

LIABILITY OF DIRECTORS AND OTHER PERSONS FOR FRAUDULENT, RECKLESS AND GROSSLY NEGLIGENT TRADING

By

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PROMOTER

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Declaration

I declare that the dissertation submitted by me to the University of Limpopo for the degree of Master of Laws in Development and Management has not previously been submitted for degree purposes at this or any other university. This is my own work in design and execution and all material contained herein has been duly acknowledged.

Signed

Date

PREFACE

This work is intended to be a comprehensive discussion of section 424 of the Companies Act 61 of 1973. It sought to deal systematically and critically with the most cherished principles of corporate law.

There have been important developments in corporate law in recent years which encouraged me to make a research about the liability of directors and other officers of the company for reckless, fraudulent and gross negligence trading.

I wish to express my appreciation to my wife and children for their support and I also thank Professor DM Matlala of the University of Limpopo for guidance in the execution of this work.

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LIABILITY OF DIRECTORS AND OTHER PERSONS FOR FRAUDULENT, RECKLESS AND GROSSLY NEGLIGENT TRADING

1. Introduction

On its formation a company, as a separate entity, acquires legal personality and exists apart from its members and accordingly acquires the capacity to have its own rights and duties. This important company law principle is exemplified in the leading case of *Salomon v Salomon and Co Ltd*.¹ There the House of the Lords held that from its inception a company is legally separate from its members. The court held further that the facts provided no basis for holding Salomon personally liable for the debts of the company because once the company was legally incorporated it must be treated like any other independent person with rights and liabilities appropriate to it.

Even though a company is an entity, it also consists of functionaries such as directors and shareholders. In practice the independence of the corporate entity is not always viewed so rigidly. As a result of the precedent established in the *Salomon* case and *Dadoo v Krugersdorp Municipal Council*,² emphasis is frequently placed on the inviolability of the entity instead of regarding it as a facet of the whole. A situation involving the company and its members, directors or representatives is judged with due consideration to the actual state of affairs pertaining within the company “behind” the corporate entity.³

Although the courts are prepared to disregard a company’s separate legal personality in certain cases in terms of the common law, the Appellate Division, per Smalberger JA, in *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd*⁴ said that the courts would not lightly disregard a company’s separate corporate personality, but should try to give effect to it and uphold it. To do otherwise would negate the policy and principles that underpin the concept of separate personality and the legal consequences that attach to it. But where fraud, dishonesty or other improper conduct is found to be present, other considerations will come into play. This need to preserve the separate corporate identity would in such circumstances have to be balanced against policy considerations, which arise in favour of piercing the corporate veil.⁵

¹ [1897] AC 22.

² 1920 AD 530.

³ Beuthin RC, Luiz SM Basic Beithin’s Company Law 3rd ed (2000) at 12.

⁴ 1995 (4) SA 790 (A).

⁵ Beuthin RC, Luiz SM Beuthin’s Basic Company Law 3rd ed (2000) at 12.

The South African courts have been reluctant to define situations where they would disregard the company's separate legal personality under the common law.¹

In this respect s 424 of the Companies Act of 1973 constitutes an exception to the principle that a company, and nobody else, is liable for its debts by providing for liability for the debts of a company on the part of directors and officers in the event of fraudulent, reckless or gross negligent trading on their part.

The provisions of the section were deliberately phrased in the wide terms to enable the courts to bring fraudulent and reckless person to book.² Proceedings can be instituted by way of motion or by way of action.

2. Historical background

2.1 Cape Colony

The Cape Model Law of 1892³ followed English law and made the directors personally liable for the debts of the company. Until then only the company was liable for its debts.

2.2 Transvaal

The Transvaal Act⁴ relied on the English Companies (Consolidation) Act of 1908 and as a result the directors and other officers of the company were personally made liable for the debts of the company.

2.3 Companies Act of 1926

The *Companies Act of 1926*⁵ provided for the liability of directors and other officers of the company for the debts of the company if they carried on the business of the company recklessly or with intent to defraud creditors of the company.

2.4 Companies Act of 1973

This Act also provides for the liability of directors and other officers of the company when it appears, whether it be in a winding-up, judicial management

¹ Cilliers HS et al *Corporate Law* 4th ed (2000) at 13.

² Section 424 of Act 61 of 1973.

³ 2 of 1892.

⁴ Companies (Consolidation) Act of 1908.

⁵ 46 of 1926.

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.¹

3. The King report

There is no mention of the personal liability of directors and other officers in the King report but there are recommendations made concerning the breach of the director's fiduciary duty.²

4. The provisions of section 424

4.1 Wording of the section

Section 424 of the Companies Act³ provides:

"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, the liquidator, the judicial manager, any creditor, 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 other liabilities of the company as the Court may direct."

This provision is based on section 80 of the Companies Act of 1926, which has since been repealed. The language of the two provisions is largely the same.

In *Pressma Services (Pty) Ltd v Schuttler and Another*⁴ Van Schalkwyk AJ interpreted the provisions of section 424(1) as follows:

"The constituent elements of s 424(1) of the Act are as follows:

1. The subsection may be invoked:

(a) At the instance of:

- (i) The Master;
- (ii) The liquidator;
- (iii) The judicial manager;
- (iv) Any creditor;
- (v) Any member;
- (vi) Any contributory of the company;

(b) Whether the company is in the process of being wound up or under judicial management or otherwise....

¹ Section 424 (1) of the Companies Act 61 of 1973.

² The Commission of Enquiry into Corporate Governance for South Africa (2002), henceforth the *King Report*.

³ 61 of 1973.

⁴ 1990 (2) SA 411 (C).

2. The relief provided for in the subsection may be granted by the Court:
 - (a) When it appears 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 other fraudulent purpose;
 - (b) In respect of any person who was knowingly a party to the carrying on of the business in the manner aforesaid.
3. The person to whom the relief is granted is declared to be personally responsible, without limitation of liability, for all or any of the debts or other liabilities of the company."

4.2 Purpose of the section

The clear purpose of s 424(1) is to render personally liable all the persons who knowingly participate in the fraudulent or reckless conduct of the business of a company. To this end, the section is phrased in wide terms.

4.3 The nature of the remedy

The nature of the remedy provided in terms of s 424(1) was considered in *Food & Nutritional Products (Pty) Ltd v Neumann*¹ where the following features of the remedy were identified:

- (a) A creditor of a company can, on the basis of fraud, seek a court order to impose personal liability on, *inter alia*, the directors and officers of a company according to the common law;
- (b) The effect of s 424(1) was to codify this common law right based on fraud, while creating a statutory right based on recklessness; and
- (c) The remedy provided in terms of s 424(1), insofar as it related to fraud, was not intended to be in substitution of any remedy available under the common law.

*In Ex parte Lebowa Development Corporation Ltd*² Stegmann J made the following seven observations which shed further light on the requirements for liability, namely:

- Firstly, there is no reason to think that the remedy provided by s 424 replaces any of the common law remedies available to anyone (including the company's creditors) injured by wrongdoers (including directors and other company officers) who carry on the business of a company and who cause injury by their *dolus* or their *culpa*. The statutory remedy supplements the common law remedies in certain circumstances: it does not replace them. It provides the victim who has suffered loss and who already has a remedy with an additional remedy;
- Secondly, the statutory remedy presupposes the existence of debts or other liabilities on the part of the company. These may include claims against the company itself arising from *dolus* or *culpa* attributable to it or arising out of

¹1986 (3) SA 464 (W).

²1989 (3) SA 71 (T).

its contracts. Unless there is already some such independent cause of action against the company, the provision made in s 424 cannot be brought into operation;

- Thirdly, when the pre-existing cause of action lies against the company alone, one of the purposes served by s 424 is to enable the court by its declaration to extend the company's liability under that cause of action (and possibly even under other causes of action too) so that such persons as may be shown knowingly to have carried on the company's business or any aspect of it, recklessly or fraudulently, become amenable to the cause or cause of action originally available only against the company. It will be convenient to refer to such persons as "the declared wrongdoers";
- Fourthly, when the pre-existing cause of action lies not only against the company but also against those persons who may qualify to be declared as wrongdoers, the purposes served by s 424 are more complex. The section then provides the claimant with an additional (and possibly a more expeditious, simpler and less costly) remedy against the declared wrongdoers for the existing cause of action. It may also serve to render the declared wrongdoers amenable to additional causes of action of a kind which, in the absence of a declaration under s 424(1), would be available against the company alone;
- Fifthly, a declaration under s 424(1) is obviously for the benefit of persons already enjoying a cause of action against the company. So far as permitted by the court's declaration, their claims against the company can thereafter also be enforced against the declared wrongdoers personally;
- Sixthly, it would appear that a declaration under s 424(1) is also intended to be for the benefit of the company itself in various ways. Naturally, if the claimant should choose to recover from the declared wrongdoer, and to forgo his claim against the company, the company would indirectly have derived benefits. For example, if the claimant should pursue his remedy against the company alone, the declaration of personal responsibility, without any limitation of liability on the part of the declared wrongdoers, may well have been intended by the legislature to enable the company to enjoy at least such rights of contribution from the declared wrongdoers as may exist between persons who are jointly liable. It may even have been intended to entitle the company to a complete indemnity from declared wrongdoers, at least in an appropriate case. A case in which the company was no more than the *alter ego* of the declared wrongdoers would obviously not be appropriate for such an indemnity. There is no reason to think that the legislature intended such a company to enjoy a benefit. On the other hand there is reason to think that the legislature intended to confer such a benefit on a company whose members, or some of whose members, were not wrongdoers; and
- Seventhly, and finally, it is of some importance for present purposes to grasp the nature of the conduct, which renders a person liable to be

declared personally responsible in terms of s 424. The section specifies four ways of carrying on any of the business of a company that may result in a declaration.

4.4 The requirements for liability

4.4.1 General

The requirements for liability under section 424(1) are as follows:

- any business of the company must be or have been carried on recklessly or for a fraudulent purpose;
- the director (or any other person) must knowingly have been party to the carrying on of the business in the reckless or fraudulent manner; and
- The company must have had debts or other liabilities.

The specified ways that may attract liability for carrying on the business of the company are:

- (1) recklessly;
- (2) with intent to defraud creditors of the company;
- (3) with intent to defraud creditors of some person other than the company; and
- (4) for any fraudulent purpose;

Categories 2, 3 and 4 all deal with fraudulent ways of conducting the company's business. They do not necessarily exhaust all kinds of fraudulent conduct, which the directors and other officers of a company may commit. For example, although even an isolated reckless or fraudulent transaction will come within the ambit of s 424 if the person responsible conducted it as part of the business of the company and knowing of its reckless or fraudulent nature yet the fact remains that an isolated reckless or fraudulent transaction by a director or other officer of a company need not necessarily occur in the course of the carrying on the business of the company. If it does not, it will not come within the ambit of s 424. The person injured will not then be able to obtain any assistance from s 424. He will in those circumstances be confined to his right of action against the responsible person derived, in terms of the common law, from the *actio doli* or *actio legis Aquiliae*.¹

¹ Neethling J *Law of Delict* at 111-112.

4.4.2. When is the company's business carried on recklessly?

To carry on the business recklessly means to run the affairs of the company with total indifference. The meaning of the term 'recklessly' was defined as follows by Stegmann J in *Ex Parte Lebowa Development Corporation Ltd*:¹

"It is important to have a clear grasp of the distinction between the relatively narrow concept of 'recklessly' as one way of making a misrepresentation and thereby incurring liability for fraud, and the relatively broader concept of 'recklessly' as one way of carrying on the business of a company and thereby incurring a liability to be declared personally responsible under s 424 of the Companies Act 1973.

In s 424 the term 'recklessly' is used in contradiction to the term 'fraudulently'. In that context "recklessly" implies the existence of an objective standard of care that would be observed by the reasonable man in conducting the business of the company concerned in the particular circumstances. A departure from that standard constitutes negligence (*culpa*). A more serious departure from that standard constitutes gross negligence (*culpa lata*), which is the same thing as recklessness in that context. Serious departures from the standard of care of the reasonable man naturally include instances of fraud. They also include a lot more. 'Recklessly', indicating all of such serious departures is therefore a relatively broad concept.

As indicated above in dealing with relevant aspects of fraud, fraud is committed, inter alia, when a person makes a misrepresentation "recklessly". Here "recklessly" is a much narrower than that just discussed. It does not include all serious departures from the reasonable man's test. It is confined to those instances in which it can be proved that the person who made the misrepresentation knew that it may not be correct and therefore had no honest belief in its truth, and yet, by making it, suggested that he did believe it to be true".

*In Fisheries Development Corporation of SA Ltd v Jorgensen and Another*²
Margo J said:

"A Hyman, in his article on "Directors" Liability for Company's Debts" in 1980 SA Company Law Journal E – 1, points out that, had the Legislature intended mere negligence to be sufficient for liability under s 424(1) or 424(3), it would have used the term "negligently" and not "recklessly". Hyman's view is that recklessness is a concept to be placed somewhere between mere carelessness and dishonesty. That really brings the definition back to "gross negligence", without necessarily appreciating or being aware of the consequences. Hyman says at E-7: if 'gross negligence' is required as an element of recklessness (as it almost certainly is) the tests will vary greatly from case to case. The criteria will be in the scope of operations of the company... the role, functions and powers of the director, the amount of the debt, the extent of the company's financial difficulties and the prospects, if any, of recovery and many other factors particular to the claim involved and the extent to which the director has departed from the standard of a reasonable man in regard thereto. No attempt at a closer definition of gross negligence is feasible or advisable".

Negligence and reckless are not the same. Recklessness is more than when one departs from the standard of a reasonable man.

¹ 1989 (3) SA 71 (T) at 111B-C.

² 1980 (4) SA 156 (W) at 170.

In *S v Goertz*¹ Fagan J stated what must be proved to establish recklessness saying:²

"It was thus not incumbent upon the State to establish that appellant foresaw detriment to the company. What was required was proof that appellant acted recklessly judged by the standards of reasonable businessmen. The test is an objective one, not a subjective one. Proof of gross negligence is sufficient to obtain a conviction. I leave open the question as to whether lesser negligence could amount to recklessness in terms of s 424(3)."

The test for recklessness is therefore an objective one. A director will be liable in terms of s 424(1) if he does not display the objective standards of care required for gross negligence. This is constituted by:

- conduct which is either reckless or grossly negligent;
- acts which are reckless in relation to one or more transactions;
- actions which evince a lack of genuine concern for the prosperity of the company.

The test applied for recklessness is an objective one and proof of gross negligence is sufficient to obtain a conviction in a criminal case and payment of damages in a civil case.³

In *Philotex (Pty) Ltd v Snyman; Braintex (Pty) v Snyman*⁴ the creditors successfully used section 424 against directors. The directors of a company allowed an insolvent company to keep on trading to create a good impression of the company group. The court said that an objective test should be applied to determine whether the directors conducted the business of the company recklessly.

In *Ozinsky NO v Lloyd*⁵ it was said that the reckless conducting of business in the accepted sense meant extreme lack of interest or extreme negligence. This means that recklessness refers to extreme negligence or gross negligence.

In *Mafikeng Mail (Pty) Ltd v Centner*⁶ the court held that recklessness is neither an error of judgment nor even a gross error of judgment. A decision cannot be subsequently characterized as reckless if it turns out to be wrong provided there is an explanation which shows that the person was confronted by a choice and that thought and reflection went into the decision *taken*.

¹ 1980 (1) SA 269 (C) at 272.

² At 272.

³ Van Dorsten JL *Rights, powers and duties of directors* (1992) at 299.

⁴ 1998 (2) SA 138 (SCA).

⁵ 1992 (3) SA 396 (C).

⁶ 1995 (4) SA 607 (W).

In *Ex Parte Lebowa Development*¹ the court said that the term "reckless" was used in contradiction to the term "fraudulent". It implied the existence of an objective standard of care that would be observed by the reasonable man in concluding the business of the company.

4.4. 3 Examples of reckless carrying on business

Circumstances in which a director will be regarded as having recklessly carried on the business of a company include among others the following:

4.4.3.1 Failure to exercise proper control

A director's conduct will be reckless if he fails to exercise proper control over the management of the company's affairs at a time when he should have been aware of mismanagement, for example, by the managing director. In the case of *Cronje NO v Stone*² the court held that a non-executive director was party to the reckless management of the affairs of the company's business and that she was personally liable for a portion of the company's debts, which related to the period during which she had acted recklessly. The non-executive director had not been involved in the daily management of the company and had left it in the hands of the managing director. The court found that she acted recklessly because she had blind faith in the proposals of the managing director, which proposals in many respects gave her incorrect information and misled her. Given her experience as a businesswoman it was found that she had not exercised the degree of caution required of her. The court expected her to take some action to safeguard her own position by resigning as a director or putting a stop to the activities of the managing director, for example, by applying for the liquidation of the company. By failing to take any action she was found to have acted recklessly and thereby incurred personal liability.

Non-executive directors who discover that all is not well with their companies are therefore advised to take some corrective action as soon as they become aware of problems and if that does not help they should resign as directors.

4.4.3.2. Continuing to trade when the company experiences financial difficulties

A director's conduct will be reckless if he continues to trade when the company is insolvent. In *S v Goertz*³ the facts were briefly as follows. The director had started and successfully operated the business on his own for some years. The business ran into trouble when in 1974 he employed a salesman to help him. Whilst the sales increased, the expenses escalated disproportionately.

¹ 1989 (3) SA 71 (T).

² 1985 (3) SA 597 (T).

³ 1980 (1) SA 269 (C) at 273-4.

His main supplier refused further supplies following this. The company was left with stock that could not be sold profitably. The director believed that, by reverting to one business, he could again make it profitable, worked 16 hours a day, drastically reduced expenditure, sought the advice of his auditors and attorneys and obtained a new supplier. He also obtained limited credit facilities by using another company as a purchase vehicle. He changed sales from a credit to a cash basis. He testified that he was confident that in the spring and summer months that they lay ahead, which were always the best times of the year for sales of the product, he could make up part of the deficit. He sold the old stocks below cost to make way for the stocks of the new supplier and made arrangements with creditors. However, his trading methods resulted in the company getting further into debt and there was an unexplained shortfall. Fagan J said:¹

'The conclusion reached by the magistrate that the creation of a shortfall of at least R11 000 over a relatively short period could mean only one thing and that is that appellant had squandered the property of the company by trading recklessly, is in my opinion unassailable. As I have reached that view on the basis of proof of gross negligence on that part of appellant in carrying on the business of the company it is not necessary to deal with the question whether any lesser negligence could amount to such recklessness as is required in 424(3).'¹

Fagan J also added:²

"The offence is serious in that creditors would have been considerably better off if appellant had not continued trading after September 1975. Part of the overheads for the ensuing three months would have been disposed of at better prices than in fact obtained. Although Mr. Fourie was justifiably suspicious as to whether there had been a misappropriation by appellant of the company's assets, that was not established. It is thus reasonably possible that appellant was honest but recklessly optimistic in continuing to trade. The background to the offence appears to confirm this possibility."

4.4.3.3. Incurring debts which cannot be repaid

A director's conduct will be reckless if he continues to carry on business and incur debts without there being a reasonable prospect of the creditors receiving payment for those debts.³

In addition to incurring personal liability, directors will also be guilty of an offence.⁴ A director who is knowingly a party to the reckless carrying on of the company's business can therefore incur both civil and criminal liability.

4.4.4. The Company's business carried on fraudulently

¹ At 273.

² At 273-274.

³ Havenga M.K 'Directors and personal liability under s 424 of the Companies Act' 1992 SA *Mercantile Law Journal* 63.

⁴ Section 424 (3) of Act 61 of 1973.

A director will be liable in terms of s 424(1) if he is knowingly a party to any business of the company being carried on with intent to 'defraud' creditors of the company or creditors of any other person or any 'fraudulent' purpose.

The meaning of fraud and what constitutes the intention to defraud were discussed in *Ex parte Lebowa Development Corporation Ltd*¹ where Stegmann J said:²

"It is convenient to start with the definition of fraud given by Hunt in *South African Criminal Law and Procedure 2nd voll II* at 755:

"Fraud consists in unlawfully making, with intent to defraud, a misrepresentation which causes actual prejudice or which is potentially prejudicial to another.

Intent to defraud may take form of *dolus directus*. It does so when the person making the misrepresentation is proved to be aware of its falsity and to intend that the respresentee should be deceived and should act on the induced misapprehension.

Intent to defraud may also take the form of *dolus eventualis*. This occurs when one person makes a representation of fact to another whilst not knowing whether his representation is true and false, if the respresentor knows that his representation may be false and reconciles himself to the risk entailed in his suggesting it to be true, to the potential or actual prejudice of that other or anyone else".

The learned judge added:³

"Fraud is not committed without dishonestly. It necessarily involves an element of conscious deceit on the part of the person making the false representation. That element can never be identified without enquiry as to the state of mind of representor as known to himself. The test is inevitably subjective unless the representor is shown to have been aware that representation will tend to mislead. The essential point is that the respesentor is aware that his representation will tend to mislead not only when he knows that it is false, but also when he knows that it may be false. In the latter case, no less than the former, he practises deceit if he misleads the respesentee into the belief that he (the respresentor) believes in the truth of the representation when he (the respresentor) can have no such honest belief, knowing that the representation may not be true. That, I think, is the substance of the distinction between gross negligence and fraud."

In *Howard v Herrigel and Another NNO*⁴ Goldstone JA said:⁵

"...at common law a director of a company who is knowingly a party to fraud on the part of his company would be liable in damages for any loss suffered by any person in consequence of the fraud. It would be necessary, in order to fix the liability of such a director, to establish a causal connection between the fraud of the company and the damages claimed from the director. The *quantum* of these damages would also have to be proved. The provisions of s 424(1) of the Act enable the Court to declare such a director liable for all or any of the debts or other liabilities of the company without proof of causal connection between the fraudulent conduct of the business of the company and the debts or liabilities for which he may be declared liable."

¹ 1989 (3) SA 71 (T) at 101 and 103.

² At 101D-E.

³ At 103E.

⁴ 1991 (2) SA 660 (A) at 672.

⁵ At 662A-C.

The wording of section 424(1) is wide enough to cover isolated acts or acts which are part of a series. A director will be liable for an isolated fraudulent transaction provided he knew of its fraudulent nature and carried it out as part of the company's business.¹

An isolated transaction as sufficient basis of liability was dealt with in *Gordon NO and Rennie NO v Standard Merchant Bank Ltd and Others*² where *De Kock J* said:³

"When one looks at the words of s 424(1) in their context, there is to my mind no reason to interpret them in such a way as to exclude a single reckless or fraudulent transaction from the ambit of the section. The intention of the Act is plainly to render personally liable any person who is knowingly a party to the carrying on of any business of the company in a reckless or fraudulent manner. I agree with Mr. Odes, for plaintiff, that, having regard to purpose of the section and the evil which the Legislation sought to combat by means of the section, there is no justification for thinking that Parliament intended to exclude from liability a director who has committed a massive fraud on a single occasion but to render liable a director who has stolen small amounts of money on few occasions. If a transaction is part of the business of the company and it is executed recklessly or with intent to defraud creditors of the company or for any fraudulent purpose it matters not in my opinion that it is done once or as part of series of acts. In either case the guilty person may be visited with personal responsibility in terms of the section."

4.4.5` Carrying on` of the business in general

Carrying on business includes any activity that occupies a person's time, attention and labour in the pursuit of gain.⁴

Therefore, a person who spends time, attention and labour on anything that does not pursue gain, is not carrying on business for the purpose of s 424.

4.4.6 Knowingly

The requirement that a person must knowingly have been a party to the reckless or fraudulent carrying on of the company's business was discussed at length in *Howard v Herrigel and Another NNO*⁵, There Goldstone JA said:⁶

"...at common law a director of a company who is knowingly a party to fraud on the part of his company would be liable in damages for any loss suffered by any person in consequence of the fraud. It would be necessary, in order to fix the liability of such a director to establish a casual connection between the fraud of the company and the damages claimed from the director. The quantum of these damages would also have to be proved. The provisions of s 424(1) of the Act enable the Court to declare such a director liable ` for all or any of the debts or other liabilities of the company` without

¹ Section 424 of Act 61 of 1973.

² 1984 (2) SA 519 (C).

³ At 522B-D.

⁴ *Orkin Bros Ltd v Belland and Others* 1921 TPD 92 at 105-108.

⁵ 1991 (2) SA 660 (A).

⁶ At 672-674.

proof of a casual connection between the fraudulent conduct of the company and the debts or liabilities for which he may be declared liable.”

Having regard to the provisions of s 424 to be entitled to an order the applicant must prove, on a balance of probabilities, that the person sought to be held liable had knowledge of the facts from which the conclusion is property to be drawn that the business of the company was or being carried on recklessly or with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose. It would not be necessary to go further and prove that the person also had actual knowledge of the legal consequences of those facts.¹

4.4.7' Party to '

The requirement for liability is that the director or other officer must have been a party to the reckless or fraudulent carrying on the company's business. *Howard v Herrigel and Another NNO*² *Goldstone JA* discussed the circumstances in which this requirement will be met saying:³

“In order to be held liable under s 424(1), knowledge of the aforesaid facts is not on its own sufficient. In *Re Maidstone Building Provisions Ltd*⁴ Pennycuik V-C said of the corresponding provisions of the 1948 English Companies, The expression 'party 'must on its natural meaning indicate no more than 'participate in', or 'concur in' and that, it seems to me, involves some positive steps of some nature. I do not think it can be said that someone is party to carrying on business if he takes no positive steps at all. So in order to bring a person within the section one must show that he is taking some positive steps in the carrying on of the company's business in a fraudulent manner.”

When the person sought to be held liable under s 424(1) is a director, he may well be a “party” to the reckless or fraudulent conduct of the company's business even in the absence of some positive steps by him in the carrying on of the business. His supine act may even amount to concurrence in that conduct. But whether such an inference could property be drawn depends upon the facts and circumstances of the particular case.⁵

In *Powertech Industries Ltd Mayberry*⁶ the court said that being a party to the carrying of the business in section 424 means joining in with the company in common pursuit of its end.

¹ Cilliers & Benade *Corporate Law* 3rd ed (2000) at 161.

² 1991 (2) SA 660 (A) at 672-4.

³ At 663E-G.

⁴ [1971] 3 All ER 363.

⁵ Van Dorsten *JL Rights, powers and duties of directors* (1992) at 307.

⁶ 1996 (2) SA 742 (W).

A company can also knowingly be party to the reckless or fraudulent carrying on of the business of another and thereby incur liability under s 424(1). This was illustrated in *Anderson v Dickson*¹ where Booysen J said:

"Section 424 cannot be invoked against a company in the absence of evidence that it, through its board or any of its directors, acquired knowledge of the business of the company whose affairs are being investigated. If it were shown, however, that a company through its directors had with *mala fides* or recklessly performed acts to induce credit for another company knowing it to be insolvent and without reasonable prospect of meeting its obligations, then such conduct would support a finding that the first mentioned company, through its directors, was knowingly a party to the reckless or fraudulent carrying on of the business or affairs of the latter company. It could then properly be said to have knowingly been a party to the carrying on of the business of the company recklessly or with intent to defraud creditors of the company within the meaning of s 424(1)."

5. Debts or other liabilities

A further requirement for the application of s 424(1) is that the company must have 'debts or other liabilities'. If the company's debts have by agreement with the creditors been extinguished, s 424(1) cannot be applied to declare a director personally liable for the non-existent debts. What this requirement entails was the subject of discussion in *Ex parte De Villiers and Another NNO: In re Carbon Development (Pty) Ltd (In Liquidation)*² where Stegmann J said:³

"Section 424(1) may perhaps be deceptively simple in appearance but it has complex ramifications. It is sufficient for present purposes to advert to only one aspect of how s 424(1) functions. What is aimed at by an application in terms of s 424(1) is that a person contemplated by the subsection (often a director or officer of an insolvent company and whom I shall call a 'wrongdoing company representative') should be declared personally responsible for "the debts or other liabilities of the company,' or a least for such of them as the court may conclude that he should be held personally responsible for.

For s 424(1) to be operative at all, the company must have 'debts or other liabilities.' If the company has no "debts or liabilities", an essential requirement is missing and s 424(1) cannot provide a remedy. In a case in which the creditors have all agreed in terms of s 311 to a compromise which specifically provides for extinction of all the company's debts and liabilities, it seems to me quite obvious that s 424(1) cannot possibly function after the extinction of such debts and liabilities by the agreement of the creditors and the sanction of the court. If the decision in *Pressma Services*⁴ implies that in such a case a creditor's right to seek a declaration of personal liability on the part of a wrongdoing company representative for a particular debt previously owed by the company is a right which necessary survives the extinction of the company's debts, I must record my respectful disagreement with it.

To my mind the words of s 424(1) make it quite clear that a debts or other liability of the company is the very foundation upon which any declaration of liability on the part of wrongdoing company representatives must stand as an ancillary liability, and that when that foundation ceases to exist (e.g. by the discharge or extinction of the company's debts) the wrongdoing company representatives who might otherwise have been

¹ 1985 (1) SA 93 (N) at110.

² 1992 (2) SA 95 (W).

³ At 107-108.

⁴ 1990 (2) SA 411 (C).

declared personally responsible in terms of s 424(1) cease to be amenable to any such declaration. The liability of the wrongdoing company representatives to be declared personally liable for a company's debts or other liabilities in terms of s 424(1) is a liability ancillary to the company's own debts or other liabilities and it cannot exist without them".

While attractive, these are the views of a single judge which cannot overrule a previous decision of a court. The above quotation is therefore a mere suggestion and not a final word on this point.

6. Liability for ordinary negligence

A person is negligent if the reasonable man in his position would have acted differently. A reasonable person would have acted differently if the unlawful causing of damage was reasonably foreseeable and preventable. This test for negligence finds its most authoritative statement in the following *dictum* of Holmes J in *Kruger v Coetzee*¹ which says:²

"For purposes of liability *culpa* arises if-

(a) a *diligens paterfamilias* in the position of the defendant-

(1) would foresee the reasonable possibility of his conduct injuring another in his person or property and causing him patrimonial loss; and

(2) would take reasonable steps to guard against such occurrence; and

(b) the defendant failed to take such steps. "

Negligence is a form of fault. Section 424(1) does not impose liability for negligent trading. When the conduct of a director has been negligent, and not grossly negligent, it will not amount to reckless in terms of s 424(1) purposes. In *Fisheries Development Corporation of SA Ltd v Jorgensen and Another*³ Margo J said:⁴

" `Negligence` as a general concept embraces everything from *culpa levissima* to *culpa latissima*, but `recklessness`, in the ordinary sense, connotes at the least *culpa lata* and `recklessly` has a corresponding meaning."

There the court found that the directors were not liable because their conduct did not in law constitute a breach of duty of care and skill to the company. The judge said that directors were entitled to accept certain information provided to them.

¹ 1966 (2) SA 428 (A).

² At 430.

³ 1980 (4) SA 156 (W).

⁴ At 160C-F.

7. The Applicant

7.1 Master

The Master refers to the Master of the High Court of South Africa appointed in terms of the the Supreme Court Act¹ and deals with the applications brought to court. He handles applications for judicial management, winding -up of companies and so forth.

7.2 Liquidator

The liquidator is a person appointed by the Master of the High Court during winding-up of companies to realize and handle the affairs of the company. Although by the procedure under section 423 (1) it is a right of the company which is enforced, the proceedings are not the proceedings by the company itself within the meaning of section 359(1) (a). Accordingly, in this context, reference to "liquidator" includes a reference of provisional liquidator.²

7.3 Member

The subscribers to the memorandum of association are deemed to have agreed to become members of a company upon its incorporation and their names must be entered into the register of members. Furthermore according to the Companies Act³ a member of the company means:

- a) Every person who agrees to become a member of a company and whose name is entered in its register of members;
- b) A person who has been appointed as the executor, administrator, trustee, curator or guardian of the estate of a deceased member of the company or of a member whose estate has been sequestrated or of a member who is otherwise under disability or as the liquidator of any body corporate in the course of being wound up which is a member of the company, shall be registered as a member *nominee officii* of the company;
- c) A person who is the bearer of a share warrant shall be a member of the company subject to the provisions of the articles of a company.

7.4 Contributory

In relation to a company limited by guarantee, a contributory is every member who has undertaken to contribute to the assets of the company in the

¹ 59 of 1959.

² Section 359 (1) (a) of Act 61 of 1973.

³ 61 of 1973.

event of its winding-up. Particulars of the amount to be contributed appear in the special conditions clause in the memorandum of such company.¹

In relation to any company which is unable to pay its debts and which is being wound up by the court or by creditor's voluntary winding-up, a contributory includes any person who is liable to contribute to the costs, charges and expenses of the winding-up of the company. Persons who are usually liable to contribute are the applicant for liquidation or a creditor who lodged a claim for payment of a debt.²

There are four types of contributories falling within the provisions of the Companies Act³, namely:

- 1) Members and, in certain circumstances, certain past members of a company limited by guarantee within the meaning of the Act;⁴
- 2) Creditors⁵;
- 3) The holders of partly paid-up shares⁶,
- 4) Members of a former unlimited company which has converted itself into a type or form of company provided for by the present Act which provides that such conversion shall not affect the liability of the members of such company in respect of any debts, liabilities or obligations incurred or contracts entered into by, with or on behalf of the company before the conversion. The 1926 Act continues to apply to unconverted unlimited companies formed under it and, therefore, the winding up of such companies is entirely governed by the provisions of that Act.⁷

7.5 Creditor

A creditor who relies on s 424(1) to claim from directors or other officers debts owed to him by the company must be able to prove both the existence of the debt and the amount thereof. The remedy provided for in s 424 will not be available to a creditor who cannot discharge this double onus. In *Retail Management Services (Edms) Bpk v Schwartz*⁸ the plaintiff instituted a claim against a company but shortly thereafter the company was placed in

¹ Section 1(1) of the Companies Act 61 of 1973.

² Section 337 of the Companies Act 61 of 1973.

³ 61 of 1973.

⁴ Section 19(1) (b); section 52(3) (b) of Act 61 of 1973.

⁵ Section 342 (2) of Act 61 of 1973.

⁶ Section 338 (2) of Act 61 of 1973 provides that in a winding-up under the Act of a company having such shares the provisions of 1926 Act continue to apply in respect of such shares and the contributories in relation thereto. It should be noted, however, that section 92 (1) of the present Act prohibits, subject to section 92 (2), the allotment or issue of any share unless the full issue price or other consideration for them has been paid to and received by the company.

⁷ Section 4 (1) and 25 (2) of the Companies Act 61 of 1973.

⁸ 1992 (2) SA 22 (W).

liquidation. The liquidators admitted the claim when the plaintiff proved it in terms of the Insolvency Act.¹ The plaintiff, basing his cause of action on s 424(1), sued the director for the amount of the claim, which had been admitted by the liquidators. The director denied any knowledge of the debt. The court had to decide two issues firstly, whether or not the plaintiff was a creditor for the purposes of s 424(1) and secondly, whether or not the court could make an order in terms of s 424(1) if the plaintiff failed to quantify the amount of the claim. It was held that where a plaintiff was a creditor of the company and therefore possessed the necessary information to prove his claim, it was essential for him to prove to the court the existence of the debt as well as the quantum thereof. In the instant case the plaintiff having failed to do this the court granted absolution from the instance.

7.6 Judicial manager

A judicial manager is someone appointed as such by the Master of the High Court after the company has been placed in judicial management.²

8. The respondent

8.1 Director

A director is someone appointed by the company to run its business. If no directors are appointed the shareholders (subscribers to the memorandum) are deemed to be directors.³

8.2 Officer

Officer means any person who exercises supervisory control over the affairs of the company for the time being or who is related to the general administration of the company.

For the purposes of the Companies Act the term 'officer' includes any managing director or the secretary in relation to the company.⁴ Officers of the company who are authorized to act on its behalf have the same fiduciary responsibility towards the company, as do the directors. The court held in *Lipschitz vWolpert and Abrahams*⁵ that an officer is a person holding office and

¹ Act 24 of 1936.

² Section 1(1) of the Companies Act 61 of 1973.

³ Section 1(1) of the Companies Act 61 of 1973.

⁴ Section 1(1) of Act 61 of 1973.

⁵ 1977 (2) SA 732 (A).

taking part in the management or direction of a company. An auditor of the company is not, however, an officer of the company.¹

A director or officer of a company includes any director or officer of a holding company of such company.² Officer includes any manager, the secretary and also others who take part in the running of the affairs of the company.³

9. On application

In *Joh-Air (Pty) Ltd v Rudman*⁴ the court left open the question whether s 424 could be invoked by an ordinary action at law. It is respectfully submitted that the answer to this question is in the affirmative. The section does not contemplate the holding of an enquiry as a preliminary step to the making of the declaration.⁵ It contemplates the court making the declaration if a case has been established by evidence adduced before it. No reasons occur why the legislature should have intended that an applicant who anticipates that the facts on which he relies may be disputed should not be entitled to institute an action rather than motion proceedings. If the applicant proceeds on motion and a dispute of fact emerges which cannot be decided without *viva voce* evidence, the provisions of Rule 6 (5) (g) of the Rules of Uniform Rules of Court and the law and practice in relation thereto should apply.⁶

10. As the court may direct

It is submitted that the declaration may be made in relation to any debt or other liability owed to the victim of the fraud or recklessness. Indeed, the declaration may be made in relation to all debts or other liabilities of the company. It may be made even where the company is able to pay its debts, in which case the declaration would have the effect, once obeyed, of benefiting the members. The court is not limited to exercise its power only if the company has been, or is being, prejudiced. Moreover the declaration may be made where the business of the company has been, or is being, carried on with intent to defraud a creditor of a person other than the company, although payment pursuant to the declaration could not be of any direct benefit to such person. Therefore, it is submitted that the purposes of the section is compensatory and punitive.⁷ The court is able to penalize the delinquent whatever other

¹ *Lipschitz v Wolpert and Abraham* at 740.

² *Van Dorsten JL Rights, powers and duties of directors* (1992) at 1.

³ *Van Dorsten JL Rights, powers and duties of directors* (1992) at 5.

⁴ 1980 (2) SA 420 (T).

⁵ Section 423 (1) of Act 61 of 1973

⁶ Supreme Court Rules.

⁷ *In re William C Leitch Brothers Ltd* 1932 (2) SA 71 (T).

consequences for the company, its members or its creditors his effecting payment pursuant to the declaration may have.

The directors' liability is in respect of the whole or part of the debt. The directors and other officers of the company are jointly and severally liable for payment of the debt of the company for which they are liable without limitation of liability.

In *re William C Leich Brothers Ltd*¹, Maugham J, with reference to the similar provisions of s 275 of the 1929 English Companies Act, said:

"I am inclined to the view that s 275 is in the nature of a punitive provision, and that where the Court makes such a declaration in relation to 'all or any of the debts or other liabilities of the company', it is in discretion of the Court to make an order without limiting the order to the amount of the debts of those creditors proved to have been defrauded by the acts of the director in question, though no doubt the order would in general be so limited. Whether to so limit the order and the extent of such limitation would be matters for the Court to consider in the due and proper exercise of the discretion conferred upon it by the section".

11. When it appears

These words do not import that the court may make the declaration merely on a *prima facie* case. The onus is on the applicant to establish his case on a balance of probabilities²

12. The court

The High Court within the area of jurisdiction of which its registered office is situated has jurisdiction to wind up a company or other body corporate so has another High Court if in its area of jurisdiction the company's or other body corporate main place of business is situated.³ Where either the registered office or the main place of business is within an area of jurisdiction, which is common to both a Provincial Division and a Local Division, there is concurrent jurisdiction to wind up in both such division.⁴

The situation as described above obtains also in the case of an external company registered as such under the Act.⁵ The court has jurisdiction to wind up an external company not registered as such under the Act but which establishes a place of business in South Africa. Where the court has no jurisdiction under the Act to wind up a body corporate or an association of persons, such body

¹ 1932 (2) SA 71 (T).

² *Joh-Air (Pty) Ltd v Rudman supra*.

³ Section 12 (1) and 1 (1) vs. "Court".

⁴ *Ex Parte Bobat: In re Kathorian Trading Co (Pty) Ltd* 1979 (3) SA 242 (T) at 246-7.

⁵ Act 61 of 1973.

corporate or association, if it is a "debtor" as defined in s 2 of the Insolvency Act,¹ may be sequestrated under that latter.²

13. Relationship between s 424 (1) and s 311 compromise

There are conflicting decisions as to the meaning of the phrase 'creditor' of the company. These words were interpreted at length in *Pressma Services (Pty) Ltd v Schuttler and Another*³ where Van Schalkwyk AJ said:⁴

"The clear purpose of s 424(1) is to impose personal liability on any person who was knowingly a party to the fraudulent or reckless carrying on of a company's business. The corollary of this purpose is to provide a meaningful remedy against which the subsection is directed.... It is, in my view, unthinkable that the Legislature could have intended that the aforesaid purpose could be frustrated and the remedy provided for in the subsection lost merely because of the sanctioning and implementation of a compromise in terms of s 311, especially in view of the fact that creditors who have voted against the sanctioning of the compromise may, in certain instances, be bound thereby.

I am accordingly of the view that the right conferred on creditors by s 424(1) is not extinguished *ipso iure* upon the sanctioning and implementation of a compromise in terms of s 311.

Whether a creditor ceases to be a "creditor" within the meaning of s 424(1) upon the sanctioning and implementation of a compromise, and therefore no longer has the right to approach the court in terms of the subsection, depends upon the word 'creditor' of the company at the time when he approaches the court in terms of s 424(1), in the sense that there is a then existing indebtedness, or they could mean, in addition a person in respect of whom there was an indebtedness which ceased to exist upon the sanctioning and implementation of the compromise. The first more restricted meaning is the more obvious and ordinary one, which, in the absence of any indication to the contrary would be the meaning to be ascribed to the words. The second, extended meaning would be permissible only upon the basis that it is consistent with the true intention of the Legislature while the first, more restricted meaning is not...

The true intention of the Legislature in this regard must, in my view, be determined with reference to the primary objects of s 424(1). These, as I have mentioned, are two- fold. The first is to render personally liable all persons who knowingly participate in the fraudulent or reckless conduct of the business of a company. The second is to provide a meaningful remedy against the abuses at which the subsection is directed. The first of these objects would be attained if, upon the sanctioning and implementation of a compromise, the personal liability of the persons concerned were maintained. This would be the case even if the right conferred on a creditor by s 424(1) were to pass to the offeror upon sanctioning and implementation of the compromise. The second object, however, would in my view not be attained if the remedy provided by the subsection were to be lost to creditors for, in the final analysis, it is to them that the debts of the company in respect of which personal liability is created by the subsection are owed'

The court continued to say:⁵

'I am accordingly of the view that the words "creditor of the company in s 424(1) must be construed so as to include a person in respect of whom there was an existing indebtedness at the time when compromise is sanctioned."⁶

¹ 24 of 1936.

² *Lawclaims (Pty) Ltd v Rea Shipping Co SA* 1979 (4) SA 745 (N); *Cassere v United Party Club* 1930 WLD 39; *Silverman v Silver Slipper Club* 1932 TPD 355; *Magnum Financial Holdings (Pty) Ltd v Summerly* (sequestration of a trust *inter vivos*) 1984 (1) 160 (W).

³ 1992 (2) SA 411 (C).

⁴ At 413C-F.

⁵ At 416-7.

⁶ At 418D.

This correctness of the view was doubted in *Ex parte De Villiers Another NNO and: In re Carbon Developments (Pty) Ltd*¹ (in Liquidation) where by Stegmann J said:²

'...in a case in which the creditors have all agreed in terms of s 311 to a compromise which specifically provides for the extinction of all company's debts and liabilities, it seems to me be quite obvious that s 424(1) cannot possibly function after the extinction of such debts and liabilities by the agreement of the creditors and the sanction of the court. If the decision in *Pressma Services* implies that in such a case a creditor's right to seek a declaration of personal liability on the part of a wrongdoing company representative for a particular debts previously owed by the company is a right which necessarily survives the extinction of the company's debts, I must record my respectful disagreement with it.'

Stegmann J continued to say:

'Furthermore, in a case in which the creditors have agreed in terms of 311 to a compromise which provides, not for the extinction or novation of their claims, but for the cession thereof to the propose of the comprise as in the *Pressma Services* case- it seems to me that (at least in the absence of agreement to the contrary) any ancillary right to approach the court in terms of s 424(1) for a declaration of personal liability on the part of a wrongdoing company representative must necessary pass to the cessionary as a right ancillary to the ceded claim. In that respect, too I find myself in respectful disagreement with the conclusion in the *Pressma Services* case.

Whether effect will be given to any agreement between the cedent and the cessionary in terms of which the cedent purports to retain ancillary rights to approach the court for declaration in terms s 424(1), whilst at the same time parting with the claim which *locus stand* to do so, seems somewhat doubtful. It is not a question which arises in the present case and I shall not now pursue it further.

No doubt the situation may change. Once a creditor has, on the strength of an existing claim against the company, obtained in terms of s 424(1) a declaration of the personal liability of a wrongdoing company representative for such debts, such creditor would not necessarily be obliged to continue to retain his claim against the company in order to exact payment from the declared wrongdoer. The creditor may become free to compromise his claim against the company in terms of s 311 without destroying the basis of the declared personal liability of the wrongdoer, provided that he takes into account whatever benefit he receive through such compromise. The Legislature's objective can only have been to make good the creditor's loss; it cannot have been to secure any further enrichment of the creditor at the declared wrongdoer's expense.

The essential points for present purposes remain:

- (1) That a declaration of personal liability on the part of wrong doing representative of a company can only be made whilst the company has debts or other liabilities, and not after its debts or liabilities have been extinguished or novated; and
- (2) That such a declaration can only benefit those who are the holders of the relevant claims against the company, and not those who, although once creditors of the company, have ceased to be such in consequence of an order sanctioning a compromise under s 311.

For all of these reasons I come to the conclusion that when, as in the present matter, a creditor of an insolvent company in liquidation is faced with a proposal under s 311

¹ 1993 (1) SA 493 (A).

² At 497E-F.

which involves an offer of compromise inviting him to agree to cede his claim against the company in liquidation in return for the right to a payment in terms of the compromise, he will also cease to qualify to enjoy the benefits of such right as s 424(1) may have afforded him had he (or anyone else with *locus standi* in terms of the section) approached the court at a time when the company owed him a debt or liability for a declaration that a wrongdoing representative of the company was personally responsible for the full amount of such debt or other liability of the company."

It is respectfully submitted that the approach adopted by Stegmann J is correct because it is in accordance with the intention of the parties to the cession and gives effect to the legal consequences of an out and out cession, namely that the a creditor parts with his claim and entirely divests himself of his right.¹

14. A critique of the section

My impression of the purpose and application of the section 424 is that it is a good section and it is applied well by the courts. This section protects creditors. The section provides that if directors carry on the business of the company recklessly and with an intention to defraud creditors, they will be personally held liable.

The courts have interpreted it correctly and great achievements have been made thus far. There are no controversial aspects of the section and the courts have always applied it correctly.

I am of the view that s 424 should have included ordinary negligence as a requirement for liability as this would give better protection to creditors of the company. The provision of this section does not protect the creditors of the company to my satisfaction. The directors and other officers who carried on the companies business negligently will escape liability under the present provisions.

15. Conclusion

Section 424 is a good provision in that its purpose is to impose personal liability on any person who was knowingly a party to the fraudulent or reckless carrying on of a business. This is a statutory right based on recklessness and was not intended to be in substitution of any remedy available under the common law. The section achieves its aim of protecting creditors and other persons affected. It appears to be well understood and applied by the courts. However I still believe that the section should have included the liability of directors and other officers of the company for negligent trading. While the section achieves

¹Cilliers and Benade, *Corporate law* 3rd ed (2000) at 161.

its main aim of protecting creditors and other affected persons, they can escape liability if they acted negligently.

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