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Personal Liability of Directors & the Case for an Audit –

An Analysis of the Companies Act No. 71 of 2008, 'the Act'

Liability of Directors is primarily considered in Section 77 and it includes:

- Actual directors
- Prescribed officers
- Members of Board Committees and / or members of Audit Committees

It is not a requirement that an individual is, in fact a director on the board of the company for liability to attract.

In addition to the many common law principles, related to the breach of fiduciary duties, liability may attract in respect of any loss damage or costs associated with the breach of the following duties:

- Non-declaration of personal financial interest in a course of action or debate;
- Use of information obtained while acting the capacity of a director solely for the advantage of the company;
- Acting in good faith and for a proper purpose, in the best interest of the company with the degree and skill that may reasonably be expected of that person carrying out the functions of a director;
- Adhering to any requirement in terms of the Act or the Companies Memorandum of Incorporation 'MOI'.

Furthermore, a director of a company is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director having—

- acted in the name of the company, signed anything on behalf of the company, or purported to bind the company or authorise the taking of any action by or on behalf of the company, despite knowing that he lacked the authority to do so;

- acquiesced in the carrying on of the company's business despite knowing that it was being conducted in a manner which could be described as
 - reckless
 - grossly negligent
 - with the intent to defraud any person
 - for a fraudulent purpose
 - trading under insolvent circumstances
- been a party to an act or omission by the company despite knowing that the act or omission was calculated to defraud a creditor, employee or shareholder of the company, or had another fraudulent purpose;
- signed, consented to, or authorised, the publication of—
 - any financial statements that were false or misleading in a material respect; or
- been present at a meeting, or participated in the making of a decision at a meeting of directors, and failed to vote against:
 - the issuing of any unauthorised shares, despite knowing that those shares had not been authorised in accordance with the MOI;
 - the issuing of any authorised securities, despite knowing that the issue of those securities was inconsistent with the required shareholder approval;
 - the provision of financial assistance for the acquisition of securities of the company, despite knowing that the provision of financial assistance was inconsistent with the Act or the company's Memorandum of Incorporation;
 - a resolution approving a distribution in circumstances prohibited or restricted by the Act or MOI;
 - the acquisition by the company of any of its shares, or the shares of its holding company, despite knowing that the acquisition was contrary to the Act or MOI;

Distributions agreed to by Directors

Notwithstanding the Act or the MOI permitting a board of directors to make distributions liability may arise if the company:

- immediately after making all of the distribution contemplated in a resolution, does not satisfy the solvency and liquidity test; and
- it was unreasonable at the time of the decision to conclude that the company would satisfy the solvency and liquidity test after making the relevant distribution; and

In addition to the liability set out elsewhere in the Act, any person who would be so liable are jointly and severally liable with all other such persons—

- to pay the costs of all parties in the court in a proceeding contemplated in this section unless the proceedings are abandoned, or exculpate that person; and

- to restore to the company any amount improperly paid by the company as a consequence of the impugned act, and not recoverable in terms of the Act.

Why the Audit ?

The Solvency & Liquidity Test

The Act is replete with circumstances where a director is required to perform the above test before continuing on a course of action and it is therefore important to understand exactly what is contemplated.

For any purpose of the Act, a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time—

- the assets of the company or, if the company is a member of a group of companies, the aggregate assets of the group of companies, as fairly valued, equal or exceed the liabilities of the company or, if the company is a member of a group of companies, the aggregate liabilities of the group of companies, as fairly valued; and
- it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of—
 - 12 months after the date on which the test is considered; or
 - in the case of a distribution 12 months following that distribution.

For the purposes contemplated above any financial information to be considered concerning the company must be based on—

- accounting records that satisfy the requirements of the Act; and
- financial statements that satisfy the requirements of the Act;

The board or any other person applying the solvency and liquidity test to a company—

- must consider a fair valuation of the company's assets and liabilities, including any reasonably foreseeable contingent assets and liabilities, irrespective of whether or not arising as a result of the proposed distribution, or otherwise; and
- may consider any other valuation of the company's assets and liabilities that is reasonable in the circumstances; and

Unless the Memorandum of Incorporation of the company provides otherwise, a person applying the test in respect of a distribution contemplated in the Act is not to regard as a liability any amount that would be required, if the company were to be liquidated at the time of the distribution, to satisfy the preferential

rights upon liquidation of shareholders whose preferential rights upon liquidation are superior to the preferential rights upon liquidation of those receiving the distribution.

Whilst the Act appears to remove the statutory audit requirement for some private companies, with the introduction of the solvency and liquidity test it may have the unintended consequence of directors being reticent to sign off on the test in the absence of an audit for fear of liability. In addition, the income tax legislation in the pipeline only increases the liability of those who sit in managerial positions and agree to distributions at times when tax may be owing to the fiscus. In the premises, I submit that it will only be the very small and the fool-hardy who will do without the protection of an audit. The audit is now perhaps more akin to an insurance than an accounting exercise when it come to directors and prescribed officers peace of mind.

Put differently, it should be remembered that in any proceedings against a director, other than for wilful misconduct or wilful breach of trust, the court may **relieve the director, either wholly or partly, from any liability** set out in the, on any terms the court considers just if it appears to the court that—

- the director is or may be liable, but has acted honestly and reasonably; or
- having regard to all the circumstances of the case, including those connected with the appointment of the director, it would be fair to excuse the director.
- A director who has reason to apprehend that a claim may be made alleging that the director is liable, other than for wilful misconduct or wilful breach of trust, may apply to a court for relief, and the court may grant relief to the director on the same grounds as if the matter had come before the court in terms of the Act

There is no doubt that a director who relies on the advice of professional advisors would be able to, at least avail himself of a defense.

