DELINQUENT CORPORATE MANAGEMENT IN THE SOUTH AFRICAN STATUTORY CONTEXT

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To my wife, Cathy, without whose patience and encouragement this might never have seen the light of day.

SOURCE MATERIAL

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Jan Van Wyk=De Vries	Commission of Enquiry into the Companies Act = Main Report = RP 45/1970

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Abbreviations:

The following abbreviations are used in this dissertation:

Businessman's Law	BL
Commercial Law Digest	CLD
Journal of Business Law	JBL
South African Chartered Account	SACA
South African Company Law Journal	SACLJ
South African Law Journal	SALJ
South AFrican Mercantile Law Journal	SA Merc LJ
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CHAPTER 1

INTRODUCTION

Full twenty years have passed since the publication of the main report of the Van Wyk-De Vries Commission of Enquiry into the Companies Act[1] and nearly twenty years have run since the promulgation of the present Companies Act, No 61 of 1973. In the interim a new corporate entity was introduced into South African law through the medium of the Close Corporations Act, No 69 of 1984. Both these Acts contain provisions which provide for the lifting of the corporate veil, which the Courts have shown a reluctance to do (save in cases concerning the fiscus), since the notion of a separate and distinct personality of a corporation distinct from the members who make it up was adopted in the Salamon saga.[2] The relevant provision in the Companies Act is section 424, which provides:

> **"424. Liability of directors and other for fraudulent conduct of business. -**
>
> (1) 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 or member or contributory of the company, declare that any person who was knowingly a party to the

[1] Jan Van Wyk-De Vries, "Commission of Enquiry into the Companies Act" - Main Report - R P 45/1970.

[2] Broderip v Salamon [1895] 2 Ch 323; Salamon v Salamon & Co [1897] AC 22.

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.

(2) (a) Where the Court makes any such declaration, it may give such further directions as it thinks proper for the purpose of giving effect to the declaration, and in particular may make provision for making the liability of any such person under the declaration a charge on any debt or obligation due from the company to him, or on any mortgage or charge or any interest in any mortgage or charge on any assets of the company held by or vested in him or any company or person on his behalf or any person claiming as assignee from or through the person liable or any company or person acting on his behalf, and may from time to time make such further orders as may be necessary for the purpose of enforcing any charge imposed under this subsection.

(b) For the purpose of this subsection, the expression "assignee" includes any person to whom or in whose favour, by the directions of the person liable, the debt, obligation, mortgage or charge was created, issued or transferred or the interest was created, but does not include an assignee for valuable consideration given in good faith and without notice of any of the matters on the ground of which the declaration was made.

(3) Without prejudice to any other criminal liability incurred, where any business of a company is carried on recklessly or with such intent or for such purpose as is mentioned in subsection (1), every person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be guilty of an offence.

(4) The provisions of this section shall have the effect notwithstanding that the person concerned may be criminally liable in respect of the matters on the ground of which the declaration is made."

Section 64 of the Close Corporations Act, which is borrowed from Section 424 of the Companies Act, contains similar provisions, if not more lucid, then certainly broader terms:

> **"64. Liability for recklessness or fraudulent carrying on of business of corporation. -**
>
> (1) If it at any time appears that any business of a corporation was or is being carried on recklessly, with gross negligence or with intent to defraud any person or for any fraudulent purpose, a Court may on the application of the Master, or any creditor, member or liquidator of the corporation, declare that any person who was knowingly a party to the carrying on of the business in such manner, shall be personally liable for all or any of such debts or other liabilities of the corporation as the Court may direct, and the Court may give such further orders as it considers proper for the purpose of giving effect to the declaration and enforcing that liability.
>
> (2) Without prejudice to any other criminal liability incurred where any business of a corporation is carried on in any manner contemplated in subsection (1), every person who is knowingly a party to the carrying on of the business in any such manner, shall be guilty of an offence."

Although, as w shall see hereunder, Section 424 was preceded by subsection 185 (bis) of the 1926 Companies Act,[3] since it was enacted in its present form a lot of water has passed under the bridge in the form of pronouncements of our Courts and academic writings and the object of this paper is to review the sections in the light of the aforegoing, having regard to their

[3] Act No 46 of 1926.

historical origins. Much of what has been said about Section 424 of the Companies Act is apposite to Section 64 of the Close Corporations Act, but as will be pointed out there are differences as well as similarities between the two sections.

CHAPTER 2

A HISTORICAL PERSPECTIVE

The two sections find their roots in the report of the Greene Committee in the United Kingdom of 1926[1] where it had the following to say in regard to fraudulent trading:

> "This subject is in practice closely connected with that of undischarged bankrupts dealt with above. Our attention has been directed particularly to the case (met with principally in private companies) where the person in control of the company holds a floating charge and, while knowing that the company is on the verge of liquidation, 'fills up' his security by means of goods obtained on credit and then appoints a receiver.
>
> We consider that this state of affairs cannot satisfactorily be dealt with by altering the law as to floating charges. This form of security is too common and important an element in company finance to be interfered with. On the other hand we consider that not only should the person whom the Court finds to have been guilty of fraudulent trading, etc., be subjected to unlimited personal liability, but any security over assets of the company held by him or on his behalf or previously held by him or on his behalf and assigned to anyone save a bona fide holder for value should be charged with the liability. Further, trading of this character should be made a criminal offence in the directors in so far as it may not be one already, and should be a ground for disqualification to act as director, etc., of a company for a period of years."[2]

As a measure to combat this fraudulent trading, the committee

[1] Report of the Company Law Amendment Committee. Cmnd 2657 (1926).

[2] Para 61.

recommended the amendment to the Companies Act by the insertion of a section,[3] which recommendation was followed almost verbatim through the various English Companies Acts and appeared as Section 332 of the 1948 Act which provided in subsection (1):

> "If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the court, on application of the official receiver, or the liquidator or any creditor or contributory of the company, may, if it thinks proper to do so, declare that any persons who were knowingly parties to the carrying on of the business in the manner aforesaid shall be personally liable, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct."

The remaining subsections largely followed the wording of our present subsections, Section 424(2)-(4).[4]

In 1939[5] the South African company legislation was amended to include the English provisions almost verbatim to the extent that Richard Brusser has described Section 185 (bis) of the 1926 Companies Act as a "clone" of its British counterpart.[6]

[3] Para 62.

[4] The present provision is Section 630 of the Companies Act of 1985 (C.6).

[5] Inserted by s 102, Act No 23 of 1939 and amended by s 106, Act No 46 of 1952.

[6] R A Brusser: "Actions against delinquent directors", (1985) SACLJ, Vol 9, No 2, at p 33.

The obvious differences between Section 185 (bis) of the 1926 South African Act and Section 332 of the 1948 English Act, on the one hand, and Section 424 of the present South African Act, on the other, are that the former only applied:

(a) to "fraudulent" trading or trading "with intent to defraud creditors of the company" - requirements which are extremely difficult to prove;[7] and

(b) to companies in the course of their being wound up.

The narrow ambit of the sections gave rise to widespread criticism and as early as 1962 the Jenkins Committee noted:[8]

> "But it is further suggested that the Act does not at present provide a sufficient deterrent to dissuade directors from continuing the business of a company which they know to be hopelessly insolvent ..."[9]

The Jenkins Committee went on to recommend the extension of the scope of liability beyond the ambit of fraud to encompass the liability of directors and others who carried out the business of the company in a reckless manner. The Committee, while content to introduce the concept of recklessness to the civil

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[7] F H I Cassim: "Fraudulent or 'reckless' trading and section 424 of the Companies Act" (1981) 98 SALJ 162 at p 162.

[8] "Report of the Company Law Committee" Cmnd 1749 (1962).

[9] Para 499.

liability of the directors specifically recommended that the criminal penalties provided by the section should not extend to reckless trading.[10] As far as criminal liability was concerned, however, the Committee recommended that the penalty for fraudulent trading should apply where the frauds are discovered other than in the course of winding up.[11]

The recommendations of the Jenkins committee have never been adopted by the English legislature,[12] but in South Africa the Van Wyk-De Vries Commission of Enquiry into the Companies Act took up the cudgels the former had brandished:

> "In regard to Section 185 bis most of the witnesses have supported the recommendations of the Jenkins Committee [paragraph 503(b) of its Report] to the effect that the section should be extended to include the carrying on of the business in a reckless manner. The gist of the proposals in regard to Section 185 bis has been that recklessness or gross negligence should be brought within its purview. This proposal, incidently, is one of the measures contemplated in regard to the 'fly by night' private company where the effect of the innovation would be to lift the veil of incorporation and to render the director concerned personally liable for the debts of the company.
>
> It has been suggested that Section 185 bis should expressly include the carrying on of business in insolvent circumstances and the carrying on of business while the liabilities exceed the value of the assets. It may be argued, however, that these instances would invariably be elements of the offence of contracting debts without a reasonable expectation of paying them; that recklessness is a wide concept

[10] Para 503(b).

[11] Para 503(c).

[12] Although the Companies Bill 1973, cl 107 would have implemented the former recommendation. Section 630 of the 1985 Companies Act (C.6) has, however, still not introduced the concept of recklessness.

> which would include that offence; and therefore if the principle of recklessness is imputed into the section, these specific acts would automatically be included."[13]

The Commission went on to say:

> "We have carefully considered the implications of importing into Section 185 bis the concept of recklessness. Although the implications are far-reaching, we have come to the conclusion that its introduction is fully justified. We are confident that in forming a judgment in regard to recklessness, the Court would be loathe to substitute its hindsight for the foresight of directors in ordinary business affairs. It seems to us that the importation of recklessness into Section 185 bis would in practice mainly result in bringing within the net the extreme cases of culpability in business matters of which the 'fly by night' company is an example. The dividing line between recklessness and fraud in business matters seems to be tenuous."[14]

As we have seen above[15] the recommendation of the Van Wyk-De Vries Commission were adopted by the South African Legislature in Section 424 of the Companies Act and Section 64 of the Close Corporations Act.

[13] Para 44.24(b).

[14] Para 44.25(c).

[15] Pages 1-3.

CHAPTER 3

AN OVERVIEW OF THE SECTIONS

Professor Gower[1] points out that the English provision represents a potent weapon in the hands of creditors and that of all the exceptions to the rule in Salamon's case it is probably the most serious attempt which has yet been made to protect creditors generally from the abuses inherent in the rigid application of the corporate entity concept.

Indeed, the ambit of the sections was intended to be wide as pointed out by Denning MR in Re Cyona Distributors Ltd,[2] with reference to Section 332(1) of the English Act:

> "In my judgment, that section is deliberately phrased in wide terms so as to enable the Court to bring fraudulent persons to book ... In short, I think that the words of the section are to be given their full width."[3]

The above dictum of Denning MR was approved in our Courts in the matter of Gordon NO and Rennie NO v Standard Merchant Bank Ltd & Others[4] where De Kock J (with Baker J concurring), having regard to the wide terms in which the language of the section is

1 Principles of Modern Company Law (1979, Stevens & Son, 4th ed), p 115-116.

2 [1967] 1 All ER 281.

3 At 284.

4 1984(2) SA 519 (C).

cast, the ordinary rules relating to the construction of statutes, the history of the section and the above dictum of Denning MR, stated:

> "It seems to me ... that the words of Lord Denning in the Cyona Distributors case supra, the section is deliberately phrased in wide terms so as to enable the Court to bring fraudulent, and now also reckless, persons to book and that the words of the section must be given their full width."[5]

This wide approach accords with the sentiments expressed by the Jenkins Committee and Van Wyk-De Vries Commission and has been welcomed by Richard Brusser in his article, "Section 424 and the single 'reckless or fraudulent' conduct".[6] As shall be seen, however, the approach of the Courts has vacillated from a more restricted interpretation of the section in the earlier decisions such as DorKlerk Investments (Pty) Ltd v Bhayat[7] to the widest interpretation placed on the sections in Cronje NO v Stone and Another[8] and Ex parte Lebowa Development Corporation Ltd[9] to a return to a somewhat more conservative approach in Howard v Herrigel and Another NNO[10] and Ozinsky NO v Lloyd and Others.[11]

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5 At 527H.

6 (1985) SACLJ, Vol 9, No 1.

7 1980(1) SA 443 (W).

8 1985(3) SA 597 (T).

9 1989(3) SA 71 (T).

10 1991(2) SA 660 (AD).

11 1992(3) SA 396 (C).

The wide approach is further highlighted by the provision in the section for both civil and criminal sanctions which exist side by side without prejudice to each other.

CHAPTER 4

THE ELEMENTS OF THE SECTION

1. **By whom may the remedy be brought?**

In terms of Section 424(1) of the Companies Act the remedy therein provided may be utilised by the following persons:

(a) The Master of the Supreme Court;
(b) The liquidator of the company;
(c) The judicial manager of the company;
(d) Any creditor of the company;
(e) Any member of the company;
(f) Any contributory of the company.[1]

The class of persons who may utilise the remedy provided in the case of a company is, of course, wider than that in the case of a close corporation and this is reflected in Section 64 of the Close Corporations Act which provides that the remedy may be utilised by:

(a) The Master of the Supreme Court;
(b) Any creditor of the corporation;
(c) Any member of the corporation;
(d) The liquidator of the corporation.

[1] Pressma Services (Pty) Ltd v Schuttler & Another 1990(2) SA 411 (C) at p 415B-C.

2. **When may the remedy be brought?**

The above persons may utilise the remedy afforded them "when it appears" that the affairs of the company have been carried on by the delinquent person in the manner prescribed by the section. The words used in the allied section of the Close Corporations Act are "if at any time it appears ..." It does not appear that these words have any difference in meaning and that the word "when" as used in Section 424 of the Companies Act is equally as wide as the words "if at any time" used in Section 64 of the Close Corporations Act, but as we shall see the opportunity afforded to the different classes of people to utilise the remedy is not the same:

In terms of the definition section of the Companies Act the term "liquidator" includes any provisional liquidator. This definition of "liquidator" has been adopted in respect of close corporations by Section 66(2)(a)(xi) of the Close Corporations Act. In Bowman NO v Sacks and Others[2] the plaintiff, the liquidator of a company, sought an order against the defendants declaring them personally responsible without any limitation of liability for all the debts and liabilities of the company as at the date of its liquidation. Subsequent to the issue of the aforesaid summons the company in question was dissolved in terms of the provisions of Section 419 of the Companies Act and the

[2] 1986(4) SA 459 (W).

liquidator asked for his release as soon as possible. One of the (main) points taken by the defendants was that upon dissolution of the company, there was a cessation of the existence of the legal person; that the plaintiff's action being in a representative capacity, it accordingly ceased when he had no one to represent, no one to account to and no one to whom the proceeds of the litigation was to be paid. The plaintiff, on the other hand, argued that Section 424 creates a self-contained remedy which the liquidators, despite dissolution, is obliged (or entitled) to pursue in order to "bring the reckless to book".[3] In this regard it is to be noted that our Courts have held that the liquidator is duty bound to make a report of liability under Section 424 and to actively seek ways to employ, in the interests of the insolvent companies' creditors, the teeth provided by the section.[4] Fleming J, in rejecting the plaintiff's argument, found that the answer lay in the extent to which the actions brought by the liquidator in terms of Section 424 is an act of administration of company affairs.[5] The Court found that three considerations pointed to the intention of the legislature in enacting Section 424:

(a) That upon dissolution of a company it disappears as a legal entity and its legal personality is destroyed.

[3] At 460D.

[4] Ex parte De Villiers NO: In re MSL Publications (Pty) Ltd 1990(4) SA 59 (W) at p 82F-G and p 88A-B.

[5] Bowman's case at 460D.

With cessation of existence, there was also an end to corporate activity and acts done thereafter would be acts of mere usurpation.[6]

(b) When the dissolution of the company took place, the statutory duty of the liquidator came to an end, having regard to the very purpose for which liquidators are appointed.[7]

(c) The recovery of assets because of a declaration in terms of Section 424 is a step in the administration of the company in liquidation.[8]

In the circumstances, the Court found that, upon dissolution the legal personality of the company disappeared, the statutory duty of the liquidator towards the creditors came to and end, and the plaintiff could accordingly not be described as a liquidator for the purposes of Section 424, and dismissed the application.

What Fleming J said in regard to the representative capacity of liquidators can, by parity of reasoning, also be applied to judicial managers who fulfil a similar function in the sense of being representative of all the corporate interests

[6] At 463G-H.

[7] 464B-F.

[8] At 464G.

and it may well be that upon the discharge of the judicial manager he is no longer in a position to utilise the remedy in terms of Section 424, but there is no reason, it is submitted, why this construction should apply to the other classes of applicants, e.g. a creditor. Notwithstanding that the Companies Act makes provision for the dissolution of a company to be declared void,[9] why should a creditor who, after the dissolution of the company, establishes a fraud was committed by one of the directors which would entitle such creditor to obtain personal redress from such director, have to go through the rather long-winded procedure of declaring the dissolution void before launching proceedings against such director in terms of Section 424? It is submitted there can be no justification for this where the applicant is acting in a capacity which is not representative of the body of creditors or other persons interested in the company as a whole.

> "Having said this, it is indeed surprising to find, what appears to be a distinct reluctance on the part of corporate litigants to sue management in terms of s 424 while the company is still alive and kicking. There is in fact not one reported case in South Africa in which a creditor or a member has either successfully or unsuccessfully sued management for reckless or fraudulent trading in situations other than in the course of a winding-up. It is not as if management were easy to sue, they are not. There are relatively few viable actions which can be brought against them and so it is all the more puzzling to find that litigants are not making better use of an extremely powerful weapon which they have in their armoury. It is of course true that the words 'or otherwise' are somewhat vague

[9] Section 420 of Act 61 of 1973.

> terms which, as yet, have not been given any precise judicial meaning. But it is equally true that there is ample evidence in the case law of the courts' willingness to give the words of the section 'their full width'. It is submitted that this leaves very little room for advisers to be over-cautious about using s 424 in situations other than in the course of winding-up or a judicial management."[10]

It is to be further noted that Fleming J raised, but left open, the question of whether or not any rights against the directors did not upon dissolution of the company accrue to the State as bona vacantia.[11]

What the learned Judge did, however, make clear was that the inclusion of the words "or otherwise" and "or is" in the 1973 South African Act widened the scope beyond that presently in the equivalent English section to provide the remedy even where the company is not in liquidation.[12] It is submitted that this reasoning applies equally to the words "was or is" as they appear in Section 64 of the Close Corporations Act.

> "There is no reason, however, why legal action under the section cannot be instituted even though the company is solvent. There may be a tactical or psychological advantage in suing or threatening to sue the directors under the section. The chief advantage of making an application under the section (for a declaration that a person should be declared personally

[10] R A Brusser, "Actions against delinquent directors" (1989) Vol 9 SACLJ 33 at p 35.

[11] At 461H.

[12] At 462H.

> liable for the debts of the company) in the course of winding-up proceedings is that the aggrieved person is thus spared the trouble and expense of suing the director or directors in his own name and taking the risk of being ordered to pay his legal costs if the lawsuit is unsuccessful."[13]

Thus, it would seem that in South Africa the remedy can arise at any time, if not from the time of the promotion of the company, in terms of Section 423 of the Act, certainly from its registration, in terms of Section 424, and will continue to be able to be brought, in the case of applicants acting representatively of the corporate interests, for as long as they enjoy that representative status in the light of the judgment in Bowman NO v Sacks and Another, while it is submitted that in the case of a non-representative application there is no limit, subject only, of course, to the ordinary rules of prescription as to when the remedy may be utilised, and this may be done even after the dissolution of the company. Some support for this view is to be found in the Cape case of Pressma Services (Pty) Ltd v Schuttler and Another,[14] in which the applicant sought to declare the respondent's director liable for the debts of the company. The history of the matter was briefly as follows:

[13] R C Williams, "No haven for scoundrels or incompetents -Limited Liability", (1984) 13 Businessman's Law 115 at p 116.

[14] 1990(2) SA 411 (C).

(a) On 15 May 1985 the company was placed under provisional liquidation at the instance of the first respondent.

(b) On 19 June 1985, upon the application of the provisional liquidator, leave was granted in terms of Section 311 of the Companies Act to convene meetings of the creditors of the company for the purposes of considering a certain offer of compromise, whereafter the appropriate meetings were held and the offer accepted by the requisite majorities, although the applicant voted against the offer.

(c) On 10 June 1985, the offer was duly sanctioned in terms of Section 311 of the Act, whereupon, in terms of the offer:

(i) the rights of creditors to obtain payment of their claims were limited to the right to obtain payment as provided for in the offer;

(ii) the creditors ceased to have further claims against the company as the offeror;

(iii) the face value of the creditors' claims were deemed to be reduced by R1,00 in respect of each claim;

(iv) the claims thus reduced were deemed to have been ceded by the creditors to the offeror.

(d) On 24 September 1987, the provisional order of liquidation was retrospectively discharged with effect from 10 July 1985 and the offer of compromise was duly implemented.

(e) On 28 January 1988, the applicant instituted the proceedings in question.

By way of a point in limine, the respondents contended that any claim which the applicant may have had against the company was extinguished upon the offer of compromise being sanctioned and implemented. The applicant then ceased to be a creditor of the company within the meaning of sub-section 424(1) and therefore no longer had the necessary locus standi to institute proceedings in terms of the sub-section.

Van Schalkwyk AJ adopted, with respect, a more liberal interpretation of the section than that adopted by Fleming J in the Bowman case, and an approach more in accord with the views of the Committees and Commissions which preceded the section:

> "As I have mentioned, 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 the abuses at which the section 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 how the words 'creditor ... of the company' are construed. The words could mean either a person who is a 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 (Steyn: "Die Uitleg van Wette", 5th ed at 6-7 and the authorities there cited). The second, extended meaning, would be permissible only on the basis that it is consistent with the true intention of the legislature, while the first, more restricted meaning is not. (Steyn (op cit at 2-4) and the authorities there cited).

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 twofold. The first is to render personally liable all persons who knowingly participate in the fraudulent or reckless conduct of the business of the company. The second is to provide a meaningful remedy at 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 was 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 the 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."[15]

In the circumstances, Van Schalkwyk AJ dismissed the point in limine.

It does not appear that the learned Acting Judge was referred to the judgment of Fleming J in Bowman's case, but it is submitted, with respect, that the more liberal approach of Van Schalkwyk AJ to Section 424(1) is to be preferred as being more in keeping with the spirit of the historical backdrop to the section. The two approaches of the WLD and the CPD in the circumstances appear irreconcilable unless one looks to the capacities in which the applicants approached the Court in each instance. Thus in Bowman's case where the applicant was acting in a representative capacity, once he lost the right of representation, he lost the right to bring the application in terms of Section 424(1), while in the Pressma case the applicant was acting in a non-representative capacity and exercising a personal right in terms of the subsection.

[15] At p 416I-417G.

Thus, it is submitted that, subject only to the laws relating to prescription, an applicant exercising a personal non-representative right would be entitled to utilise the subsection notwithstanding the dissolution of the company.

The views expressed by Van Schalkwyk AJ have recently been qualified and dissented from by Stegmann J in Ex parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (In Liquidation).[16] In this case Stegmann J held that insofar as Van Schalkwyk AJ had found that the rights enjoyed by a creditor in terms of Section 424(1) of the Companies Act are, as a matter of law, incapable of being extinguished, compromised or alienated by a compromise as arrangement proposed, accepted and sanctioned in terms of Section 311 of the Act, the decision was wrong. Inasmuch as Van Schalkwyk AJ had postulated an ambiguity in Section 424(1), suggesting that a "creditor" there may have been confined to existing creditors, or may have been extended to include former creditors who had ceased to be creditors by virtue of a compromise in terms of Section 311 of the Act, this was a curious choice to have postulated, for if the creditors contemplated by Section 424(1) are to be understood as including not only existing creditors, but also former creditors who had by virtue of the compromise disposed of their claims to existing creditors in terms of

[16] 1992(2) SA 95 (W) at p 104-107.

that compromise, the legislature would have created an unlikely situation in which at least some of the company's debts would have to be paid twice over: once to the existing creditors and once to the former creditors. This absolutely could not have been intended by the legislature.[17] There is nothing in Section 424(1) or its context, said Stegmann J, which abridges a creditor's freedom to agree in terms of Section 311 to compromise any rights he may derive from Section 424(1), or to alienate such right or to extinguish them. If the impact of Van Schalkwyk AJ's judgment is that the creditors referred to in Section 424(1) are confined to the company's former creditors and do not include the company's existing creditors by virtue of the compromise then it would appear that the Legislature, when providing the rights created by Section 424(1) in the circumstances therein defined, intended to create a species of incorporeal property which was different from virtually all other incorporeal property in that the holder thereof was to have no power to cede it or compromise it, or extinguish it. In consequence, creditors are placed in the remarkably advantageous position of being free to compromise, alienate or extinguish their claims against a company in terms of Section 311, secure in the knowledge that nothing they may agree to can extinguish their rights in terms of Section 424(1) and to that extent creditors are free to "have their

[17] At 106A-C.

cake and eat it."[18] Such right must pass to the cessionary[19] and the former creditor ceases to enjoy the benefits conferred by Section 424(1).[20]

Whilst it is true that the decisions of Van Schalkwyk AJ and Stegmann J appear irreconcilable, the decision of the former Acting Judge is supported by the decision of the Supreme Court of New South Wales, Australia, in Re Knebel Woodworking Co (Pty) Ltd,[21] a decision to which Stegmann J made no reference in his judgment and who seems to have approached the matter purely from a consideration of common law principles. Another factor which appears to have weighed with Van Schalkwyk AJ is that the plaintiff, Pressma Services (Pty) Ltd., had at the meeting of creditors voted against the scheme but had been bound by the decision of the majority, whereas this was not the case in the matter before Stegmann J.

Hambridge and Luiz welcome the conclusion reached by Van Schalkwyk AJ but point out that it was achieved on the basis of a rather strained interpretation of the term "creditor of the company" and express the view that the

[18] p 107A-C.

[19] p 108C.

[20] p 109B.

[21] (1985) 3 ACLC 739.

matter calls for legislative attention.[22]

Whatever the correct position may be, and whoever may be a creditor for the purpose of Section 424(1), it is respectfully submitted that the basic proposition I have made, namely, that a creditor exercising what is a personal non-representative right would be entitled to utilise either Section 424(1) of the Companies Act or Section 64(1) of the Close Corporations Act, notwithstanding the dissolution of the corporate entity.

3. **Against whom may the remedy be brought?**

Both sections can be invoked against "any person who was knowingly a party" to the carrying on of the business in the manner proscribed therein. This in turn raises two separate questions, namely:

(a) Who is a person for the purpose of the sections?

(b) When is such a person "knowingly a party" to the conduct of the business of the company?

As far as the first enquiry is concerned, the question which arises is whether only a natural person can incur liability in terms of the sections or whether a juristic

[22] "Compromise and Personal Liability under Section 424 of the Companies Act: Two Judicial Approaches" (1991) 3 SA Merc LJ 123 at p 128.

person such as a company can also incur liability?

In Ensor NO v Syfret's Trust and Executor Company (Natal) Ltd,[23] where it was sought to impute liability to a company for the fraudulent conduct of its managers, the Court held that a person who may be vicariously liable for the conduct of another is not hit by the section (Section 185 bis(1) of the earlier Act). Even if the knowledge of the managers of the company were imputed to the company it did not follow that the company was "a party" to the fraud.[24]

This does not, however, mean that a company can never be "a party" and attract liability in terms of the sections. This much was made clear by Booysen J in Anderson and Others v Dickson and Another NNO (Intermenua (Pty) Ltd intervening)[25] where the learned Judge spelt out the circumstances under which a company could incur liability under Section 424 of the Companies Act.[26]

> "It is, of course, correct that s 424 may not be invoked against a company merely upon the basis that it is vicariously liable on account of the conduct or fault of its servants or agents. (Ensor NO v Syfret's Trust and Executor Co (Natal) Ltd 1976(3) SA 762 (D) at 766B; Fisheries Development Corporation of SA Ltd v Jorgensen and Another; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd and Others

[23] 1976(3) SA 762 (N).

[24] At p 768B.

[25] 1985(1) SA 83 (D).

[26] At p 109I-110G.

1980(4) SA 156 (W) at 167E). It does not follow, however, that a company cannot be held liable under s 424. It is equally clear that one has to distinguish between a situation in which it is sought to invoke s 424 to hold a company liable on account of its own conduct or fault and a situation in which it is sought to hold the company vicariously liable on account of the conduct or fault of its servants or agents.

> 'Where fraud is alleged, the difference between these two types of cases becomes particularly important (cf Levy's case and Ravena Plantations Ltd v Estate Abrey 1928 AD 143) because, in a case where it is alleged that the company has been guilty of fraud, the knowledge and the state of mind of the company are obviously relevant, whereas in cases where fraud is alleged on the part of its servants or agents for which the company is vicariously liable, only the state of mind and the knowledge of the servants or agents are relevant, the company being liable without any reference to its state of mind or knowledge.'

(Per HEFER J, as he then was, in the Ensor case at 767H-768A.)

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 - cf the Fisheries Development case at 167H. 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 prospects of meeting its obligations, then such conduct would support a finding that the firstmentioned company, through its directors, was knowingly a party to the reckless or fraudulent carrying on of the business or affairs of the latter company. See the Fisheries Development case at 168E-F. 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)."

As far as the second enquiry is concerned, the tendency of the Courts was initially to look at the standing of the person sought to be held liable in the company hierarchy. This approach was no doubt prefaced by the fact that in the earlier English (and South African) forerunners to Section 424 specific mention was made to the directors of the company, whether past or present. Thus in Re Maidstone Buildings Provisions Ltd[27] the liquidator of a company sought to hold the company secretary, who also acted as financial adviser to the company, liable in terms of Section 332(1) of the English Companies Act, on the basis that in his said capacity as company secretary and financial adviser he had failed to advise the directors that the company was hopelessly insolvent and should cease to trade, thereby preventing the directors from continuing to purchase goods on credit, thus was "knowingly a party to the carrying on of the business" of the company in a fraudulent manner within the meaning of Section 332(1). Pennycuick V-C, on the application of the secretary to strike out the proceedings against him on the grounds that they disclosed no reasonable cause of action, found for him at p 368f-g:

> "The expression 'party to the carrying on of a business' is not, I think, a very familiar one but, as far as I can see, the expression 'party to' must on its natural meaning indicate no more than 'participates in', 'takes part in', or

[27] [1971] 3 All ER 363 (Ch).

> 'concurs 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 a 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."

Whether this exclusion of the potential liability of a company secretary on the basis of his position in the company hierarchy is valid is open to some doubt, given the decision of the Court of Appeal in Panorama Developments (Guildford) Limited v Fidelis Furnishing Fabrics Limited[28] reported earlier in the same volume of the All England Reports,[29] where Lord Denning MR with Salmon and Megaw LLJ concurring held:

> "The second point of counsel for Fidelis is this. He says that the company is not bound by the letters which were signed by Mr Bayne as 'Company Secretary'. He says that, on the authorities, a company secretary fulfils a very humble role; and that he has no authority to make any contracts or representations on behalf of the company. He refers to Barnett, Hoares & Co v South London Tramways Co (1887) 18 QBD 815 at 817 where Lord Esher MR said:
>
> > 'A secretary is a mere servant; his position is that he is do to what he is told, and no person can assume that he has any authority to represent anything at all ...'
>
> Those words were approved by Lord Macnaghten in George Whitechurch Ltd v Cavanagh [1902] AC 117 at 124. They are supported by the decision in Ruben v Great Fingall Consolidated [1906] AC 439, [1904-07] All ER Rep 460; they are referred to in

[28] [1971] 3 All ER 16 (CA).

[29] At p 18g-19c.

> some of the textbooks as authoritative. But times have changed. A company secretary is a much more important person nowadays than he was in 1887. He is an officer of the company with extensive duties and responsibilities. This appears not only in the modern Companies Acts, but also by the role which he plays in the day-to-day business of companies. He is no longer a mere clerk. He regularly makes representations on behalf of the company and enters into contracts on its behalf which come within the day-to-day running of the company's business. So much so that he may be regarded as held out as having authority to do such things on behalf of the company. He is certainly entitled to sign contracts connected with the administrative side of a company's affairs, such as employing staff, and ordering cars, and so forth. All such matters now come within the ostensible authority of a company's secretary. Accordingly I agree with the judge that Mr R L Bayne, as company secretary, had ostensible authority to enter into contracts for the hire of these cars and, therefore, the company must pay for them. Mr Bayne was a fraud. But it was the company which put him in the position in which he, as company secretary, was also to commit the frauds. So the defendants are liable."

From the above it seems that the position which a person holds within the company may only form a portion of the enquiry as to whether or not that person was "knowingly a party" to the carrying on of the business of the company. The reference to directors in both the English and South African sections has been dropped and it is submitted that it serves no purpose to merely look at the standing of a particular person within the company. Thus it would become possible for an outsider to attract liability in terms of the section as in the case of the controller of a puppet director. Indeed in Re Gerald Cooper Chemicals Limited,[30]

[30] [1978] 2 All ER 49 (Ch).

which concerned the position of a loan creditor, Templeman J stated that if it were shown that he accepted money well knowing it had been procured fraudulently, he would be held liable.

In South Africa the matter received the attention of the Appellant Division in Howard v Herrigel and Another NNO[31] where the Court held that the word "knowingly" must be given the same meaning in both subsections (1) and (3) of Section 424.[32] After reviewing the authorities Goldstone JA held:[33]

> "Having regard to the provisions of s 424 and to its purpose, 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 properly to be drawn that the 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. It would not be necessary to go further and prove that the person also had actual knowledge of the legal consequences of those facts.
> In order to be held liable under s 424(1), knowledge of the aforesaid facts is not on its own sufficient. It is further necessary that the person was 'a party to the carrying on of the business in the manner aforesaid.'"

It does not appear that such person need take positive steps to be a party to such conduct as Goldstone JA went on

[31] 1991(2) SA 660 (AD).

[32] At p 673A.

[33] At p 673I-674B.

to point out.[34]

> "In my opinion, it follows that, 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 company's business. His supine attitude may, I suppose, even amount to concurrence in that conduct. Whether such an inference could properly be drawn will depend upon the facts and circumstances of the particular case."

From the above it appears that the enquiry is a factual one to be looked at objectively and determined on the balance of probabilities on the facts of each case.

[34] At p 674G-H.

CHAPTER 5

THE ONUS AND QUANTUM OF PROOF

The onus of establishing recklessness or fraudulent conduct on the part of the respondent rests with the applicant. That is the import of the decision in Dorklerk Investments (Pty) Ltd v Bhyat.[1]

This was the first reported case in which liability under Section 424 was considered.

The applicant company had purchased a certain property which was occupied by a company of which Mr Bhyat was a director and shareholder. The applicant obtained an order for the ejectment of the company from the premises on 12 October 1973. The company then appealed to the Transvaal Provincial Division, which appeal was dismissed on 16 October 1974, whereupon the company, with leave from that Division, appealed to the Appellant Division. This latter appeal was dismissed on 26 September 1985. The effect of all these appeals was, of course, to suspend the order of ejectment.

On the day after the appeal was dismissed by the Appellate Division, the respondent and the other shareholders of the company resolved to apply for the winding up of the company.

[1] 1980(1) SA 443 (W) at 444F.

As the company was allegedly liable to the applicant for payment of the sums of R3 228,64 and R56 610,00 in respect of the company's holding over, this situation posed a decided threat to the latter's interest since there were only limited assets available with which the applicant's claims could be satisfied. The applicant accordingly sought an order in terms of Section 424 against the respondent, declaring him personally liable for these sums. The applicant alleged that the respondent had conducted the business of the company in a reckless manner and with intent to defraud the applicant. It was the applicant's contention that the respondent's aim was to ensure that, after many years of fruitless appeals, which he knew from the outset were doomed to failure, there would be no assets left in the company to satisfy the applicant's claim for damages for holding over when the ejectment order ultimately became effective. During the course of argument, however, this basis for the claim shifted somewhat, as appears from **p 446E-F** of the judgment:

> "The applicant's counsel realised that the conduct of the company in appealing as it had done could not in itself be described as fraudulent or reckless. Consequently he shifted his stance somewhat and contended that it was fraudulent or reckless on the part of the company to ensure that the cupboard was bare when the appeals were over. His submission was that that constituted moral blame as contemplated by the section."

It was further the applicant's view that the sole purpose of the liquidation of the company was to obscure the fact that the

respondent and his brother had denuded the company of its assets so as to render the applicant's claim worthless. It alleged that in the expectation that the successive appeals would meet with failure, the respondent caused the company to pay himself and co-directors sums of which money which were lawfully owing to them in respect of loans made by them to the company which were payable on demand, thereby rendering the cupboard bare without having made any provision for the payment of damages for holding over.

The respondent on the other hand maintained that this was a most unfair accusation. The company had acted on the advice of senior counsel throughout and its resistance to the applicant's attempts to eject it was motivated by the firm belief that the applicant had no right to eject it rather than in an attempt to delay the applicant or defeat creditors. All the payments made were lawfully due and were made openly ex facie the company's books of account. The assets of the company had, furthermore, been disposed of openly and at fair prices. The respondent, therefore, submitted that Section 424(1) had no application and that for this reason alone the applications should be dismissed. The Court agreed with the respondent.

> "In my opinion the respondent is correct in this submission, If it were otherwise, every voidable or undue preference would constitute fraud or recklessness and would render the directors of a company in liquidation liable under s 424(1)."[2]

[2] At p 447A.

The Court found that the applicant's claim was more than a complaint that the respondent caused the company to effect voidable preferences but went on to point out that there are mechanisms in both the Companies Act[3] and the Insolvency Act No 24 of 1936[4] from remedying voidable preferences.

Having stated that the applicant bore the onus of proof, the Court went on to say:

> "In my view, before the Court should make a decision against a director under s 424(1) it should require to be satisfied on the balance of probabilities that the creditor's claim exists and that it is quantified by acceptable evidence."[5]

It is to be noted that the learned Judge assumed that the test was the "balance of probabilities", although this does not seem to have been argued before him.

The Court went on to find that the applicant had not placed sufficient evidence before it to justify its exercising its discretion in terms of Section 424 and accordingly dismissed the application with costs.

[3] Section 340.

[4] Section 29 read with Section 32(1).

[5] At 447F.

This early case was criticised by E P Van Eeden,[6] in that it did not contain a thorough analysis of the somewhat nebulous concept of reckless trading and that confusion as to its scope and meaning still remained. This aspect is dealt with hereunder when later judgments are considered.

J S A Fourie,[7] on the other hand, points out, it is submitted, something that the use of the words "every voidable preference" in the above quoted dictum implies that some voidable preferences could constitute fraud or recklessness, for example, where a director satisfies a financial obligation but conceals it or does not record it in the company books, or where the director's loan account is debited with a fictitious amount which does not accord with the true value of the asset being taken over by the company.

In the more recent decision of Retail Management Services (Edms) Bpk v Schwartz[8] it was held that the plaintiff in an action in terms of Section 424(1) must prove not only the existence of the debt, but also the quantum thereof. In this case the plaintiff had originally sued a company in contract for work done and materials supplied. The company denied liability on the pleadings but before the matter could be decided was placed in liquidation. The plaintiff then proved its claim with the

[6] (1980) 16 SACA 154.

[7] (1980) 43 THRHR 328.

[8] 1992(2) SA 22 (W).

liquidator, who admitted it without objection in its full amount. When the plaintiff thereafter sought to hold the director of the company liable in terms of Section 424 the Court held that the mere fact that a claim had been proved with the liquidators might make the plaintiff a creditor for the purposes of the Insolvency Act, Act No 24 of 1936. This did not mean that the plaintiff was automatically a creditor for the purposes of a claim in terms of Section 424(1). To hold this would be to preclude the defendant director from raising any defences which the company might have (and indeed had raised) in its pleadings. Although this might provide prima facie proof of the existence of an underlying debt, this was not conclusive but cast a burden of rebuttal on the defendant, which could be discharged in the ordinary way. As the evidence led by the plaintiff concentrated solely on the aspect of fraud or recklessness on the part of the director and no expert evidence had been led in respect of the claim (or the particular circumstances required) the plaintiff had proved neither that he was a creditor of the company, nor the quantum of his claim.

As far as the proof of quantum is concerned, the Courts place a heavier burden on a creditor, who is usually in possession of the information necessary to prove his claim, than on other persons such as a liquidator, judicial manager or the Master.[9]

The word "appears" features in both sections and at first blush

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[9] Cronje v Stone 1985(3) SA 597 (T); Retail Management Services Ltd v Schwartz 1992(2) SA 22 (W) at 29E.

it would seem that all that is required is that an applicant in terms of the sections needs make out is a prima facie case. Indeed this was argued before the Full Bench in Joh-Air (Pty) Ltd v Rudman.[10] In this case two companies, Rudvian (Pty) Ltd and Rudvian Freight Services (Pty) Ltd carried on business in competition with the applicant, which carried on business as shipping, clearing and forwarding agents at Johannesburg. Rudvian (Pty) Ltd and Rudvian Freight Services (Pty) Ltd were placed in final liquidation on 4 July 1978 because of their inability to pay their debts due to a loss of income resulting from the fact that the road link to Malawi had been severed. The applicant sought to recover from the respondent, a director of both companies in liquidation, payment of the sum of R5 375,00 being the agreed price of conveying certain goods to Malawi by the applicant at the instance and request of the two companies prior to liquidation. The applicant alleged that the request of the respondent was reckless in that the Respondent knew at that stage that neither of the companies could pay its debts. The respondent denied this, saying that he had been promised a loan of R150 000,00 for which he had already paid part of the raising fee.

As the Court a quo was not called upon to refer the matter to trial in terms of the Rules of Court,[11] it decided the matter on the papers and found that the applicant had failed on a balance

[10] 1980(2) SA 420 (TPD) and commentary in (1980) 16 SACA 312.

[11] Rule 6(5)(g).

of probabilities to show that the respondent had acted recklessly in the conduct of the business of the companies and that suspicion of such conduct may have been aroused, but no more than that[12] and dismissed the application with costs on that basis.

On appeal counsel for the applicant, while conceding that the applicant had not proved a case on the balance of probabilities, contended inter alia that the word "appears" in Section 424(1) of the Act only required the applicant to make out a prima facie case. Counsel's submission was based on the judgment in Timmers and Another v Spansteel (Pty) Ltd[13] where the Full Bench had held in connection with an application in terms of Section 423(1), where the word "appears" is also used, that the standard of proof required by an applicant in terms of that section was no more than a prima facie case.[14]

The Court looked at the purpose of the two sections, namely, that the object of Section 423(1) is merely to ascertain whether an enquiry should be held in regard to delinquent directors, while Section 424(1) envisages a declaration of liability on behalf of the directors, and held:

> "The application for an enquiry into the conduct of the persons enumerated in s 423 is on the basis that it appears that the alleged conduct

[12] At 423H.

[13] 1979(3) SA 242 (T).

[14] At 249A, per Coetzee J.

should be enquired into. In terms of s 424 a totally different situation is dealt with. It must appear to the Court that any business of the company was carried on recklessly as a final determination of liability. Such a final determination can only, in my view, be made on a balance of probabilities and most certainly not on a mere prima facie case. It was for this reason that I have quoted the relief claimed by the applicant in the Court a quo as being a final order compelling the respondent to pay a fixed sum of money and costs.
The applicant is a creditor of the companies in liquidation and is obliged in my view to establish its claim against the respondent on an ordinary basis of proof in civil cases. In the judgment of Timmers' case supra this distinction between an enquiry and a judgment for payment was appreciated."[15]

[15] Joh-Air at p 425H-426A.

CHAPTER 6

THE FORM OF PROCEEDINGS

Both Section 424(1) of the Companies Act and Section 64(1) of the Close Corporations Act provide that the Court may "on the application" of the entitled parties enumerated therein make the appropriate declaration.

The question in regard to these words in Joh-Air (Pty) Ltd v Rudman[1] was whether the legislature meant to make it imperative for the applicant for the relief envisaged therein to proceed by way of motion proceedings rather than by way of action. In that case, in view of the fact that the applicant had elected not to request that the matter be referred to evidence or trial in terms of the provisions of Court Rule 6(5)(g), the Court left open the question.

In Food & Nutritional Products (Pty) Ltd v Neumann[2] the plaintiff excepted to a special plea to its combined summons where the point had been taken that Section 424(1) enjoined the plaintiff to proceed on motion by the use of the word "application". The basis on which the plaintiff alleged there had been fraud or recklessness on the part of the defendant is unimportant for the present purposes. The Court had regard to the earlier cases

[1] 1980(2) SA 420 (TPD).

[2] 1986(3) SA 464 (WLD).

heard in terms of the provisions of Section 424 and the preceding sections thereto[3] and pointed out that save for the Joh-Air case where the question was left open, no objection had been taken to the form of proceedings adopted in each case. The Court had regard to the nature of the motion proceedings in general and the kind of dispute likely to be encountered in proceedings under Section 424(1):

> "It is not difficult, with reference to the purport of s 424, to conceive of the section as a hot bed for profound potential disputes of the nature (of being unable to be satisfactorily determined without the advantages of trial). Allegations of fraudulent or reckless conduct of the business of a company with a claim involving personal responsibility (with criminal liability lurking in the background) would leave few defendants capitulating without resistance. The very subject-matter of the section would accordingly favour the view that a claimant under s 424(1) should have the choice of proceeding by action or motion depending on the circumstances of the particular matter."[4]

The Court further reviewed the various sections of which made references to "applications" and concluded that motion proceedings are not peremptory in terms of the section.

[3] Joh-Air (Pty) Ltd v Rudman 1980(2) SA 420 (T); Dorklerk Investments (Pty) Ltd v Bhyat 1980(1) SA 443 (W); Fisheries Development Corporation of SA Ltd v Jorgensen and Another; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd and Others 1980(4) SA 156 (W); Ensor NO v Syfret's Trust and Executor Co (Natal) Ltd 1976(3) SA 762 (D); Lipshitz and Another NNO v Wolpert and Abrahams 1977(2) SA 732 (A); Gordon NO and Rennie NO v Standard Merchant Bank and Others 1984(2) SA 579 (C).

[4] At p 469H-I.

The Appellate Division recently assumed, without considering the above decision of Schabort J that this section of the Act does not restrict a litigant to application proceedings and that relief thereunder may properly be brought by action proceedings to be correct.[5] The Appellate Division went on to restate the approach of the Courts in cases such as proceedings under Section 424 as espoused by Miller JA in Tamarillo (Pty) Ltd v B N Aitken (Pty) Ltd:[6]

> "A litigant is entitled to seek relief by way of notice of motion if he has reason to believe that facts essential to the success of his claim will probably be disputed. He chooses that procedural form at his peril, for the Court in the exercise of its discretion may decide neither to refer the matter for trial nor to direct that oral evidence on the disputed facts be placed before it, but to dismiss the application (Room Hire Co (Pty) Ltd v Jeppe Street Mansions (Pty) Ltd 1949(3) SA 1155 (T) at 1168). But if, notwithstanding that there are facts in dispute on the papers before it, the Court is satisfied that on the facts stated by the respondent, together with the admitted facts in the applicant's affidavits, the applicant is entitled to relief (whether in respect of all of his claims or one or more of them) it will make an order giving effect to such finding, with an appropriate order as to costs. (Cf Stellenbosch Farmers Winery Ltd v Stellenvale Winery (Pty) Ltd 1957(4) SA 234 (C) at 235; Burnkloof Caterers (Pty) Ltd v Horseshoe Caterers (Green Point) (Pty) Ltd 1976(2) SA 930 (A) at 938). The Court does not exercise a discretion in motion proceedings whether or not to grant claims established by the admitted or undisputed facts; except perhaps in very extraordinary circumstances the applicant has a right to an order in respect of such established claims (Room

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[5] Howard v Herrigel and Another NNO 1991(2) SA 660 (A) at 664.

[6] 1982(1) SA 398 (A).

Hire case at 1166)."

In the circumstances it would seem that the question of whether or not an applicant in terms of Section 424 is restricted to motion proceedings has now been resolved in the negative for once and for all.

CHAPTER 7

THE COMPONENTS OF "CARRYING ON BUSINESS"

The question of what is meant by the phrase "carrying on business" raises two questions:

(i) Whether business must be carried on in the commercial sense of active trading;

(ii) Whether the expression requires a continuous course of conduct or whether it encompasses a single transaction.

(a) The first of these questions has been answered in the negative in the English Courts in Re Sarflax Ltd.[1] In this case Sarflax Limited (the company) had contracted in 1966 to sell certain goods to Italian buyers. The goods were not supplied satisfactorily and the buyers rescinded the contract bringing an action for damages against the company in the English Courts in 1970, which action they allowed to lapse. On 31 January 1971 the company passed a resolution to cease trade as from the close of business on 30 April 1971. It sold its assets, stock in trade and work in progress to its parent company at a price equal to their book value which was set off pro tanto against a debt due to the parent company. Over the next two years the

[1] [1979] 1 All ER 529 (Ch).

company's remaining assets were got in and employed in discharging the company's debtors, but no account was taken of a pending claim in the Italian Courts commenced by the Italian buyers in October 1971.

On 23 September 1971, the company went into voluntary liquidation and a liquidator was appointed. In November 1973, the Italian buyers obtained judgment in the Italian Courts against the company and the liquidator in turn admitted proof of judgment debt in the liquidation. The liquidator then applied for a declaration against the directors of the company and against the parent company in terms of Section 332(1) of the Companies Act 1948:

(1) That from 13 January 1971 until 7 September 1973 the business of the company was carried on with intent to defraud creditors, in particular the Italian buyers, in that the respondents, knowing that the company was unable to pay its debts in full, had caused the company's assets to be distributed amongst its creditors, other than the Italian buyers to the intent that such creditors (and, in particular, the parent company) should be preferred to the buyers; and

(2) That the respondents were jointly and severally liable to pay him a sum equal to the amount of the loss found to have been caused to the buyers, being the amount to which they would have been entitled if all the

company's assets had been retained and distributed pari passu amongst all its creditors, including the buyers.

The respondents moved for the striking out of the summons as disclosing no cause of action on the grounds:

(1) That the mere collection and distribution of assets did not constitute "carrying on business" within the meaning of Section 332(1) of the 1948 Act; and

(2) There was no intention to defraud.

On the first ground the Court found against the respondents and held that the phrase "carrying on business" in Section 332(1) of the 1948 Act is not synonymous with actively carrying on trade. The collection of assets acquired in the course of the business and distribution of the proceeds of those assets in the discharge of business liabilities would constitute "carrying on business" and in the circumstances of the case did so because there was a course of active conduct not merely a passive suffering of undischarged liabilities.[2]

On the second ground the Court held for the respondents on the basis that the granting of a mere preference of one creditor over another did not amount to an intention to

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[2] At 534.

defraud.[3]

(b) As far as the second enquiry is concerned, namely, as to whether a single transaction can constitute "carrying on business" for the purposes of Section 424(1), this aspect has been considered by our Courts in Gordon NO and Rennie NO v Standard Merchant Bank and Others.[4] In this matter the first and second defendants held a beneficial interest of 54% and 36%, respectively, in a company known as Master Development Corporation Limited ("MDC"). The second defendant was also a director of a company known as Rooderust (Pty) Limited, which company was a wholly owned subsidiary of a company known as Master Homes Limited, itself a wholly owned subsidiary of MDC. The third defendant was a director of Rooderust (Pty) Limited, chairman of MDC and the managing director of the first defendant.

The principal asset of Rooderust (Pty) Limited was a township comprising 360 erven, of which more than 300 had been sold to individual purchasers in terms of instalment sales. Towards the end of 1976, MDC ran into financial difficulties and was indebted inter alia to the Bank of Johannesburg as trustee for debenture holders in the sum of R2 million and accrued interest, of which the sum of

[3] Compare Dorklerk Investments (Pty) Ltd v Bhyat in Chapter 5 at p 37 (supra).

[4] 1984(2) SA 519 (C).

R1 million, together with the accrued interest, was payable on or before 28 February 1977, failing which the whole of the debenture debt would become due and payable.

At a meeting of the directors of MDC on 3 November 1976, the third defendant told the meeting that the second defendant was concerned that the cash flow problems of MDC could lead to judicial management or worse and that it was necessary to devise a strategy for the short term future and that the first defendant as a bank would stand behind MDC until the end of March 1977. MDC was unable, by February 1977, without the assistance of the first defendant, to meet its obligations to the Bank of Johannesburg and, when asked to furnish an estimate of the funds required by MDC, the second defendant, when reporting on the estimated cash flow shortage, indicated that as security for monies advanced to MDC, the first defendant should have a mortgage bond over the immovable property owned by Rooderust (Pty) Limited. On this basis the first defendant resolved to make a loan of R1,1 million to MDC on 8 February 1977.

On 22 February 1977, the first defendant, purporting to act in response to an "application" by Rooderust (Pty) Limited, granted a "loan" of R250 000,00 to it against security of a mortgage bond over its immovable property. On 28 February 1977 the second defendant, purporting to act on behalf of Rooderust (Pty) Limited by virtue of a resolution taken at the meeting of the directors of the company on that date,

accepted the terms and conditions of the loan which provided:

(i) the capital and interest was to be repaid to the first defendant on 30 days' notice but in any event not later than 31 December 1977;

(ii) each residential stand forming part of the immovable property secured under the mortgage bond would only be released by the first defendant from the operation of the bond upon payment of the sum of R1 200,00 by Rooderust (Pty) Limited to the first defendant.

Purporting to act pursuant to the loan, the first defendant, with the knowledge and consent of the second and third defendants, paid R200 000,00 to the Bank of Johannesburg on or about 28 February 1977 in partial discharge of the indebtedness of MDC, and R50 000,00 to a company known as Master Management Services ("MMS"), another wholly owned subsidiary of MDC.

A bond having been duly registered, the books of Rooderust (Pty) Limited reflected the transaction as a loan of R250 000,00 by the first defendant to it and as a loan thereafter in the same sum by it to MMS.

On the above facts it was contended by the plaintiffs, the

joint liquidators of Rooderust (Pty) Limited, which was finally wound up on 18 April 1979, that the second defendant had carried on the business of Rooderust in a reckless manner in that:

"(a) he failed to apply his mind to the merits and demerits of the loan insofar as it affected the interests of Rooderust;

(b) he agreed to the encumbrance of the immovable property of Rooderust without ensuring that Rooderust obtained any or adequate security or quid pro quo therefor;

(c) he knew that no reasonable director, acting in the interests of Rooderust, could have agreed to the transaction;

(d) he failed to ensure that the proceeds of the loan would be utilised by Rooderust in its interests;

(e) he failed to ensure that Rooderust was adequately secured when lending the said sum to MMS;

(f) he committed a breach of his fiduciary duty to Rooderust by omitting to act in the interests of that company and by being indifferent as to the repercussions of the transaction to the company and as to its ability to recover the money lent by it to MMS;

(g) he knew or must have known that there was no reasonable prospect of MMS repaying the sum of R250 000 to Rooderust;

(h) he knew that the loan to Rooderust by first defendant and the mortgage bond in favour of first defendant and the loan by Rooderust to MMS had not been discussed nor approved by the board of directors of Rooderust;

(i) he knew that the mortgage bond passed in favour of first defendant covered and included immovable property which he knew had been sold but not yet transferred to purchasers and he knew that such purchasers and other creditors of Rooderust would be prejudiced by the said bond or its terms;

(j) he knew that Rooderust as a result of the said transaction would have severe cash problems, would be unable to meet its current liabilities, and was insolvent;

(k) he failed to ensure that the security (or part thereof) which had been released by the Bank of Johannesburg against payment to it by MDC, was utilised to secure the loan by Rooderust to MMS;

(l) he knew that the major creditors of Rooderust would probably apply for its liquidation if they knew that the said mortgage bond was being registered;

(m) he failed to disclose to the said major creditors of Rooderust the fact that the said mortgage bond was being registered."[5]

The second defendant excepted to the plaintiffs' summons as disclosing no cause of action, it being contended that Section 424(1), properly construed, cannot be applied to a single isolated transaction, the words "carrying on" of business requiring some continuity of action which a single isolated transaction lacked.

In what Brusser[6] has described as a "well reasoned and generally fine judgment", De Kock J (with Baker J concurring) held that the enquiry as to whether a single transaction could attract liability under the section is misconstrued. One should work at the purpose of the section having regard to its wide terms:

[5] At pp 523-524.

[6] 1985 SACLJ Vol 9, No 1, p 11, "S 424 and the single 'reckless or fraudulent' conduct."

> "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 plaintiffs, that, having regard to the purpose of the section and the evil which the Legislature 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 a 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 a series of acts. In either case the guilty person may be visited with personal responsibility in terms of the section."[7]

From the above it is clear that even a single reckless or fraudulent act can attract liability in terms of the section.

[7] At 628G-H.

CHAPTER 8

THE GROUNDS FOR THE REMEDY

At first blush the grounds for the remedy as set out in Section 424 of the Companies Act appear narrower than those set out in Section 64 of the Close Corporations Act.

Section 424(1) of the Companies Act requires the business of the company to be carried on:

(i) recklessly; or

(ii) with intent to defraud the creditors of the company; or

(iii) with intent to defraud creditors of any other person; or

(iv) for any fraudulent purpose.

Section 64(1) of the Close Corporations Act, on the other hand, requires the business of the corporation to be carried on:

(i) recklessly; or

(ii) with gross negligence; or

(iii) with intent to defraud any person; or

(iv) for any fraudulent purpose.

The first obvious difference between the sections is that Section 64 incorporates the notion of gross negligence as well as recklessness. As we shall see below[1] our Courts have regarded the concept of recklessness in Section 424 as including gross negligence and this difference between the sections is therefore more apparent than real.

The second difference between the sections is that Section 424 requires the business of the company to be conducted with intent to defraud "creditors" of either the company or any person, while Section 64 merely requires the business of the corporation to be conducted with intent to defraud "any person". Inasmuch as the concept of fraud encompasses potential prejudice and not only actual prejudice to the victim thereof, it is conceivable that the provisions of Section 64 are wider than Section 424 in this regard, e.g. where a director makes an intentional fraudulent statement to a person who is neither a creditor of the company or a creditor of any other person and the person to whom the representation is made does not act on that misrepresentation. Once again the difference between the sections appears to be more apparent than real as such conduct would undoubtedly be covered by the last qualification of conducting the business "for any

[1] See p 74 et seq (infra).

fraudulent purpose".

It appears then that with the benefit of hindsight into the reported cases set out hereunder the draughtsmen of Section 64 have achieved the same range of liability in terms of recklessness and fraudulent trading by employing greater economy of language.

What is clear from both sections is that the fraudulent or reckless conduct must relate to the carrying on of the business "of the company/corporation". Thus, if a person sought to be held liable in terms of either section who committed a fraudulent or reckless act other than in carrying on the corporate entity's business, the sections do not come into operation. Judicial support for this proposition is to be found in the dictum of Stegmann J in Ex parte Lebowa Development Corporation Ltd.[2]

> "They (the categories dealing with fraudulent ways of conducting the company's business) do not necessarily exhaust all kinds of fraudulent conduct which the directors and other officers of the company may commit. For example, although even an isolated reckless or fraudulent transaction will come within the ambit of s 424 if the person or persons responsible for it conducted it as part of the business of the company and knowing of its reckless and fraudulent nature (cf Gordon NO and Rennie NO v Standard Merchant Bank Ltd and Others 1984(2) SA 519 (C) at 524-5), 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 of 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

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[2] 1989(3) SA 71 (T).

> 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 the actio Legis Aquiliae.
>
> Recklessness may also characterise an act (or omission) by a director or other officer of the company, and even an isolated instance of recklessness may occur in the company or of the business of the company. If it does, and if the responsible director or other officer acted knowingly (or knowingly failed to act) s 424 will be available to assist persons injured by such recklessness, However, a reckless act (or omission) by a director or other officer in the name of the company need not necessarily occur in the carrying on of the business of the company. When it does not, it does not come within the ambit of s 424. The person injured will not then be able to obtain any assistance from a declaration under s 424. He will be confined to his common law right of action for damage caused by negligence."[3]

As Brusser points out, the grounds for actions in terms of the section have received thorough scrutiny and while three possible grounds exist, namely, (a) recklessness; (b) intent to defraud creditors; and (c) any fraudulent purpose, we are dealing with essentially two concepts, namely, fraud and recklessness[4] and I turn to deal with these hereunder.

"FRAUDULENT" TRADING:

As far as the fraudulent ground is concerned the problem is what is meant by "fraud" and how extensive an interpretation is it to receive? The problem is compounded by the fact that in the

[3] At p 110G-111C. See also Ex parte De Villiers & Another NNO: In re Carbon Developments 1992(2) SA 95 (W) at p 107E-H.

[4] (1985) SACLJ, Vol 9, No 2, p 35.

1930's in England within the space of a year, two apparently irreconcilable judgments were given by Maugham J.

In the first case, Re William C Leitch Bros Ltd.[5] Leitch was the governing director of the company and held a debenture of the company's property. When the company got into financial difficulties it found that it could not pay £6 500 for goods supplied. Thereafter Leitch ordered goods to the value of £6 000 which became subject to the charge of his debenture. As chargee Leitch appointed a receiver and was appointed manager. He then collected debts and removed goods to the satisfaction of his debenture and subsequently a declaration was sought that Leitch should be liable for £6 000. Maugham J held that

> "If a company continues to carry on business and to incur debts at a time when there is, to the knowledge of the directors, no reasonable prospect of the creditors ever receiving payments of those debts, it is, in general, a proper inference that the company is carrying on business with intent to defraud."

The Court, in the circumstances, found Leitch liable for the £6 000. There is no doubt that this was a classic case of dishonesty and, as J H Farrar points out[6] it was the basic paradigm of fraudulent trading which the Greene Committee had in mind when preparing their report which led to the introduction of the section.

[5] [1932] 2 Ch 71.

[6] "Corporate Insolvency and the Law", (1976) JBL 214 at p 224.

In the following year in Re Patrick & Lyon Ltd,[7] Maugham J was again required to consider the question of fraud in terms of the forerunner to Section 332. Here an order was sought against a director who was alleged to have continued the business of the company, not for ordinary trading purposes, but to prevent debentures which he held from being invalidated. The Judge said that this was not fraud and, while stating that no Judge has ever been willing to define fraud, he attempted to give some sort of idea of what fraud is referred to here:

> "I will begin by stating that section 275 of the Companies Act, 1929, under which relief is claimed is a very remarkable section and one which is by no means easy to construe. I have myself dealt with one aspect of it in Re William C Leitch Ltd (1); and my brother Eve has dealt with a second branch of it in Re William C Leitch Ltd (2). Without repeating anything which my brother Eve has said or I have said in either of those cases, I will express the opinion that the words 'defraud' and 'fraudulent purposes', where they appear in the section in question, are words which connote actual dishonesty involving, according to current notions of fair trading amongst commercial men, real moral blame."

Clearly this interpretation is much narrower than the one given in Re William C Leitch Ltd and the cases seem irreconcilable.[8] Farrar suggests that one can reconcile these cases on the basis that the latter case sets out the true legal position whilst the former simply states a proposition of evidence as proof and not

[7] [1933] Ch 786.

[8] Brusser, (1985) Vol 9 No 2 SACLA at p 36; Palmer, Company Law, Vol 1, 23rd ed., p 1192.

of substantive law. He points out that while the High Court of Australia expressed doubts with regard to the Leitch case in Hardie v Hanson[9] it was nevertheless followed in the unreported case of Re White and Osmond (Parkstone) Ltd (heard on 30 June 1960), where Buckley J accepted Maugham J's interpretation of the Leitch case, while his application of it enables one to effect the reconciliation with the Patrick and Lyon case in the manner suggested by Farrar:

> "In my judgment, there is nothing wrong in the fact that the directors incur credit at a time when, to their knowledge, the company is not able to meet all its liabilities as they fall due. What is manifestly wrong is if directors allow a company to incur credit at a time when the business of the company is being carried on in circumstances that it is clear that the company will never be able to satisfy its creditors, However, there is nothing to say that the directors who genuinely believe that the clouds will roll away and the sunshine of prosperity will shine upon them again and disperse the fog of their depression are not entitled to incur credit to help them get over the bad time."[10]

The above three cases were all considered by the Court of Appeal in R v Grantham[11] where the question to be decided was whether the appellant who obtained credit where there was no reasonable prospect of the company paying its debts when due or shortly thereafter had carried on the business of the company with "intent to defraud creditors" in terms of Section 332 of the

[9] [1960] 105 CLR 451.

[10] Palmer, Company Law, 23rd edition, 1982, Vol 1, para 84-85, p 1192.

[11] [1984] 3 All ER 166 (CA).

Companies Act, 1948. Lord Lane CJ referred to the cases of Leitch and Patrick & Lyon relied upon by the appellant and pointed out that in those cases Maugham J was expressly disavowing any intention to define "fraud".[12] As far as the White and Osmond case was concerned, the learned Chief Justice pointed out that Buckley J had found in favour of the trader in that instance on the basis that, although he might have been guilty of insufficient care and supervision of his business, he could not be said to have been guilty (in the words of Maugham J) of real moral blame for the debts of the company without limit. Lord Lane held further that in so far as Buckley J was saying that it is never dishonest or fraudulent for directors to incur credit at a time when, to their knowledge, the company is not able to meet all its liabilities as they fall due, the decision was incorrect.[13] In the circumstances, the Court held that where a person who takes part in the management of a company's affairs obtains credit or further credit for the company when he knows there is no reason for thinking that funds will become available to pay the debt when it becomes due or shortly thereafter he may be found guilty of an offence under Section 332 of the Companies Act of carrying on the company's affairs with intent to defraud creditors. It is unnecessary for the prosecution to prove that there was no reasonable prospect of the company's creditors receiving payment of their debts. In the instant case there was ample evidence

[12] At 169J.

[13] At 170D-E.

that the company was being run dishonestly and the conviction of the appellant was upheld.

This decision essentially renders redundant the attempts to reconcile the earlier cases.

By way of an aside, it should be mentioned that a similar dispute as to what constitutes fraudulent trading has arisen in the South African Courts. In three judgments[14] all delivered by Stegmann J in the Transvaal, the more far-reaching interpretation followed by Maugham J in Re William C Leitch Bros Ltd is adopted, while in the Cape the more restrictive approach followed in Re Patrick & Lyon Ltd is adopted.[15]

The three judgments of Stegmann J all relate to applications to the Court in terms of Section 311 of the Companies Act for leave to convene meetings to consider offers of compromise. One of the factors to be placed before the creditors is what possibilities exist of recovering the company's debts from its directors and a duty rests on the liquidator or judicial manager to report on this to the creditors to enable them to consider the offer in a proper and businesslike manner. To the extent

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[14] Ex parte De Villiers NO: In re MSL Publications (Pty) Ltd (In Liquidation) 1990(4) SA 59 (W); Ex parte Lebowa Development Corporation Ltd 1989(3) SA 71 (T); Ex parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (In Liquidation) 1992(2) SA 95 (W).

[15] Cooper v A & G Fashions (Pty) Ltd; Ex parte Millman NO 1991(4) SA 204 (C); Ozinsky NO v Lloyd and Others 1992(3) SA 396 (C).

that what Stegmann J had to say in relation to fraudulent trading (as is set out hereunder) was not germane to the decisions in those judgments, being based in the main on speculation in the absence of such reports by the liquidator and/or judicial manager they may be considered obiter.

The first if these cases was Ex parte De Villiers NO: In re MSL Publications (Pty) Ltd (In Liquidation)[16] where the learned Judge stated:[17]

> "It is improbable that the director or other officer of the insolvent company who placed the order for such goods or services with each of the trade creditors will, when doing so, have volunteered the explanation which a decent sense of commercial morality would have called for. What he ought to have done when ordering goods or services on credit in the circumstances was to have explained to the supplier that the insolvent company had no capital to speak of, and that whether its trade creditors were to receive payment or not would depend on two factors. In the first place it would depend on whether the insolvent company managed to trade profitably in the period ahead. If it did, the prospect of paying its trade creditors would be good. If it did not, it would have no resources of its own from which to pay them, and their prospect of being paid would then depend entirely on the second factor.
> The second factor was the willingness of the so-called providers of loan capital to go on lending more and more money to the insolvent company to pay its other creditors. It would depend, in other words, on the insolvent company managing to go on borrowing from Peter in order to pay Paul. The willingness of the so-called providers of loan capital to keep the insolvent company going might come to an end at any moment. Indeed it obviously did come to an end in July or August 1986, when they finally left the insolvent company to founder with trade creditors unpaid to the extent of R190 000.
> If those explanations had been given, as they should

[16] 1990(4) SA 59 (W).

[17] At p 79I-80G.

> have been, before taking goods and services on credit, it would have been made apparent to the trade creditors that they were in substance being asked to bear a part of the risk of the enterprise on which the insolvent company had seen fit to embark without itself risking anything more than its issued capital of R100. It must be doubtful whether any of the trade creditors would willingly have agreed to take on any part of that risk. They each had the risks of their own businesses to manage. They are unlikely to have wished to take on the additional risks of a business over which they had no control.
> It is therefore to be inferred that the trade creditors have been imposed upon by the directors or other officers of the insolvent company or, to put it more colloquially, they have been taken for a ride. They may even have been defrauded."

The Court went on to say that on the ground of public policy the Court should turn its face against allowing insolvent companies which had traded in insolvent circumstances and lost its capital to be returned to the commercial world.[18]

In Ex parte Lebowa Development Corporation Ltd,[19] which case, although reported earlier than the previous matter, was in fact heard after the latter, Stegmann J followed his previous approach. In fact the learned Judge went further and after examining the English authorities,[20] came to the following conclusion:[21]

> "In other words, to obtain credit for a company without disclosing a known risk that the terms of

[18] At p 86H-87B.

[19] 1989(3) SA 71 (T).

[20] R v Sinclair and Others [1968] 3 All ER 241 (CA); R v Grantham [1984] 3 All ER 166 (CA).

[21] At p 105A-D.

> payment may not be honoured is fraud on the creditor; and the fact that the representor may not have intended to cause a loss, and may honestly have believed that the debt would probably be paid, provides no sufficient excuse. The dishonest exposure of the creditor to the known and undisclosed risk of a possible loss establishes potential prejudice induced by fraudulent intent and amounts to fraud. This is fully in accord with the principles of our law as reflected in, for example, Orkin Bros Ltd v Bell and Others 1921 TPD 92. The facts of that case were, however, such that the fraud could be found to have been committed on the basis that the defendants obtained goods on credit for a company whilst knowing that there was no likelihood that the company would be able to pay since it had no means of payment. As indicated, however, it is not necessary to go so far as to prove that the representor knew that there was no likelihood of payment. It is sufficient to prove that the representor was aware of a risk that the company might not be able to pay in full on due date, even if the representor honestly believed it more likely that the company would be able to pay."

This approach, of course, accords with the dictum of Maugham J in Re William C Leitch Bros Ltd cited above.

Stegmann J then adopted the moral high ground and dubbed trading in insolvent circumstances as "a widespread social evil"[22] which required the Court's recognition that public policy precludes the Court from facilitating, encouraging or condoning.[23]

Despite this approach being labelled as "dogmatic" by Conradie J in Cooper v A & G Fashions (Pty) Ltd; Ex parte Millman No[24] Stegmann J continued to hold that trading by a company in

[22] At p 116D.

[23] At p 117C.

[24] 1991(4) SA 204 (C) at 210D.

insolvent circumstances is to be regarded as dishonest in terms of public policy and considerations of commercial morality and as unlawful unless it pays cash for all goods and services received and always discloses its insolvency to a supplier before accepting his goods on credit. This much appears from his judgment in the subsequent case of Ex parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (In Liquidation).[25] Having commenced his judgment by taking note of Conradie J's criticism of his previous judgments, Stegmann J nonetheless held:[26]

> "However, in the nature of things it is somewhat unlikely that such honourable disclosures would have been made to the trade creditors. For if such disclosures had been made, it is unlikely that the credit would have been granted by the trade creditors. On such information as is presently available it seems more likely that proper enquiry will reveal that the directors and other officers of Carbon Developments were either negligent in failing to establish that after 30 September Carbon Developments was trading in insolvent circumstances and thereby creating a risk for the creditors who were kept in ignorance of that state of affairs; or else that some at least of Carbon Developments' directors and other officers knew of the risks to which they were exposing every trade creditor from whom they thereafter caused or allowed Carbon Developments to order goods or services on credit, and simply chose to keep silent about those risks, and thereby knowingly placed at risk the interests of every such trade creditor without his knowledge or consent.
> The latter conduct, if it can be proved as a matter of probability against either or both of the directors, or against any other officer of Carbon Developments, would be fraud on their part. (Compare Ex parte Lebowa Development (supra at 105A-B, and the authorities cited in the passage from 101C-105D).)
> Moreover, obtaining credit for a company in the course of conducting the company's business at a time when

[25] 1992(2) SA 95 (W).

[26] At p 135I-136D.

> the company is known to be insolvent constitutes the crime of fraudulent trading under the English equivalent of s 424(3) of our Companies Act 61 of 1973. (Compare R v Inman [1966] 3 All ER 414 (CA) at 418D-419E.) There is no reason to doubt that such conduct is similarly proscribed as criminal by s 424(3) of our own Act."

This approach was criticised in the Commercial Law Digest as being based too heavily on policy considerations and as losing sight of commercial reality:

> "It should of course be remembered that in South Africa, there is no minimum capital requirement for a company. A company is free to choose its own proportions of debt and equity. Where, as in this case, it chooses to have a miniscule equity component, there can be no objection to this for there is no statutory requirement that it be more. If it is thought that a company which intends to engage in activities which could result in sudden substantial liabilities exceeding its assets should have a substantial capital base, then this is a requirement based on equitable considerations rather than principles of law and therefore cannot constitute a reason for imposing personal liability on the directors or other officers of the company.
> It should finally be remembered that there are many companies presently trading under insolvent circumstances. Without going through the formalities of judicial management, they are being 'nursed' in the 'sick bays' of banks or they are undergoing major surgery in government bail-outs. There is little doubt that the hope of creditor and company is that the outcome of these remedial measures is the eventual solvency of the company, the reason for them ultimately the health of the company and correspondingly that of their creditors. Surely, there can be nothing wrong with this. In an economy which imposes on companies unexpected reductions in profit margins and unanticipated liabilities, there is surely no inflexible need to liquidate an insolvent company or inject it with new capital. Certainly, the interests of smaller creditors must be protected, and perhaps in circumstances where companies are engaging in compromises with their creditors they should be required to inform the smaller creditors of this. But the implications of this course have yet to be considered. For the man in the street, not to say the Stock Market, would be surprised by the identities of

the companies popularly thought to be solid as a rock and yet trading under insolvent circumstances."[27]

Indeed, based on similar considerations, the approach of Stegmann J has been dissented from and rejected by Van Deventer J in Ozinsky NO v Lloyd and Others:[28]

"In South African legal and commercial practice it has been customary for many decades, for tax and other good reasons, to incorporate private companies with a nominal authorised share capital and to finance them with shareholders' loans and it is general knowledge, not only within the enlightened business community, that many if not most private companies, particularly those controlled by individuals, are not financed with share capital but with members' loans, with the result that if so-called 'inside liabilities' are taken into account, many commercially active private companies will be found to be technically insolvent.
I agree in this connection with the following views expressed by Friedman J and Wilson J in Ex parte Strydom NO: In re Central Plumbing Works (Natal) (Pty) Ltd; Ex parte Spendiff NO: In re Candida Footwear Manufacturers (Pty) Ltd; Ex parte Spendiff NO: In re Jerseytex (Pty) Ltd 1988(1) SA 616 (D) at 623D-J:

> 'Any company which has accumulated losses in excess of its share capital is insolvent in this sense and there are undoubtedly very many companies operating exceedingly successfully in the real business world in this position ...
> All of this is well known in the commercial world and persons who supply goods to companies have regard to the realities of the situation in considering whether or not to grant credit to the company. If they are not satisfied with the company's credit-worthiness they may insist upon being paid cash or refuse to supply. That is their prerogative. The Courts do not make their decisions for them ...'

Apart from the many private companies trading in technically insolvent situations, there must be

[27] (1992) Vol 1, Part 1 CLJ 3 at p 7.

[28] 1992(3) SA 396 (C).

> thousands of undercapitalised and de facto insolvent one-man businesses and other small undertakings who operate quite legitimately and acceptably in the market-place without disclosing their insolvency to their creditors.
> When they accept goods on credit they do not impliedly represent that the value of their assets exceed their liabilities.
> Their suppliers do not involuntarily rely on their customers' factual solvency whenever credit is granted - they rely on the customer's future ability to pay on due date. It is well known that dealers usually base a prospective buyer's credit rating on trade references and credit records. In the case of private companies suretyships are often required from the directors.
> A company, like any other persona when it applies for a credit facility, impliedly represents no more than that it will be able to pay in terms of its undertaking and that it has no reason to believe that it may not be able to pay on due date. (Compare Orkin Bros Ltd v Bell and Others (supra).)"

Having regard to the above, Van Deventer J went on to reject the liquidators' claim against the directors of the company on the ground that they had allowed the company to continue trading and incurred credit in insolvent circumstances without informing potential creditors of the plight of the company.

While I am informed by the attorneys for the liquidators that leave to appeal to the Appellate Division has been granted in the above matter (although no date for hearing of the appeal has as yet been set), the case does illustrate an impasse between the Cape Division and the Transvaal Divisions of the Supreme Court, similar to that found in the English decisions referred to above. Fortunately in South Africa this seems set to be resolved by the Appellate Division in due time.

It is further respectfully submitted that, having regard to what is stated hereunder, Ozinsky's case illustrates a reluctance to afford Section 424 the widest interpretation possible previously afforded by the Courts in the cases like Ex parte Lebowa Development Corporation and Cronje v Stone.[29]

While the question of what constitutes "fraud" for the purpose of Section 332 of the English 1948 Companies Act may be important in English law, in that the English section does not contemplate liability for "reckless" conduct, the distinction is of lesser importance in the South African context for, as was pointed out by Milne J in S v Harper,[30] where conduct falls short of being "fraudulent", it will invariably be caught in the net of "recklessness":

> "It was common cause that, in deciding whether business had been carried on 'recklessly', the test to be applied is an objective one, and that proof of gross negligence is sufficient. S v Goertz 1980(1) SA 269 (C) at 272A-B; S v Parsons en 'n Ander 1980(2) SA 397 (D) at 400; Fisheries Development Corporation of SA Ltd v Jorgensen and Another; Fisheries Development Corporation of SA Ltd v A W J Investments (Pty) Ltd and Others 1980(4) SA 156 (W) at 169-170. The main factors to be taken into account are dealt with at 170B-C of the Fisheries Development Corporation case which, in my view, with respect, correctly sets out the position. It is also clear that, if a company continues to carry on business and to incur debts when there is, to the knowledge of the directors, no reasonable prospect of the creditors ever receiving payment of those debts, it is, in general, a proper inference that the

[29] See p 91 infra.

[30] 1981(2) SA 638 (D).

> company is carrying on business with intent to defraud: a fortiori, where the income of the company is appropriated as loans to employees or directors of the company. R v Wax 1957(4) SA 399 (C) at 404-5 and the authorities there cited, and see Dorklerk Investments (Pty) Ltd v Bhyat 1980(1) SA 443 (W). If, in the particular circumstances, it is for some reason not permissible to infer an intent to defraud, such conduct would almost invariably be reckless."[31]

An examination of what constitutes reckless trading in terms of the section is therefore necessary.

RECKLESS TRADING

As has been pointed out this is a concept which is an innovation in the South African context and distinguishes Section 424 of the Companies Act and Section 64 of the Close Corporations Act from its English counterpart. In the circumstances, there are no English cases which can assist in ascertaining what is meant by the concept of reckless trading.

The first case in point is S v Goertz.[32] In this matter the appellant had formed a company, in which he was the major shareholder and director, which carried on business as an importer of health sandals. During 1975 the company started to trade in insolvent circumstances and ultimately a creditor of the company applied for its liquidation. This application was opposed by the appellant who stated that the company's liabilities exceeded its assets by approximately R8 000,00 and

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[31] At 681A-C.

[32] 1980(1) SA 269 (C).

that R19 000,00 of the assets was represented by stock which could be sold at a 20% profit if the company were allowed to continue trading; whereas a forced sale would realise less than true market value, to the prejudice of creditors. If the Court were to allow the company to continue trading it would be able to pay off all its creditors and once again trade profitably. Accordingly, the company was allowed to carry on business but some four months later a second application for the winding up of the company was successful.

The appellant subsequently completed a statement of the affairs of the company as at the date of winding up.

When the appellant was charged in the Regional Court under Section 424(3) of the Companies Act, the evidence given against the appellant was largely based on a comparison of the figures given by him at the first and second applications for the liquidation of the company, respectively. These figures evidenced that the loss incurred between the first and second liquidation application was five times higher than the loss sustained in a period twice as long, prior to the first liquidation. The liquidator testified that after making provision for understated assets, overheads and the like there was still a shortfall of R11 000,00 which was unaccounted for.[33] The Regional Court accordingly convicted the appellant.

[33] E P Van Eeden, (1980) 16 SACA 122.

On appeal it was contended on behalf of the appellant that the word "recklessly" as used in Section 424(3) was used in the sense of "dolus eventualis" and that to obtain a conviction under the section the State had to prove that the appellant carried on the company's business whilst foreseeing detriment to the company as a real possibility and nonetheless persisted in his conduct.

Whilst drawing a sharp distinction between reckless and dishonest conduct, Fagan J (with Van Winsen J concurring) held that the word "recklessly" was to be given its ordinary meaning unless the context of the section otherwise indicated. In this regard, the Court was guided by the definition of the word "recklessly" and "roekeloos" as contained in the Oxford English Dictionary and Handwoordeboek van die Afrikaanse Taal, respectively, as being:

> "in a reckless manner, carelessly, negligently, without regard to consequences, rashly, through carelessness, accidentally"

and

> "sonder sorg, onverskillig, onbesonne, vermetel, nie op gevaar lettende nie."

The Court was also influenced by the consideration given by the

Appellate Division in S v Van Zyl[34] to the word "roekeloos" as used in Section 138(1) of Ordinance 21 of 1966 in terms whereof it was an offence to drive a vehicle on a public road recklessly or negligently. In that case the Appellate Division had held that the meaning of "roekeloos" ("recklessly") included gross negligence with or without appreciation of risk. In the circumstances, the Court upheld Goertz's conviction and held:

> "The plain meaning of the word 'recklessly' does not limit it to dolus eventualis. I can, furthermore, find no indication that the Legislature intended to place such a restricted meaning upon the word. I can also find nothing disturbing in Legislation aimed at punishing those who carry on the business of a company recklessly in the sense of grossly negligently."[35]

He went on:

> "It was thus not incumbent upon the State to establish that the appellant foresaw detriment to a 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)."[36]

A similar decision was reached by Leon J in S v Parsons[37] with

[34] 1969(1) SA 553 (A).

[35] At 271H.

[36] At p 272A.

[37] 1980(2) SA 397 (D).

reference to S v Goertz.

This inclusion of gross negligence in the concept of recklessness serves to negate the difference in language between Section 424 of the Companies Act and Section 64 of the Close Corporations Act, as mentioned above.[38]

The question as to whether lesser negligence than gross negligence would suffice for liability under the sections was answered in the negative in Fisheries Development Corporation of SA Ltd v Jorgensen and Another; Fisheries Development Corporation of SA Ltd v A W J Investments (Pty) Ltd and Others[39] This was a matter in which two actions with the same plaintiff were consolidated. The plaintiff, a State-owned corporation formed for the purpose of promoting the fishing industry in South Africa, sued the defendants in the first action, A W Jorgensen and A R Jorgensen, jointly and severally, for two sums, R575 827,50 and R362 577,87, which the plaintiff had lent to the International Fishing Corporation (Pty) Ltd ("IFCOR") on the strength of two deeds of suretyship signed by the defendants on 16 October 1974 and 1 November 1975, respectively, IFCOR having been wound up on 1 December 1976. In the second action, the plaintiff averred that A W Jorgensen had ceded to it as collateral security for the repayment of loans made to IFCOR his claims on loan account, which amounted to approximately

[38] See p 58.

[39] 1980(4) SA 156 (W).

R1 million, against A W J Investments, the Jorgensen Family Trust (Pty) Ltd and Bud Holdings (Pty) Ltd. The plaintiff accordingly sued these companies for payment of the claims ceded to it.

The defendants raised several pleas and counterclaims, most of which were rejected or abandoned and ultimately only three remained in issue:

1. The second alternative plea in which the defendants alleged that in January 1976 the plaintiff acquired the total issued shareholding of IFCOR, assumed full control of the management and administration of IFCOR, and appointed its servants or agents, one Stoops and one Du Plessis, as its nominees to the board of directors, and that, from then until IFCOR was placed under a winding-up order, the plaintiff, through its agents and nominees, conducted the business, management and administration of IFCOR in such a manner as to cause prejudice to the defendant as sureties, in consequence whereof the defendants were discharged from liability.

2. In the third alternative plea, the defendants alleged that the plaintiff, through its servants or agents, conducted the business of IFCOR recklessly, that the plaintiff was knowingly a party thereto, and that the defendants, as contingent creditors of IFCOR, were entitled to an order in terms of Section 424 of the Companies Act declaring that

the plaintiff was liable for all the debts and other liabilities of IFCOR, the effect of which order would be to extinguish the principal debt and therefore the liability of the sureties.

3. The fifth and sixth alternative pleas were to the effect that the plaintiff and IFCOR had entered into certain collusive transactions, whereby the latter had made certain payments to the plaintiff at a time when IFCOR was unable to pay its debts and was insolvent. The defendants accordingly sought to have these transactions set aside in terms of Section 31(1) of the Insolvency Act and applied for an order under Section 31(2) of the Act, declaring the plaintiff to have forfeited its claims against IFCOR.

The first difficulty facing the defendants was the decision in Ensor NO v Syfrets Trust and Executor Company (Natal) Ltd[40] in which it had been held that Section 185 (bis)(1) of the 1926 Act could not be invoked against persons not mentioned therein, more particularly not against persons who may be vicariously liable at common law for the conduct of whom it may be invoked.[41] In the circumstances the plaintiff could not be held liable for the conduct of Stoops and Du Plessis.

The Court went on to restate and explain the nature and extent

[40] 1976(3) SA 762 (D).

[41] Ensor's case at 766B, per Hefer J (as he then was).

of the director's common law duties and potential liability for failing to discharge those duties, broadly as follows: The director's duty is one to observe the utmost good faith towards the company and in exercising his duty the director must act independently and make decisions according to the best interests of the company as his principal. Although the director may in fact be representing the interests of the person who nominated him and may in fact be servant or agent of that person, he is, in his capacity as director, obliged in law to serve the interest of the company to the exclusion of the interests of any such nominator, employer or principal. A director as such is thus not the servant or agent of the shareholder who votes for or otherwise procures his appointment to the board of directors and he is therefore not subject to the control of any employer or principal other than the company.

The extent of a director's duty of care and skill and his liability in case of failure to perform that duty depends to a considerable degree on the nature of the company's business and on any particular obligation assumed by or assigned to him. Furthermore, it is necessary to distinguish between the so-called full-time or executive director who participates in the day-to-day management of the whole or part of the company's affairs, and the non-executive director who has not undertaken any special obligation in this regard. In the present case the Court had to consider the position of the latter type and the following points were made with reference to cases decided in South Africa and particularly in England. The non-executive

director is not bound to give continuous attention to the affairs of the company, but his duties are of an intermittent nature to be performed at periodical board meetings and at other such meetings which may require his attention. His duties and qualifications are not equal to those of an auditor or accountant and he need not possess special business expertise or even experience in the business of the company, but must nevertheless exercise the care which can reasonably be expected of a person with his knowledge or experience. A director is not liable for mere errors of judgment and is justified, in respect of duties which may be delegated to some other official, to rely on such official to perform those duties honestly. He is compelled to examine entries in the company's books and is entitled to accept and rely on the judgment, information and advice of the management. In exercising reasonable care a director would, however, not accept information and notice blindly but would give it due consideration and exercise his own judgment in the light thereof.

On the facts the Court found that there had been no recklessness or gross negligence on the part of Stoops and Du Plessis and turned to the question of whether negligence per se was a ground for liability in terms of Section 424. The Court went on to approve Hyman's view in his article, "Directors' Liability for Company's Debts"[42] that had the legislature intended mere negligence to be sufficient for liability under Section 424(1).

[42] 1980 SACLJ E1.

or Section 424(3), it would have used the term "negligently" and not "recklessly". Hyman's view is then that recklessness is a concept to be placed somewhere between mere carelessness and dishonesty. In attempting to explain the concept of gross negligence, Hyman says:

> "... if 'gross negligence' is required as an element of recklessness (as it most 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 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 standards of a reasonable man in regard thereto.
> No attempt at a close definition of gross negligence is feasible or advisable."[43]

In agreeing with these views the Court pointed out that "negligence" as a general concept embraces everything from culpa levissima to culpa latissima, but that "recklessness" in the ordinary sense connotes at the least culpa lata and "recklessly" has a corresponding meaning.[44]

F H I Cassim[45] expressed disappointment after this case that the Courts had not laid down a more objective and higher standard of business competence and skill in the activities of a company for directors, and particularly non-executive directors. Referring

[43] Ibid op cit E7.

[44] At p 170C.

[45] (1981) 98 SALJ 162.

to the test of Romer J in In re City Equitable Fire Insurance Co Ltd[46] that "[a] director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected for a person of his knowledge and experience", Cassim makes the point that the less a director knows and the more inexperienced he is the less the likelihood of his being held liable for negligence in the performance of his duties. It is, in other words, precisely the director's ignorance that saves him from liability.[47] Cassim went on to express the hope that the Appellate Division would adopt a less lenient approach when faced with the question of the director's duty to exercise reasonable care and skill.

The hopes expressed by Cassim were to some extent realised in two subsequent decisions, namely, Cronje NO v Stone and Another[48] and Howard v Herrigel and Another NNO[49] dealt with hereunder.

Cronje's case marks the widest cast of the net of liability in terms of Section 424 yet imposed by our Courts. The case concerned an application by the liquidator of a company called Laserprint (Pty) Limited which had been floated in November 1979 and liquidated on 21 September 1982. The first respondent had at all times been managing director of the company, while the

[46] [1925] Ch 407 (CA) at p 428.

[47] At p 171-172.

[48] 1985(3) SA 597 (T).

[49] 1991(2) SA 660 (AD).

second respondent had joined the board on 26 March 1991. While the Court had no difficulty in holding the first respondent liable in terms of the section, the difficulty arose in respect of the second respondent who had her own successful company which engaged much of her energies and who had been brought into Laserprint (Pty) Limited as a non-executive director and played the role more of a financier. On this context the statements of Margo J in the Fisheries Development case about the duties of a director became relevant. Le Roux J referred to Margo J's judgment and analysed the position of the second respondent as follows:[50]

> "Wat die tweede respondent se posisie betref, is dit ietwat moeiliker. Sy is klaarblyklik in 'n ander posisie omdat sy nie die besturende direkteur van die maatskappy was nie. Sy het ingekom hoofsaaklik as 'n bron van finansiering. Dat daar 'n onderskeid tussen 'n persoon wat 'n besturende direkteur is en 'n ander direkteur blyk afdoende uit die beslissing in die saak van Fisheries Development Corporation of SA Ltd v Jorgensen and Another; Fisheries Development Corporation of SA Ltd v A W J Investments (Pty) Ltd and Others 1980(4) SA 156 (W). Sy was volkome deur die eerste respondent beïnvloed tot op 'n sekere stadium, en sy het sy woord aanvaar vir wat hy aan haar gesê het. Sy was hoofsaaklik beïndruk deur die adreslyste, maar ook deur haar prokureur en ouditeur se voorstellings aan haar. Soos reeds gesê, sy het nie spesifiek kennis gedra van die drukkersbedryf en hoe dit werk nie; sy het 'n redelike naïewe geloof gehad dat 'n kontantinspuiting (soos hy dit genoem het, 'n 'hupstootjie') die maatskappy op sy voete sou stel. Waar hierdie blinde geloof van haar presies vandaan gekom het, is nie duidelik nie want sy het klaar in haar getuienis en in haar beantwoordende verklarings gemeld dat sy nie tevrede was met die werk wat die eerste respondent voorheen vir haar maatskappy verrig

[50] At p 609-610.

het nie."

Having accepted all the above, the learned Judge went on to say that her passive attitude counted against her. She had received numerous warning signals, namely, the ever-increasing overdraft, the auditors' statement that they had reported that the company was trading in insolvent circumstances and the fact that she had settled a creditor's claim of R12 000,00 after a summons had been received in that amount for arrear rental in respect of essential equipment, at which stage she ought to have either resigned as a director or moved for the winding up of the company. Notwithstanding the fact that the second respondent had been the victim of fraudulent non-disclosure on the part of the first respondent and had relied on a report (albeit superficial) given to her by her auditors at her request when she first suspected difficulties in the company's management, Le Roux J, relying on the decision in S v Goertz[51] prefaced his enquiry into the recklessness of the second respondent's conduct by stating that negligence must be judged by considering what a reasonable man with a similar background and education would have done in the circumstances. Having regard to her skill, expertise and educational background and allowing a certain latitude in the light of personal tragedies which had beset her, he concluded that like the "honest but foolish optimist" in S v Goertz, "sy nie voldoende op haar hoede was soos van haar verwag was nie, gesien haar posisie en gesien haar ervaring as 'n

[51] 1980(1) SA 269 (C) (supra).

sakevrou nie."[52]

In the circumstances the Court came to the conclusion that she was knowingly a party to the reckless management of the company.[53]

This decision has been criticised as going too far. Stephanie Luiz[54] suggests that while it is fair to say that the second respondent was negligent it cannot be said she was grossly negligent:

> "As it happens, the second respondent was not in a similar position to that of the accused in Goertz. The latter knew that the company was trading at a loss and he had successfully staved off a bid to have the company liquidated by a creditor. He had sold off old stocks at below cost to make way for new supplies. He had an unfounded optimism in his ability to pull the company straight, despite knowing full well that it was in dire financial straits. The second respondent in Cronje had met the first respondent through the latter's wife, who was a friend of hers. She was very impressed by the first respondent and his company's potential, and had no reason to distrust him. She, like many other people before her, indicated this trust clearly by investing her own money in the company. She was a busy woman, running her own business in Pretoria, and so did not participate in the management of the company. She ought perhaps to have taken a greater or more active interest in the company and not have blindly accepted the first Respondent's assurances. She may have been negligent, and in breach of her duty as a director to exercise care and skill. However, the section requires her to have been reckless.

[52] At p 614I.

[53] At p 614J.

[54] "Extending the Liability of Directors", (1988) 105 SALJ 788.

her conduct with recklessness."[55]

It is respectfully submitted that the view expressed by Luiz is not without merit. What Cronje's case does illustrate, however, is how far the Courts are prepared to go in casting the net of liability in terms of the section.

Indeed Cronje's case seems indistinguishable from Howard's case[56], where the facts are remarkably similar. This case involved an appeal by Mr Howard against a declaration by the Witwatersrand Local Division declaring him liable for the debts incurred by an investment company called Loredo (Pty) Limited. It was common cause that the business of the company had been conducted fraudulently by Howard's co-director, a Mrs Smith, and the company's attorney, a Mr Gelb, who had stolen investors' money and fled overseas. It was common cause that the business of Loredo had been conducted fraudulently in the circumstances and the question was whether Howard was knowingly a party to the business of Loredo being carried on recklessly or with intent to defraud its creditors or for any fraudulent purpose. The involvement of Howard in the affairs of Loredo was certainly more extensive than that of Mrs Cronje in that:

1. He was an experienced businessman and director of a number of companies in Johannesburg, the business of which related

[55] At 793.

[56] Howard v Herrigel and Another NNO 1991(2) SA 660 (AD).

to investment.

2. He was a founder member of Loredo, had had extensive discussions with his co-director, Mrs Smith, during which he laid down certain requirements regarding the appointment of auditors, their access to the company's books and the appointment of the company's attorneys. He also agreed with Smith as to the exact way in which the company would be run prior to its actually being incorporated.

3. He was a signatory to the bank account of the company.

4. From the outset he was appointed the company's public officer.

5. He was actively involved in discussions with clients, in particular one Boshoff, and participated in the recruitment of potential agents and clients.

6. He received regular reports from Mrs Smith as to the progress of the company.

7. He was a signatory to the certificate of investment issued by the company.

8. He received complaints from investors that they were not receiving their interest payments.

9. He actively instructed the company's auditors to prepare trial balance sheets and received reports from them that:

   (a) the books were not available;

   (b) the books, once they became available, had not been completely written up;

   (c) source documents were missing;

   (d) difficulties were experienced in collating the moneys which had been invested with the company and those which had in turn been placed by it on loan on behalf of such investors;

   (e) they were unable to obtain the register containing details of the bonds registered to secure investments.

10. There were in the circumstances numerous alarm bells which should have rung for him.

Having regard to the far greater extent to which Howard was involved with the affairs of Loredo, when compared to the involvement of the defendant in Cronje's case, it seems surprising that the Appellate Division upheld his appeal and discharged him from liability for the debts of Loredo. Both cases were brought by way of application and in both cases a transcript of the enquiries held before the Master was before

the Court. While the Appellate Division held that it was unhelpful and even misleading to classify company directors as "executive" or "non-executive",[57] the Court, while critical of Howard's conduct and finding him to have been negligent in at least three aspects, found that he was not "knowingly a party" to the fraud perpetrated by Smith and Cohen. What is noteworthy from the judgment is that from the outset and throughout the course thereof, Goldstone JA stressed that the finding that he was making was based on the premise that he had to accept the version of Howard where it conflicted with that of the respondents in view of the fact that the form of the proceedings adopted was that of application proceedings rather than by way of action.[58] The reader of the judgment is thus left with a taste in the mouth that if the respondents had elected to proceed by way of action rather than application, the outcome may well have been very different. Whatever the position, it is respectfully submitted that Howard's case marks a check by the Appellate Division on the extremely wide net cast by the WLD in Cronje NO v Stone and Another similar to that evidenced by the judgment in Ozinsky's case in respect of the earlier decision of Ex parte Lebowa Development Corporation.[59] One is left with a feeling that the Courts have suddenly found that they have gone a little too far and are trying to back-pedal.

[57] At p 678A-B.

[58] See for example p 664E-665G; 669A; 671I and 678H-I.

[59] See p 73 above.

CHAPTER 9

THE POWERS OF THE COURT

The powers of the Court in terms of the sections are extremely wide.

In the event of the Court imposing criminal liability in terms of Section 424(3) of the Companies Act it may on conviction sentence an offender to a fine of eight thousand rand or to imprisonment for a period not exceeding two years, or to both such fine and imprisonment.[1] In the case of a contravention of Section 64(2) of the Close Corporations Act, however, for some strange reason the maximum fine which may be imposed has not been amended and remains at two thousand rand, while the remaining provisions are the same.[2] There is no logical basis for this discrepancy and it can only be attributed to a legislative oversight. What is not clear from the Acts, however, is whether the Court must regard the fraudulent or reckless trading collectively or whether it can convict for fraudulent or reckless acts individually and sentence the offender accordingly. This is an aspect which invites legislative intervention. Whatever the situation might be, Van Eeden suggests,[3] it is submitted correctly, that where the offence in terms of Section 424(3) of

[1] Section 441(1)(d).

[2] Section 82(1)(a).

[3] (1980) 16 SACA 312 at p 313.

the Companies Act involves either the intent to defraud or a fraudulent purpose, the provisions of Section 218(1)(d)(iii) of the Act in that in the latter case where a person has been convicted and has been sentenced therefor to imprisonment without the option of a fine or to a fine exceeding one hundred rand such person shall be disqualified from being appointed or acting as a director of a company save under authority of the Court.

In respect of civil liability the Court may in terms of both Section 424 of the Companies Act and Section 64 of the Close Corporations Act declare persons found liable in terms thereof be "personally liable, without any limitation of liability, for all or any of the debts or other liabilities of the company/corporation." The sections go on to empower the Court to give such directions as it may deem fit to give effect to such declaration of liability.

It was originally felt on the authority of Re William C Leitch Bros Ltd[4] that the Court had to make a declaration of liability in a particular amount. This opinion was, however, laid to rest in South African law in Cronje NO v Stone and Another[5] where the point was taken by counsel for the (second) respondent that the liquidator of the company had not claimed a particular sum and accordingly there was not compliance with Section 424(1). The

[4] [1932] 2 Ch 71.

[5] 1985(3) SA 597 (T).

applicant, on the other hand, adopted the attitude that the liquidator was not at that stage in a position to claim a specified amount as not all claims against the company had been proved. Le Roux J pointed out that unlike its English counterpart, Section 424 did not have the equivalent provision of Section 275(6)[6] of the 1929 English Company act, to which the decision of Re William C Leitch Bros Ltd pertained and which provided:

> "Where the declaration under ss(1) of this section is made in the case of a winding-up in England the declaration shall be deemed to be a final judgment within the meaning of para (g) of ss 1 of the Bankruptcy Act 1914."

In the circumstances, having regard to the fact that such a provision was deliberately omitted from the South African legislation, the Leitch case was not authority for the proposition that the Court had to make a declaration in a specified amount.[7] One of the reasons for reaching this conclusion was that the liquidator, Master or judicial manager could hardly be expected to make a final submission of claims against the company before a declaration in terms of the section was obtained. The legislature could not have been ignorant of the normal procedure applicable to proof of claims in insolvent estates and the liability of a creditor who proves a claim for

[6] The forerunner to Section 332.

[7] At p 604F-I. See, however, the dictum in Retail Management Services (Pty) Ltd v Schwartz referred to at p 40 (supra).

a contribution to the liquidation and administration costs and consequent reluctance of creditors to prove claims until such time that they would be assured of receiving a dividend.[8] The learned Judge further held obiter that the situation might be otherwise in the case of a creditor who could be expected to furnish more detail regarding his claim but this was not a general rule.[9]

The next vexed question, which has given rise to considerable academic debate is, in the event of the Court ordering payment in terms of the sections, to whom should it order payment to be made; to the liquidator, the company or the applicant creditors (or class of them)? The confusion arises because of certain decisions in English law:

In Re William C Leitch Bros Limited (2)[10] Eve J held, in dealing with the corresponding Section 275 of the 1929 Companies Act, that if payment is ordered, it would have to be effected to the company for the benefit of creditors generally. It thus falls into the general assets of the company and should be applied accordingly. The defrauded creditor would, in the circumstances have no preferential rights.

[8] At p 604A-B.

[9] At p 604D. See also Retail Management Services (Pty) Ltd v Schwartz 1992(2) SA 22 (W) at 29E.

[10] [1933] 1 Ch 261.

On the other hand, in Re Cyona Distributors Limited[11] where the Court was dealing with an application under Section 332 of the 1948 Companies Act, Lord Denning MR and Dankwerts LJ indicated that where the claim was made by a creditor who had been defrauded, such claim was made for his own account and not in a capacity as a trustee for the body of creditors as a whole. the Court had regard to the wide discretion conferred upon it by Section 332 and indicated that payment could, in the circumstances, be ordered to a particular creditor, to a particular class of creditor or to the liquidator, in which event it would fall into the company's general assets.

A compromise between these two approaches was suggested by Templeman J in Re Gerald Cooper Chemicals Ltd[12] where it was held that the Court could order payment to an applicant creditor, but that this should be subject to the approval of the liquidator to avoid the situation of the respondents being placed in double jeopardy by the possibility of further proceedings once payment had been ordered to the creditor.

There are no South African decisions on point and the assistance to be obtained from the English decisions are, of course, limited to proceedings brought in the course of winding-up, and, while not being definitive in respect of Section 424, do nonetheless carry great weight.

[11] [1967] 1 All ER 281 (Ch).

[12] [1978] 2 All ER 49 (CA).

The South African writers are not unanimous either. Richard Brusser favours the approach suggested by Templeman J in Re Gerald Cooper Chemicals Ltd. He argues that by giving the liquidator the first bite at the cherry, all the creditors would be protected by his decision. At the same time, in the event of the liquidator not electing to bring the action, the Court is not precluded from ordering payment to the applicant creditor directly. Brusser submits that this limitation on the Court's discretion is necessary to prevent the absurd situation arising to prevent the fastest creditor (as opposed to the creditor with the strongest claim) getting in first and obtaining satisfaction of his claim, stripping the offending party bare, and leaving the rest of the creditors without any remedy. This cannot, he argues, be what the legislature intended. When a company is in the course of being wound up, it is right that the liquidator be given the right of way to be able to protect the interests of all creditors if necessary. Where the company is not in liquidation, however, there is no reason why the Court should not exercise its discretion in favour of a particular creditor or class of creditors in terms of Section 424, as the other creditors of the company are still in the position that they can be paid in full and, as such, should have no cause for complaint.[13]

The difficulty with the approach adopted by Brusser is that the

[13] "Actions against delinquent directors", (1985) Vol 9, No 2 SACLJ 33 at p 43.

mere fact that a company is not in the course of winding-up, does not guarantee its commercial insolvency. It also flies in the face of affording the provisions of the section its full width. There is, in any event, nothing to prevent a liquidator from intervening in proceedings instituted by a particular creditor in order to protect the interests of the remaining body of creditors, which is, after all, one of the purposes of his appointment.

Meskin and others[14] approach the matter on the basis of the wording of Section 424. The learned authors state that whatever the position may be under English law, from the wording of Section 424 the intention is not that the delinquent should be responsible to the company with the result that payment by him would be for the benefit of the general body of creditors. The intention is rather that such delinquent is to be responsible in the sense of himself being obliged to pay the debt or debts to which the declaration pertains. The intention is not that the Court should make a declaration in respect of a particular amount, but in respect of a particular debt or particular debts or all the debts. Thus, irrespective of whether or not a company is in winding-up or judicial management, if the creditor obtains a declaration that the delinquent is personally responsible for the debt due to him, the Court can only order payment by the delinquent to such creditor where an order is obtained by a liquidator or judicial manager of a company in

[14] Henochsberg on the Companies Act (1985 Butterworths, 4th ed), Vol 2 at p 749-10.

liquidation or under judicial management to the effect that the delinquent is personally liable for the debts owed only to certain creditors, whether those defrauded or not, the Court can only direct payment to the liquidator or judicial manager for the benefit of those particular creditors if it does not order payment to them directly.

While there is much to be said for this, it is submitted that the approach adopted by Michele Havenga[15] is to be preferred. She suggests one should view the matter having regard to the purpose of the section. The purpose was to provide a meaningful remedy against the abuse contemplated by the legislature and the Court should therefore give the words of the section their full breadth as stated in Gordon NO and Rennie NO v Standard Merchant Bank and Others[16] and in Re Cyona Distributors Ltd.[17] If, in the event of a successful application by a defrauded creditor, the Court was obliged to order payment to the company, there would be uncertainty as to whether such creditor would actually receive anything in the long run. At the same time such creditor would have to foot the bill (or at least a portion of it) for the bringing of the application and might even be required to furnish security for costs.[18] The section is there

15 "Creditors, Directors and Personal Liability under Section 424 of the Companies Act" (1992) 4 SA Merc LJ 63 at p 68-9.

16 1984(2) SA 515 (T) at p 527E.

17 [1967] 1 All ER 281 (Ch) at p 284.

18 Kelly & Hingle v Cohen 1923 WLD 140 at p 145.

for the benefit of creditors and should not act as a deterrent to their proceeding under it. Accordingly, it follows that the Courts have the widest discretion in ordering payment, and in the exercise of its discretion as to when to order payment to be made, should take into account such factors as to whether or not the company is in liquidation or under judicial management, the size of the purse available for distribution and the security held by the creditors, etc. Havenga goes on to suggest that certainty in respect of the order for payment will only be achieved by the amendment to Section 424 and only then will it become a truly effective remedy in the hands of company creditors.

CHAPTER 10

CONCLUSION

Section 424 of the Companies Act and Section 64 of the Close Corporations Act grew from English law since the report of the Greene Commission in 1926. The growth of the South African sections has been more dynamic in that their scope is wider than their English counterpart. The former sections apply whether or not the corporate body is in the process of winding-up, judicial management or otherwise, while the latter applies only in winding-up. In addition, notwithstanding numerous amendments to the English Company Statutes, the English section applies only to fraudulent trading while in South Africa the sections encompass recklessness or gross negligence. Having regard to the historical roots of the sections it is clear that they are intended to be extremely wide in ambit.

Although there is a marked difference in the wording of Section 424 of the Companies Act and Section 64 of the Close Corporations Act, this difference is more apparent than real and the effect of the sections is the same.

The sections may be invoked by the persons mentioned therein at any time. This, however, is not unlimited as a person such as a liquidator or judicial manager can only utilise the section for as long as he acts in such capacity and once he ceases so to act

he loses rights under the section.[1] In the case of a creditor there is a judicial conflict as to whether a creditor still has the right to invoke Section 424 after an offer of compromise has been sanctioned in terms of Section 311 of the Act.[2] The sections may be invoked against any person, which could include a juristic person,[3] who was knowingly a party to the carrying on of the business in the proscribed manner. Such person need not necessarily be part of the company hierarchy and could even be an outsider.[4]

"Knowingly a party" means having actual or constructive knowledge of the facts of the proscribed conduct. The taking of actual or positive steps is not a requirement and the adoption of a supine attitude may in certain circumstances suffice for a person to be "knowingly a party" within the meaning of the section.[5]

The onus of proving that the miscreant is liable under the section rests with the person seeking to invoke it[6] and the

1 Bowman NO v Sacks and Others 1986(4) SA 459 (W).

2 Compare Pressma Services (Pty) Ltd v Schuttler and Another 1990(2) SA 411 (C) with Ex parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (In Liquidation) 1992(2) SA 95 (W).

3 Anderson and Others v Dickson and Another NNO (Intermenna (Pty) Ltd intervening) 1985(1) SA 83 (D).

4 In re Gerald Cooper Chemicals Ltd [1978] 2 All ER 49 (Ch).

5 Howard v Herrigel and Another NNO 1991(2) SA 660 (AD).

6 Dorklerk Investments (Pty) Ltd v Bhyat 1980(1) SA 443 (W).

burden upon him is to prove his case on the balance of probabilities.[7] Such person should prove not only the existence of the debt but also the quantum thereof and the Courts place a heavier burden on a creditor who is usually in possession of the information necessary to prove his claim than in persons such as the liquidator, judicial manager or the Master.[8]

It is open to a person seeking to invoke the section to proceed either by way of action or by way of application, although in the latter case he runs the risk of the Court not referring the matter to trial in the event of a dispute of fact and determining the matter on the papers.[9]

As far as the expression "carrying on business" is concerned this must relate to the business of the company. Fraudulent or reckless trading which does not pertain to the business of the company does not result in the section being applicable.[10] Carrying on business is further not synonymous with active trading and has a wider meaning.[11] Even a single fraudulent or reckless act is sufficient to invoke liability under the

7 Joh-Air (Pty) Ltd v Rudman 1980(2) SA 420 (T).

8 Cronje NO v Stone 1985(3) SA 597 (T); Retail Management SErvices Ltd v Schwartz 1992(2) SA 22 (W).

9 Howard v Herrigel and Another NNO 1991(2) SA 660 (AD); Tamarillo (Pty) Ltd v B N Aitken (Pty) Ltd 1982(1) SA 398 (AD).

10 Ex parte Lebowa Development Corporation Ltd 1989(3) SA 71 (T).

11 In re Sarflax Ltd [1979] 1 All ER 529 (Ch).

sections.[12]

As far as fraudulent trading is concerned there exists in both English and South African decisions a conflict as to what this comprises, i.e. whether continuing to incur credit and trade in insolvent circumstances per se amounts to fraud,[13] but in South Africa this impasse seems set to be resolved by the Appellate Division. The distinction may not be that important in South African law as the South African sections include the concept of recklessness, which includes gross negligence, and will invariably catch in its net conduct falling short of fraudulent conduct.[14]

Reckless conduct does not necessarily mean dishonest conduct[15] and connotes at the least culpa lata, the determination whereof depends on factors such as the nature of the company's business, the duties and position of the miscreant as well as his knowledge and experience.[16] Our Courts have given the concept of

[12] Gordon NO and Rennie NO v Standard Merchant Bank and Others 1984(2) SA 519 (C).

[13] In re William C Leitch Bros Ltd [1932] 2 Ch 71; In re Patrick & Lyon Ltd [1933] Ch 786; Ex parte Lebowa Development Corporation Ltd 1989(3) SA 71 (T); Ozinsky NO v Lloyd and Others 1992(3) SA 396 (C).

[14] S v Harper 1981(2) SA 638 (A).

[15] S v Goertz 1980(1) SA 269 (C).

[16] Fisheries Development Corporation of SA Ltd v Jorgensen and Another; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd and Others 1980(4) SA 156 (W).

"fraudulent trading" by the Transvaal Courts on the one hand,[19] which approach is rejected by the Cape Courts on the other as being dogmatic[20] and out of step with commercial reality.[21] So too the widest ambit of reckless trading was cast in Cronje NO v Stone and Another only to be checked by the Appellate Division in Howard v Herrigel and Another NNO. The impression that remains is that from a reluctant start in Dorklerk Investments (Pty) Ltd v Bhyat the judicial pendulum has done a full swing and is now on the return. This in turn may lead to a reluctance to invoke the sections in certain instances as there may exist uncertainty as to whether particular conduct is proscribed by them. Perhaps after nearly twenty years of service, Section 424 (and Section 64) should, in the light of judicial decisions and academic criticism, be subject to legislative review to clarify the grey areas which exist.

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19 Ex parte De Villiers NO: In re MSL Publications (Pty) Ltd (In Liquidation) 1990(4) SA 59 (W); Ex parte Lebowa Development Corporation Ltd 1989(3) SA 71 (T); Ex parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (In Liquidation) 1992(2) SA 95 (W).

20 Cooper v A & G Fashions (Pty) Ltd; Ex parte Millman NO 1991(4) SA 204 (C).

21 Ozinsky NO v Lloyd and Others 1992(3) SA 396 (C).