Hogan Lovells

Paying the piper

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"Creditors have better memories than debtors."
Benjamin Franklin

More often than not companies trade for months under insolvent or financially distressed circumstances before eventually filing for business rescue proceedings as a last hope to keep the wolves from the door.

Creditors, having supplied goods and/or services on credit prior to the company filing for business rescue proceedings, are then faced with the unfortunate consequence of not being compensated for goods and/or services supplied to the company when the company was, at the very least, trading under financially distressed circumstances.

Due to the moratorium placed on the institution of legal proceedings against a company in business rescue, or in relation to property in its lawful possession, creditors are often left frustrated due to the inability to effectively enforce their rights. However, it would appear that the Companies Act 71 of 2008 has tried to alleviate this frustration with the incorporation of section 218(2).

It is trite law that the Companies Act and the common law place a host of statutory and fiduciary duties on directors of a company. A breach of these duties gives rise to a claim, in terms of section 77(3) of the Companies Act, which provides that a director of a company is liable for any loss, damage or costs sustained by the company as a direct or indirect consequence of the director having, *inter alia*, been party to reckless trading or to an act or omission calculated to defraud creditors. Section 22(1) provides that a company must not conduct its business recklessly.

If, for example, a company places an excessive order for goods, takes possession of those goods immediately prior to filing for business rescue and then uses the moratorium of business rescue proceedings to avoid making payment in respect of such goods, it is a clear indication that the company, under the management of the board of directors, is trading recklessly with the intent to defraud creditors. In these circumstances, the company is well stocked with goods, enabling it to trade without an enforceable obligation to make payment in respect of such goods to the prejudice of the creditors.

Section 77(3) only provides for a claim against the directors of the company *by or on behalf of the company for losses sustained by the company*. It does not afford any right of recovery to the creditors of the company in situations as per the above. The creditors may not institute action against the company by virtue of the *moratorium* envisaged in section 133 of the Companies Act, but this does not necessarily mean that they are without a remedy.

It would seem that the legislative authority endeavoured to ensure that third parties, such as creditors, are not left with their hands in their hair by incorporating section 218(2) of the Companies Act. Section 218(2) provides that "any person who contravenes any provisions of this Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention". This will not necessarily fall within the ambit of the moratorium contained in section 133 of the Companies Act as the institution of action in terms of section 218(2) will not be "legal proceeding, including enforcement action, *against the company*", but rather *against the directors* of the company.

It has to be proven in terms of section 218(2) that the director has contravened the Companies Act and that the creditor instituting action has suffered loss due to that breach. In order not to open the floodgates to frivolous claims based on every possible breach of the Companies Act, it is submitted that the contravention has to be a contravention of a *peremptory* requirement rather than a mere *directory* requirement.

One such peremptory requirement can be found in section 129(7) of the Companies Act, which places an obligation on the board of the company to deliver a notice to each affected person, setting out the criteria referred to in section 128(1)(f) stating its reasons for not adopting a resolution placing the company under business rescue proceedings, when the board of such company has reasonable grounds to believe that the company is financially distressed.

It needs to be emphasised that financial distress does not happen overnight and that, in fact, companies trade under these circumstances for months without filing for business rescue. If a company then fails to deliver a notice to each affected person and continue to trade (recklessly so) for example incurring further credit, the directors may be held personally liable, either in terms of sections 77 (to the company) or 218 (to the creditors), of the Companies Act.

The enforceability of section 218(2) has been crystallised in the case of *Rabinowitz v Van Graan and Other* 2013 (5) SA 315 (GSJ). The court confirmed that a director can be held personally liable in terms of section 218(2) as read with section 22(1) of the Companies Act. The court stated, however, that a plaintiff had to allege and prove the exact contravention of the Companies Act as well as the causation between the act complained of and the damages suffered.

Furthermore, company law is not solely based on legislation, but also on common law principles. In this light, it can be seen that section 218(2) affords creditors a statutory version of a delictual claim for damages. This was clearly emphasised in the judgment of Ex Parte Lebowa Development Corporation Ltd [1989] 4 All SA 492 (T) in which the court dismissed an application brought by one of the creditors (who was also the major shareholder) for an order authorising the calling of meetings of the creditors to decide upon a proposal of a compromise between the company under judicial management and its creditors.

The learned Judge Stegmann dismissed the application by noting that the court cannot knowingly expose creditors to further risk when it was clear that the applicant had no intention to provide the insolvent company with capital in order to settle outstanding amounts due to creditors. He pointed out that anyone, including directors and other company officers, who causes a third party to suffer loss by way of fraud or negligence, is personally liable to such third party in terms of the common law.

The full ambit of section 218(2) is yet to be ventilated in our courts, but what can be said with definite certainty is that creditors suffering harm at the hands of reckless directors and/or shareholders are not left remediless. If applicable, the moratorium prohibiting creditors from instituting action is only for the duration of business rescue proceedings and places no such prohibition of enforcement action thereafter. However, creditors should be cognisant of the fact that business rescue plans usually provide for the discharge of the debt owed to the creditor. In these circumstances the right to proceed against the officers, directors or shareholders of a company is lost as the cause of action is effectively extinguished and creditors should accordingly oppose any such provisions.

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