

## **Delinquent directors under the Companies Act 71 of 2008**

By Rehana Cassim

While the Companies Act 71 of 2008 (the Act) has increased the powers of company directors, it has, at the same time, increased their liabilities.

A significant innovation under the Act is that it provides for a court application to declare a director delinquent or to have him placed under an order of probation.

The Act confers *locus standi* on a broad range of persons to apply to court for such an order and such applications can have far-reaching implications for directors. Also of significance is that a court may impose various restrictive conditions when granting such an order.

In the recent case of *Kukama v Lobelo and Others* (GSJ) (unreported case no 38587/2011, 12-4-2012) (Tshabalala J) the South Gauteng High Court granted the first order of delinquency against a director under the Act. This judgment indicates that courts will not shy away from placing directors under delinquency (or probation) should the circumstances warrant this.

### ***Locus standi***

Under s 162(2) of the Act, those who may apply to court for an order declaring a director delinquent or placing him under probation include a company, a shareholder, a director, a company secretary or prescribed officer of a company, a registered trade union that represents employees of a company or another employee representative, the Companies and Intellectual Property Commission (CIPC) and the Takeover Regulation Panel.

In addition, any organ of state responsible for the administration of any legislation may bring an application to declare a director delinquent. Specific grounds of delinquency or probation are available to each of these persons, as set out in s 162(2), (3) and (4).

A director who has resigned from a company or who has been removed as a director will not escape a court order being issued against him in terms of s 162 as the application may also be brought against a former director if he was a director in the 24 months preceding the application.

### **Grounds of delinquency**

In terms of s 162(5) of the Act, a court 'must' make an order declaring a person a delinquent director if he –

- consented to serve as a director, or acted in the capacity of a director or prescribed officer, while ineligible or disqualified to be a director in terms of s 69 of the Act;
- while under an order of probation, acted as a director in a manner that contravened that order;
- while a director, grossly abused this position;
- while a director, contrary to s 76(2)(a) of the Act, took personal advantage of information or an opportunity, or intentionally or by gross negligence inflicted harm on the company or a subsidiary of the company;
- while a director, acted in a manner that amounted to gross negligence, wilful misconduct or breach of trust or in a manner contemplated in s 77(3)(a), (b) or (c) of the Act (unauthorised acts, reckless trading or fraud);
- has repeatedly been subject to a compliance notice or similar enforcement mechanism;

- has at least twice been personally convicted of an offence or subjected to an administrative fine or penalty in terms of any legislation; or
- within a period of five years, was a director of one or more companies or was a managing member of one or more close corporations, or controlled or participated in the control of a juristic person (irrespective of whether concurrently, sequentially or at unrelated times) that was convicted of an offence or subjected to an administrative fine or similar penalty in terms of any legislation.

It is clear from the use of the word 'must' in s 162(5) that a court does not have a discretion whether to grant an order of delinquency if any of these grounds are established. In contrast, in terms of s 162(7) of the Act, a court 'may' declare a person under probation in the circumstances set out below and thus has a discretion whether to grant such an order.

### **Grounds of probation**

In terms of s 162(7) of the Act, a court 'may' declare a person under probation if the person –

- while a director, was present at a meeting and failed to vote against a resolution despite the inability of the company to satisfy the solvency and liquidity test, contrary to the Act;
- while a director, acted in a manner materially inconsistent with the duties of a director;
- while a director, acted in or supported a decision of the company to act in a manner that was oppressive or unfairly prejudicial in terms of s 163(1) of the Act; or
- within ten years after the effective date (1 May 2011) was a director of more than one company or a managing member of more than one close corporation (concurrently, sequentially or at unrelated times), and during that time two or more of those companies or close corporations failed to fully pay all of their creditors or meet all their obligations (except under a business rescue plan resulting from a board resolution in terms of s 129 of the Act or a compromise with creditors in terms of s 155 of the Act).

### **Effect of delinquency or probation order**

The effect of an order of delinquency is that a person is disqualified from being a director of a company

(s 69(8)(a)). The order may under certain circumstances be unconditional and subsist for the lifetime of the delinquent director or it may be conditional and subsist for seven years or longer, as determined by the court.

Likewise, a person who has been placed under probation may not serve as a director, except to the extent permitted by the order of probation (s 69(5)). The probation order may be subject to any conditions the court considers appropriate and generally subsists for up to five years (s 162(9)).

Without limiting the powers of the court, some of the conditions it may impose are that the director is required to undertake remedial education relevant to the nature of his conduct as a director or to carry out community service (s 162(10)).

A court may also order the director to pay compensation to any person adversely affected by his conduct, to the extent that such a victim does not otherwise have a legal basis for claiming compensation. The validity of this provision is questionable as it may be interpreted to mean that if one of the elements that ought to be present

for contractual or delictual liability is not established, a court may nevertheless order a director to pay compensation to a victim in circumstances where such an order would not ordinarily have been made under the principles of contract or delict law (see FHI Cassim, MF Cassim, R Cassim, R Jooste, J Shev and J Yeats *Contemporary Company Law 2ed* (Cape Town: Juta 2012) at 438).

A further condition the court may impose on a probation order is that the director 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 he is the sole shareholder (s 162(10)(d)). The King Report on Governance for South Africa 2009 encourages mentorship of inexperienced directors by experienced directors (see the King report at p 42).

Some of these conditions could have far-reaching consequences for errant directors.

### **Application to suspend or set aside delinquency or probation order**

Some relief for directors is that the Act offers them the opportunity to apply to court to suspend the order of delinquency or to set aside the probation order.

In terms of s 162(11) of the Act, three years after the order of delinquency is made, the delinquent director may apply to court to suspend the order, and substitute an order of probation (with or without conditions). If the order of delinquency is suspended, the court may on application set it aside after two years of suspension. A person subject to an order of probation may apply to court to set aside the order at any time two years after it is made.

Notably, where a director has been declared delinquent for consenting to serve as a director or for acting in the capacity of a director while ineligible or disqualified, or on account of contravening a probation order, the declaration of delinquency subsists for such person's lifetime and may not be suspended or set aside (see s 162(11)).

Despite this prospect of relief for directors, a court will not readily set aside or suspend these orders and will not do so unless the applicant satisfies any conditions attached to the order. A court may grant the order if, having regard to the circumstances leading to the original order and the conduct of the applicant in the ensuing period, it is satisfied that the applicant has demonstrated satisfactory progress towards rehabilitation and that there is a reasonable prospect that he will be able to serve successfully as a director of a company in the future (s 162(12)).

### **The *Kukama* case**

In this matter the applicant, Kukama, applied to court for the first respondent, Lobelo, to be declared a delinquent director and for his removal as a director of two companies, Peolwane Properties (Pty) Ltd (Peolwane) and Diphuka Construction (Pty) Ltd (Diphuka), of which Kukama and Lobelo were each 50% shareholders. Kukama and Lobelo were also directors of Peolwane, although Lobelo was the sole director of Diphuka.

In 2010 and 2011 the South African Revenue Service (SARS) made two refunds of approximately R 22 million and R 39 million into the bank account of Diphuka. The amount of R 22 million was a rebate due by SARS to Peolwane but SARS in error paid this into the bank account of Diphuka. It transpired that the payment of R 39 million was not due by SARS at all, to either Peolwane or Diphuka, and seemed to

have been made following fictitious invoices submitted by Peolwane's tax consultant, who had been appointed by Lobelo without Kukama's consent to handle the tax affairs of the companies. The payment of R 22 million had not been transferred to Peolwane's bank account as it should have been and Lobelo had instead used it for the benefit of other companies that were not subsidiaries of Peolwane.

Kukama averred that Lobelo had engaged in reckless trading contrary to s 22 of the Act; that he had used his position as a director, as well as information acquired as a director, to gain a personal advantage (contrary to s 76); that he failed to act in good faith and for a proper purpose or in the best interests of the company (contrary to s 76(3)); that he had contravened s 77(3) of the Act; and that he had grossly abused his position as a director in the manner envisaged in s 162(5) of the Act.

### **Court's findings**

The court found as follows:

- The conduct of Lobelo in his dealings with the affairs of Peolwane 'did not measure up to the standard required and expected of a director' (para 9) and Lobelo was in breach of his fiduciary duties to Peolwane.
- Lobelo was in breach of s 76(2)(b) of the Act by failing to communicate to Kukama (as a co-director and co-shareholder of Peolwane) the information relating to the payments by SARS into the bank account of Diphuka.
- The effect of Lobelo's failure to refund SARS the R 39 million had not only caused 'irreparable harm' (para 11) to Peolwane as envisaged in s 162(5)(c)(iii) of the Act, but had also exposed Peolwane and Kukama to criminal liability as envisaged in s 332(1) and (2) of the Criminal Procedure Act 51 of 1977.
- By using the funds destined for Peolwane for the benefit of other companies (which were not its subsidiaries) Lobelo inflicted harm on Peolwane in terms of s 162(5)(c)(iii) of the Act and breached his fiduciary duties to Peolwane.
- Lobelo's failure to detect the fraud of R 39 million to SARS amounted to gross negligence and, by failing to pay it back to SARS or to the bank account that had been opened to service the value added tax obligations of Peolwane, Lobelo's conduct amounted to 'wilful misconduct or breach of trust as envisaged in section 162(5)(c)(iv)(aa) and (bb)' (para 13).
- The court concluded that Lobelo's conduct 'fell short of the standard expected of a director of Peolwane to such an extent that it amounts to wilful misconduct, breach of trust and a gross abuse of his position as a director' (para 19.1).

### **Court's decision**

The court declared Lobelo a delinquent director, however it did not specify the duration of the declaration. In terms of s 162(6)(b) of the Act, however, a declaration of delinquency in terms of s 162(5)(c) to (f) subsists for seven years from the date of the order or a longer period determined by the court.

The court in addition granted Kukama leave to institute legal proceedings in the name of Peolwane against Diphuka or against Lobelo in his personal capacity for recovery of the R 22 million.

The court further held that, in view of the effect of an order of delinquency, it was not necessary to also order the removal of Lobelo as a director of the company due to the 'automatic inherent effect of such a declaration' (para 21).

### **Public register**

Section 69(13) of the Act requires the CIPC to establish and maintain a public register of persons disqualified from serving as a director or who are subject to an order of probation as a director in terms of a court order. While probation orders are public knowledge, it is not a specific requirement that the CIPC maintains a register of directors who have been declared delinquent by a court order. Thus a company that appoints directors to its board of directors may not know whether such persons have been declared delinquent directors unless this information is disclosed. It may consequently be advisable for companies to require that, prior to appointment, a prospective director sign an undertaking that he has not been declared delinquent by a court order and that no such proceedings are pending against him.

Of interest is that, in terms of s 7.B.2(m) of the Johannesburg Stock Exchange Listings Requirements, in any pre-listing statements and circulars relating to rights offers, capitalisation issues and category 1 or 2 transactions (which are principally acquisitions or disposals by listed companies as described in s 9 of the Listings Requirements), directors of the issuer and its major subsidiaries must disclose the details of any court orders declaring them delinquent or placing them under probation in terms of s 162 of the Act.

#### **Close Corporations Act 69 of 1984**

The provisions of s 162 of the Act relating to an application to declare a director delinquent or to place him under probation would apply *mutatis mutandis* to an application to declare a member of a close corporation delinquent or under probation (see s 47(1)(c)) of the Close Corporations Act). A member who has been placed under probation may not participate in the management of the business of the close corporation, except to the extent permitted in the order of probation (s 47(1A) of the Close Corporations Act).

#### **Conclusion**

Section 162 of the Act is a new remedy available to shareholders and certain stakeholders to hold directors (including non-executive directors) accountable (see the 'Memorandum on the objects of the Companies Bill', 2008 at para 8). The rationale of this remedy is that a director who is guilty of serious abuse of his position and infringements of his fiduciary duties should not be allowed to continue to hold a directorship or should only be allowed to continue to do so under strict conditions imposed by a court.

Section 162 sets out to raise the standards of good behaviour and integrity expected of directors and makes them accountable not only to the company, shareholders and fellow directors but also to the employees of the company.

It is important, however, to guard against abuse by those with *locus standi* to bring such applications, since such persons may well abuse this mechanism to lodge vexatious claims, which could result in damage to the reputation of directors (Cassim *et al (op cit)* at 436).

Indeed, even if a director were successful in having the order of delinquency or probation suspended or set aside, the reputational damage and stigma caused by such an order is likely to be significant and may last for a long time. The *Kukama* case illustrates that the courts will not hesitate to grant orders of delinquency where the circumstances warrant this. It remains to be seen whether Lobelo will apply to have his order of delinquency suspended after three years.

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