

The Corporate Report

Facilitating Business in South Africa

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The Corporate Report

Facilitating Business in South Africa

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CONTENTS

About the Editors

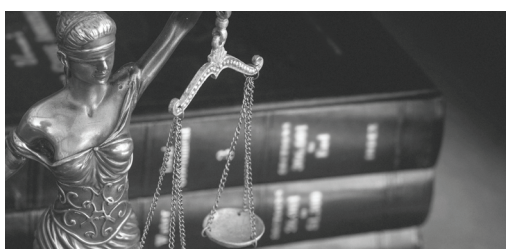
Mervyn E King SC..... iv

Anton van Wyk..... iv

Michael Kuper SC..... v

Note to Contributors..... vi

Note from the Editor-in-Chief ix



Articles

From the corporate armchair: it is time to take a stand
– Annamarie van der Merwe..... 1

Unconscious bias, latent discrimination and real consequences
– Cynthia Schoeman 3

The challenges facing company secretaries in South Africa today
– Stephen Sadie, Joanne Matisonn and Sabrina Paxton 8

What is business rescue?
– Peter J Veldhuizen 27

Fraud investigations and subsequent actions
– Craig Bristow 33

Business rescue proceedings: consequences for directors
– Michael Judin and Annamarie van der Merwe..... 39

The intersection of talent development and social impact
– Sarah Galvin..... 47

Subscription..... 52

By and large, directors seem to become 'puppets' of the business practitioner although a director charged with management functions could potentially refuse to exercise such functions if deemed 'unreasonable'.



Business rescue proceedings: consequences for directors

Michael Judin and Annamarie van der Merwe

The focus of the writers is specifically on the consequences of business rescue proceedings on directors, in particular the standard of conduct expected from these affected directors, if any, and the potential for personal liability based on directors' conduct during such proceedings.

Introduction

The concept of 'business rescue' was introduced in corporate South Africa in 2011 when the Companies Act No. 71 of 2008 ('the Act') became effective. According to section 7(k), one of the purposes of the Act is to 'provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders'. The relevant provisions were incorporated into chapter 6 of the Act.¹

The purpose of this paper is not to dissect the detailed provisions of chapter 6 as far as business rescue is concerned or to provide an elaborate overview of all technicalities and dynamics associated with

As such, the focus of the writers is specifically on the consequences of business rescue proceedings on directors, in particular the standard of conduct expected from these affected directors, if any, and the potential for personal liability based on directors' conduct during such proceedings.

Problem statement

Section 66 of the Act provides that the business and affairs of a company must be managed by or under the control of the board, which has the authority to exercise all of the powers and perform any of the functions of the company, except to the extent that the Act or the company's memorandum of incorporation provides otherwise.

The directors of the financially distressed company therefore remain directors but their powers and duties are severely restricted in that the business practitioner assumes full control over the company.

these proceedings. It is assumed that the reader has a basic understanding of the relevant provisions and technicalities. Suffice it to say that business rescue proceedings have far-reaching consequences for all stakeholders in a financially distressed company and not less so for the directors of such company.

However, when a financially distressed company becomes the subject matter of business rescue proceedings, a business practitioner is appointed who assumes responsibility for the 'temporary supervision of the company, and of the management of its affairs, business and property'.² The directors of the financially

¹ Reference to sections in the text and footnotes are in respect of the Companies Act of 2008 unless otherwise indicated.

² Section 128(1)(b)(i).

distressed company therefore remain directors but their powers and duties are severely restricted in that

as alluded to above and comply with the requirements relating to personal financial interests (section 75).⁶

As a first observation, the question must be asked what ‘functions’ the directors would still be required to exercise considering that they have been ‘substituted’ by the business practitioner.

the business practitioner assumes full control over the company. Section 140(1)(a) of the Act goes so far as to state that the business practitioner, amongst other things, ‘has full management control of the company in substitution for its board and pre-existing management’.

Notwithstanding the ‘substitution’ of the board by the business practitioner as contemplated in section 140(1)(a) of the Act, directors are required to:

- continue to exercise the functions of director, subject to the authority of the practitioner;³
- exercise any management function within the company in accordance with the express instructions or direction of the practitioner, to the extent that it is reasonable to do so;⁴ and
- comply with the requirements of section 75 concerning personal financial interests of the director or a related person.⁵

According to the Act, directors are relieved from the statutory duties of a director as set out in section 76, as well as the liabilities set out in section 77, other than:

- section 77(3)(a) – acting outside the director’s authority;
- section 77(3)(b) – being party to reckless trading; and
- section 77(3)(c) – being party to or knowing that fraud is being committed.

The purported relief is only to the extent that such directors adequately exercise the management functions

In summary, and at a high-level, the statutory position of the directors of a company in business rescue seems to be as follows:

- Directors are substituted by the business practitioner (who may or may not be appropriately skilled and experienced to effectively manage the affairs of the affected company).
- Directors are expected to continue to exercise the functions of a director under the authority of the business practitioner.
- Directors may, under certain circumstances and subject to specific limitations, be relieved of their statutory duties as well as potential liabilities.

The concern that this paper attempts to bring to the fore, based only on an academic interpretation of the relevant statutory provisions, is the precarious position that directors could potentially find themselves in while being ‘substituted’ by the business practitioner and the potential challenges and risks that they may face as a result thereof.

Relevant statutory and common law considerations

As a first observation, the question must be asked what ‘functions’ the directors would still be required to exercise considering that they have been ‘substituted’ by the business practitioner. Attending board meetings, approving decisions at such meetings and signing written resolutions as instructed by the business practitioner seem to potentially complete the list of these ‘functions’. Executive directors seem

³ Section 137(2)(a).

⁴ Section 137(2)(b). It has to be assumed that this duty would be more relevant where an executive director is concerned as opposed to a non-executive director who does not, under normal circumstances, become directly involved in the management of the affairs of the company.

⁵ Section 137(2)(c).

⁶ Section 137(2)(d).

to have a duty to exercise any ‘management function’ within the company in accordance with the express instructions or direction of the practitioner, but only to the extent that it is ‘reasonable’ to do so. By and large, directors seem to become ‘puppets’ of the business practitioner although a director charged with management functions could potentially refuse to exercise such functions if deemed ‘unreasonable.’⁷

What section 137(2) therefore seems to be saying, based on a ‘plain language’ interpretation, is that a director ‘exercising the functions of a director under authority of a business practitioner’ need *not* do so in good faith, for a proper purpose, in the best interest of the company and/or with care and skill and diligence (as long as he or she complies with the other requirements of section 137(2)). Can

The fiduciary duties are based on the concept of good faith, and are owed to the company as a result of the control that directors exercise over the assets of the company, and the power that is held by such directors to act on behalf of another.

When a director is in control of the affairs of a company (i.e. in the absence of business rescue and therefore a business practitioner) a certain standard of conduct is expected from such director, in the absence of which he or she could potentially face personal liability.⁸ According to section 137(2)(d) however, a director would be relieved from the duties (standard of conduct) set out in section 76 as well as the liabilities listed in section 77, subject to certain limitations, if such director exercised the required ‘management functions’ as contemplated in section 137(2)(b) and complied with the requirements of section 75 as far as personal financial interests are concerned.

Based on the provisions of section 76, and in addition to the requirements for a director not to abuse his or her position to benefit him- or herself or a third party to the detriment of the company and to share material information with the board, a director is required to:⁹

- act in good faith and for a proper purpose;
- act in the best interest of the company; and
- act with the degree of care, skill and diligence that one can expect from a reasonable director (objective test) and a director with the knowledge, skills and experience of the director (subjective test).

this be the real intention of the drafters of this legislation and is this even a legitimate and/or enforceable objective?

Even if one assumes for the time being that it is completely acceptable and/or possible to relieve a director of a certain standard of conduct when exercising functions under the authority of the business practitioner, i.e. arguing that the director is for all intend and purposes acting as a rubber stamp of the business practitioner without being expected to really apply his or her own mind, the question has to be asked whether such a director could not still face accountability based on the common law and his or her duties as a fiduciary of the company.

Section 76(3) as set out above has, amongst other things, been referred to as a ‘codification of the common law duties’ of directors. These common law duties encompass the fiduciary duties of directors as well as the duty to act with diligence and care. The fiduciary duties are based on the concept of good faith, and are owed to the company as a result of the control that directors exercise over the assets of the company, and the power that is held by such directors to act on behalf of another.

⁷ The complexities brought about by this qualification for both the director and the business practitioner can be endless and, in itself, the cause of numerous arguments.

⁸ Sections 76 and 77.

⁹ Section 76(3).

The provisions of chapter 6 and, in particular, those relating to the position of a director of a company in business rescue, are fraught with risks for directors and need a serious review by the drafters.



Fiduciary duties are non-negotiable and cannot be waived in any manner or form. These duties include:

- duty not to exceed powers, i.e. directors may not act ultra vires or otherwise beyond their capacity;
- duty to exercise their powers for the proper purpose, i.e. not to act for an improper or collateral purpose, to act bona fide in the interests of the company and in a manner in which he or she conceives to be for the benefit of the company as a whole;
- duty to exercise an independent and unfettered discretion;
- duty not to place themselves in a position of conflict between their personal interests and those of the company – this includes the duty to disclose any such personal interests to the company and the duty not to make secret and/or incidental profits at the expense of the company;
- duty to account for profits, and not to make secret or incidental profits; and
- duty not to act on behalf of company in any matter in which he or she has an interest that conflicts, or may conflict, with his or her duties to the company.

Section 137(2) is silent on the director also being relieved of his or her fiduciary and common law duties. Is it perhaps assumed that a director of an

conduct and/or common law duties, presumably being relieved from these duties, could not be said to in fact be a ‘party to reckless trading’, specially where it is obvious that the business practitioner is not meeting these requirements in the manner in which the affairs and business of the affected company are being managed, the director thereby in any event forfeiting the so-called relieve contemplated in section 137(2)(d).

A number of other relevant provisions of the Act need to be noted for purposes of this discussion:

- In the event that a director failed to comply with a requirement of the business rescue process or hinders the business rescue practitioner in the performance of his or her powers and functions and impedes the business rescue proceedings or the management of the company in any way, the business rescue practitioner may, at any time during the business rescue proceedings, apply to a court for an order to remove a director from office.¹⁰
- If any director of the company purports to take any action on behalf of the company that requires the approval of the practitioner, that action is void unless it is approved by the practitioner.¹¹
- During the business rescue proceedings, the business practitioner has the responsibilities, duties and liabilities of a director of the company,

If any director of the company purports to take any action on behalf of the company that requires the approval of the practitioner, that action is void unless it is approved by the practitioner.

affected company who has been substituted by a business practitioner, yet is expected to continue to fulfil certain functions, will not or cannot be regarded as a fiduciary of the company for the duration of the business rescue proceedings? It is not certain that such an argument would succeed in a court of law.

An additional question that arises is whether a director who does not act according to the statutory standard of

as set out in sections 75 to 77 and, other than as contemplated aforesaid, is not liable for any act or omission in good faith in the course of the exercise of the powers and performance of the functions of practitioner; but may be held liable in accordance with any relevant law for the consequences of any act or omission amounting to gross negligence in the exercise of the powers and performance of the functions of practitioner.¹²

¹⁰ Section 137(5).

¹¹ Section 137(4).

¹² Section 140(3).

Potential scenarios and implications for directors

Where a business practitioner acts in accordance with the required standard of conduct as per section 140(3) and has the necessary skills, having regard to the company's circumstances, to effectively, efficiently and successfully manage the affairs of the affected company and in the best interest of such company, directors should not have any valid and/or serious cause for concern and should in fact do everything possible to support the business practitioner.

However, what remedies does a director have where this is in fact not the case and where there are serious concerns over the manner in which the business and affairs of the affected company are being managed by and under the supervision of the business practitioner? A director can potentially take the view that he or she has no responsibility and/or accountability in this scenario as he or she has effectively been relieved of his or her duties. He or she therefore consciously assumes the position of 'rubber stamp' (whether fully or partially/selectively), exercising the functions required and instructed by the business practitioner without question or with little question.

Then there is the scenario where the directors wish to see the business and affairs of the affected company being managed in a diligent and responsible manner and in line with the standard of conduct that would have been expected from them as directors. A non-executive director is in a particularly precarious position as he or she is only 'empowered' in terms of section 137(2) to fulfil the functions of a director subject to the authority of the business practitioner. He or she is not entitled by law to question the reasonableness of the actions of the business practitioner. Although a business practitioner can, by application to court, be removed from the position based, amongst other things, on his or her lack of skills, such application can only be brought by an 'affected person'.¹⁴

The definition of 'affected person' leaves one with the impression that a non-executive director would not be regarded as an 'affected person' as a non-executive director does not fall within any of the stipulated categories of affected person.¹⁵ Section 130(2) does however contemplate a 'director' being an applicant to set aside the appointment of business practitioner but this is not an unqualified right and such application

Again, it could be argued that only an executive director would fall within the definition of 'affected person'.

It is unfortunate to contemplate a scenario where a director or directors would choose to take this approach, but reality tells us that this is not completely far-fetched. Based on the earlier discussion of the relevant provisions, directors who wish to take this approach would be well advised to carefully consider their positions and possible exposure. As indicated before, the purported relieve from the duties as per section 76 might not be as secure as intended and/or perceived. This could have a number of implications for such directors, not only claims for damages in terms of sections 76 or 218,¹³ but also a possible declaration of delinquency as contemplated in section 162, amongst others.

cannot be brought by a director who had approved the resolution relating to the appointment of the business practitioner unless he or she can convince the court that he or she had acted in good faith and based on information that had subsequently been found to be false or misleading. Again, it could be argued that only an executive director would fall within the definition of 'affected person'.

The director cannot act on behalf of the affected company in an attempt to intervene without the approval of the business practitioner and any such action is void unless it is approved by the business practitioner.

¹³ Section 218 provides for a civil claim in the event of any person contravening any provision of the Act and thereby causing harm to any person.

¹⁴ Section 130(1)(b)(iii).

¹⁵ Section 128(1)(a).

Two other options that are worth mentioning in passing by are:

- Resigning as director – for a number of reasons (including possible liability for a period of three years following such resignation or the director wanting to do what is right for the company and all its stakeholders), this may not be the best option.
- Raising concerns and refusing to fulfil certain functions as directed by the business practitioner, thereby forcing the business practitioner to bring an application for the removal of the director. Although this may be an opportunity for the director to raise his or her concerns over the performance of the business practitioner in a public forum, the costs and potential reputational consequences also makes this a less attractive option.

Relevant provisions of the Act

The following provisions are of relevance for purposes of this article:

Section 137(2) *During a company's business rescue proceedings, each director of the company—*

- (a) *must continue to exercise the functions of director, subject to the authority of the practitioner;*
- (b) *has a duty to the company to exercise any management function within the company in accordance with the express instructions or direction of the practitioner, to the extent that it is reasonable to do so;*
- (c) *remains bound by the requirements of section 75 concerning personal financial interests of the director or a related person; and*
- (d) *to the extent that the director acts in accordance with paragraphs (b) and (c), is relieved from the duties of a director as set out in section 76, and the liabilities set out in section 77, other than section 77 (3)(a), (b) and (c).*

Section 137(4) *If, during a company's business rescue proceedings, the board, or one or more directors of the company, purports to take any action on behalf of the company that requires the approval of the practitioner, that action is void unless approved by the practitioner.*

Section 137(5) *At any time during the business rescue proceedings, the practitioner may apply to a court for an order removing a director from office on the grounds that the director has—*

- (a) *failed to comply with a requirement of this Chapter; or*
- (b) *by act or omission, has impeded, or is impeding—*
 - (i) *the practitioner in the performance of the powers and functions of practitioner;*
 - (ii) *the management of the company by the practitioner; or*
 - (iii) *the development or implementation of a business rescue plan in accordance with this Chapter.*

Section 140(1) *During a company's business rescue proceedings, the practitioner, in addition to any other powers and duties set out in this Chapter—*

- (a) *has full management control of the company in substitution for its board and pre-existing management;*
- (b) *may delegate any power or function of the practitioner to a person who was part of the board or pre-existing management of the company;*
- (c) *may—*
 - (i) *remove from office any person who forms part of the pre-existing management of the company; or*
 - (ii) *appoint a person as part of the management of a company, whether to fill a vacancy or not, subject to subsection (2); and*
- (d) *is responsible to—*
 - (i) *develop a business rescue plan to be considered by affected persons, in accordance with Part D of this Chapter; and*
 - (ii) *implement any business rescue plan that has been adopted in accordance with Part D of this Chapter.*

Section 140(3) *During a company's business rescue proceedings, the practitioner—*

- (a) *is an officer of the court, and must report to the court in accordance with any applicable rules of, or orders made by, the court;*
- (b) *has the responsibilities, duties and liabilities of a director of the company, as set out in sections 75 to 77; and*
- (c) *other than as contemplated in paragraph (b)—*
 - (i) *is not liable for any act or omission in good faith in the course of the exercise of the powers and performance of the functions of practitioner; but*
 - (ii) *may be held liable in accordance with any relevant law for the consequences of any act or omission amounting to gross negligence in the exercise of the powers and performance of the functions of practitioner.*

Conclusion

The provisions of chapter 6 and, in particular, those relating to the position of a director of a company in business rescue, are fraught with risks for directors and need a serious review by the drafters. But until such time that these provisions are addressed, if ever, directors will be well advised to tread with caution and not place too much reliance on the 'protection' provided by law during business proceedings.

So, what does a conscientious director, finding him- or herself in this situation, do to not only have comfort that he or she is acting in the best interest of the affected company and fulfilling his or her duties as fiduciary to the company but at the same time limiting the risk of personal liability and harm. The simple answer seems to be that, notwithstanding section 137(2)(d) every director should continue to adhere to the standard of conduct required by section 76 in exercising the functions of director under the authority of the business practitioner. Do not 'abdicate' fiduciary responsibility and be on record when not in agreement with the proposed decisions

and plans of the business practitioner. At all times, act in good faith and for a proper purpose. Raise concerns when the actions of the business practitioner do not seem to be in the best interest of the company and, lastly, continue to exercise care and skill and diligence in whatever it is that is required from the directors.

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