This is generally referred to as the "business judgement test". In addition, in proceedings against directors where the charges do not relate to wilful misconduct or wilful breach of trust, the court may relieve the directors from personal liability if they can show that they acted honestly and reasonably and that it would be fair to excuse them from liability.

A word of caution in this regard. The general liability section of the Companies Act effectively empowers any aggrieved person to hold any other person (including directors) who contravenes the Companies Act, personally liable for any loss or damage suffered by the aggrieved person. In addition, each shareholder of a company has a claim for damages against any person who

intentionally, fraudulently or due to gross negligence, causes the company to do anything inconsistent with the Companies Act.

To make matters worse for reckless directors, a court may potentially declare one or more directors to be categorised as "delinquent". Such a declaration prohibits or limits the capacity of a person to hold the office of a director for a specific period. Finally, the NPA might become involved in circumstances where a person (which again can include a director) commits an offence by knowingly being party to an act or omission by a company calculated to defraud a creditor, employee or a holder of the company's securities, or with another fraudulent purpose.

A bit of welcome relief was recently afforded to companies who find themselves in a temporary insolvent position. On the 24th of March 2020, the CIPC issued a practice note in terms of paragraph 4(1)(b) of the Companies Regulations which states that:

"In light of the Covid-19 pandemic and the declaration of a national state of disaster under the Disaster Management Act, 57 of 2020, the Commission will not invoke its powers under section 22 of the Act, in the case of a company which is temporarily insolvent and still carrying on business or trading."

The Practice Note effectively announces that the Commission is temporarily suspending the exercise of the power afforded to it by section 22 of the Companies Act, which essentially empowers the Commission to issue notices, and if necessary, compliance notices, requiring companies to cease carrying on business or trading, if the Commission has reasonable grounds to believe that a company is trading recklessly or unable to pay its debts.

It is important to note that the suspension contained in the Practice Note has the following limitations:

1. The benefits of the suspension will not be enjoyed by companies whose temporary insolvency is not attributable to Covid-19;
2. The suspension will expire 60 days after the declaration of a national disaster is lifted; and
3. The suspension does not absolve directors from personal liability arising from reckless trading.

The key takeaway from this is that directors who manage the operations of a company must be aware of the civil and criminal liability that could potentially arise if such operations are conducted recklessly. It is therefore very important during these unprecedented times, for directors of temporarily insolvent companies, to obtain proper legal advice before incurring unserviceable debt with creditors.

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