

THE LIABILITY OF DIRECTORS FOR FRAUDULENT AND / OR RECKLESS  
TRADING - SECTION 424 OF THE COMPANIES ACT 61 OF 1973

This dissertation is presented in partial fulfilment of the  
requirements of the degree of Masters of Laws, the other  
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by

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INTRODUCTION

One of the chief principles of company law is that a company is a separate legal personality and that the liability of a member in a company, limited by shares, is limited to the amount, if any, unpaid on his shares. A problem down the years has been to prevent these principles being exploited by the controllers of the company, largely its directors and thereby to protect creditors of the company. Although judges have at times regarded certain companies whose misdemeanours have come under the spotlight as a 'cloak' and a 'sham',<sup>1</sup> the fact remains that a company as a separate legal personality comes into existence on the date of incorporation and that no recourse can be founded on the proposition that a company's misdemeanours cause it ipso facto to forfeit its existence.

The most important statutory incursion into the principle of the separate personality of a company is contained in what are commonly known as the fraudulent or reckless trading provisions of the Companies Act 61 of 1973, namely s 424. This provision replaces s 185 bis (1) of the Companies Act 46 of 1926 which was derived from what is presently s 630 of the Companies Act (1985) of the United Kingdom (s 332 of the Companies Act 1948) which is still limited to fraudulent

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<sup>1</sup> R v Grubb (1915) 2 K.B. 683 at 691.

trading only.

### HISTORY

The Australian fraudulent trading provisions presently contained in Section 592(6) of the Corporations Law were, too, inspired by the provisions of the United Kingdom Companies Legislation where the first formulation of a statutory remedy came in response to the Greene report of 1926. The relevant paragraph of the report reads as follows:

"Our attention has been directed particularly to the case (met 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 not only should the person whom the court finds to have been guilty of fraudulent trading ... be subjected to unlimited personal liability, but that any security over assets of the company held by him or on his behalf, and assigned to anyone save a bona fide holder for value, should be charged with liability. Further trading of this character should be made a criminal offence."<sup>2</sup>

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<sup>2</sup> Cmd. 2657 (1926) at p.28.

The particular mischief identified by the Greene report occurred in the context of the imminent winding-up of the company. As a result, the fraudulent trading provisions in the United Kingdom were drafted in such a way that they were limited to companies that were being wound-up and, indeed, only where the fraudulent trading comes to light in the course of the winding-up.

The Jenkins Committee said with reference to the fraudulent trading provisions of the United Kingdom (then s 332 of the Companies Act 1948):

"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."

The Committee accordingly recommended that the civil sanction as contained in s 332(1) be extended to include reckless trading and further, that the criminal offence as contained in s 332(3) be applicable to circumstances other than those where the company is in the process of being wound up.<sup>4</sup> These recommendations, apart from the one relating to circumstances other than those where the company is in the

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<sup>3</sup> Cmd. 1749 (1962) para. 499.

<sup>4</sup> Cmd. 1749 (1962) para. 503(c).

process of winding-up which has now been implemented in the criminal offence of fraudulent trading contained in the present s 458 of the Companies Act 1985, have still not been adopted in English law but the Van Wyk de Vries Commission elected to adopt them.

SECTION 424 OF THE COMPANIES ACT 61 OF 1973: AN ANALYSIS

Section 424(1) thus reads:

"Where 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 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."

In addition, a maximum fine of R8 000,00 or imprisonment for a period not exceeding two years or both may be imposed on

those persons who were knowingly parties to the fraudulent or reckless trading in terms of s 424(3) read with s 441(d).

When one reads the section, one cannot but agree with De Kock J that one is immediately struck by the wide terms in which it is cast.<sup>3</sup> The section applies when any business of the company was, or is, being carried on in a fraudulent manner and empowers and empowers the court to make an order that any person who was knowingly a party to the carrying on of the business in this manner be personally responsible for some or all of the debts or other liabilities of the company. This can all occur whether or not the company is in the process of being wound-up.

"ANY BUSINESS OF THE COMPANY WAS OR IS BEING CARRIED ON"

The crisp issue that came before De Kock J in Gordon NO and Rennie NO v Standard Merchant Bank Ltd and Others 1984 (2) SA 519 was whether a single transaction could be regarded as covered by the words "any business ... was or is being carried on" in the section. De Kock J looked at the intention of the Act and the mischief which the section was attempting to prevent which was plainly to render personally liable any person who is knowingly a party to the carrying on of any business in a fraudulent manner and having regard to

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<sup>3</sup> 1984 (2) SA 519(C) at 527A.

this held that:

"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."<sup>6</sup>

De Kock J cited with approval the words of Lord Denning in *Re Cyona Distributors* ([1967] 1 All ER 281) at 284 where he held with reference to section 332(1) of the English Act (now s 630 of the Companies Act 1985) that:

"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."

"WITH INTENT TO DEFRAUD ... OR FOR ANY FRAUDULENT PURPOSE"

Three possible grounds for actions exist in terms of the section, namely: recklessness; intent to defraud creditors; and any fraudulent purpose. It seems that essentially what is required is a definition of fraudulent intent or purpose

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<sup>6</sup> 1984 (2) SA 519 (C) at 528H.

and recklessness. As far as the fraudulent intent or purpose is concerned, our main guidance has come from English law where the first reported decision on what was then Section 275 of the Companies Act 1929 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 payment of these debts, it is, in general, a proper inference that the company is carrying on business with intent to defraud."

The very next year Maugham J had another opportunity to consider the question of fraud and whilst stating that he was not going to attempt a definition of fraud, he stated that in the context of the section, fraud connoted "actual dishonesty involving, according to current notions of fair trading among commercial men, real moral blame."<sup>7</sup> This conception of fraudulent trading is much narrower than the aforementioned one. Farrar<sup>8</sup> suggests that these cases can possibly be reconciled on the basis that the later statement reflects the true substantive legal position while the earlier one merely

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<sup>7</sup> Re William C. Leitch Bros. Ltd (no 1) [1932] All ER 892 at 895.

<sup>8</sup> In re Patrick and Lyon [1933] All ER 590 at 594.

<sup>9</sup> J H Farrar: Fraudulent Trading in (1980).

gives one practical guidance on the evidence required. It does seem, as noted by Farrar, that in the earlier decision the judge talked about such evidence giving rise to an inference as to the intention to defraud.

Farrar<sup>10</sup> states that a later decision enables one to reconcile the two aforementioned decisions in the manner suggested by himself. Buckley J said in the unreported case of *Re White and Osmond (Parkstone) Ltd*:

"In my judgement there is nothing wrong in the fact that 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 is being carried on in such circumstances that it is clear that the company will never be able to satisfy its creditors. However, there is nothing to say that 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 and to help them to get over the bad time."<sup>11</sup>

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<sup>10</sup> Ibid p341 *Journal of Business Law* 336 at 341.

<sup>11</sup> Unreported decision.

The important thing, therefore, is to consider what the directors' view was of the company's position at the relevant time and it seems that, as noted by Williams, a purely subjective standard is adopted. Thus he notes that genuine optimism on the part of directors, though completely unfounded will negate an intent to defraud.<sup>12</sup> This, essentially, formed the basis of the criticism of the then section by the Jenkins Committee quoted above and led to their recommendation that the section be extended to include reckless trading.

It is to be noted, before turning to the question of reckless trading, that there is authority in the United Kingdom that the courts have lately moved away from a purely subjective standard towards an objective standard. Thus in *R v Grantham*, which was an appeal against a conviction of fraudulent trading under s 332 of the Companies Act 1948. The Court of Criminal Appeal found no error with the following direction to the jury:

"if a man honestly believes when he obtains credit that although funds are not immediately available he will be able to pay them when the debt becomes due or within a short time thereafter, no doubt you would say that is

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<sup>12</sup> R C Williams: *Fraudulent Trading* in (1986) 4 *Company and Securities Law Journal* 14 at 24.

not dishonest and there is no intent to defraud, but if he obtains or helps to obtain credit or further credit when he knows there is no good reason for thinking funds will become available to pay the debt when it becomes due, or shortly thereafter, then though it is entirely a matter for you, this question of dishonesty, you might well think that is dishonest and that there is an intent to defraud."<sup>23</sup>

The crucial words here are "when he knows there is no good reason" and, as noted by Williams,<sup>24</sup> these import a partly subjective and partly objective standard. There must be no good reason for the thinking that funds will become available to pay the debt objectively and the person in question must know that there is no good reason, subjectively. Thus this test, states Williams, means that unfounded optimism will not negate an intent to defraud.

#### "RECKLESSLY"

As has been noted above, the Van Wyk De Vries Commission recommended that recklessness be included as an additional basis for liability under s 424 of the Companies Act 61 of

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<sup>23</sup> [1984] 3 All ER 166 at 169.

<sup>24</sup> R C Williams: Fraudulent Trading in (1986) 4 Company and Securities Law Journal 14 at 25.

1973 which was duly implemented as from the beginning of 1974.

In *S v Goertz*,<sup>15</sup> a criminal prosecution brought under s 424(3), the word "recklessly" fell to be judicially defined for the first time. It was argued on behalf of the appellant that the State had to prove that the appellant carried on a company's business whilst foreseeing detriment to the company as a distinct possibility and nonetheless persisted in his conduct. In other words, the word 'recklessly' was used in the sense of *dolus eventualis*.

Fagan J looked at dictionary definitions giving the ordinary sense of the word *recklessly* and also the case of *S v Van Zyl*<sup>16</sup> where Steyn CJ found that the ordinary meaning of the words 'reckless' and 'roekeloos' included 'cases of recklessness' which did not include as an element 'foresight of the consequences'. Steyn CJ had concluded that the ordinary meaning of *recklessly* included gross negligence with or without appreciation of risk. Fagan J accordingly held that:

"The plain meaning of the word 'recklessly' does not

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<sup>15</sup> 1980 (1) SA 269 (C).

<sup>16</sup> 1969 (1) SA 553 (A).

limit it to dolus eventualis. I can, furthermore, find no indication in s 424(3) that the legislature intended to place such 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 ... I leave open the question of whether lesser negligence would amount to recklessness in terms of s 424."<sup>17</sup>

Fagan J accordingly held that the test of recklessness was an objective one and "what was required was proof that appellant acted recklessly judged by the standards of reasonable businessmen".<sup>18</sup>

Williams states that an objective standard of the kind as laid down in Goertz's case is problematic in the sense that the word 'businessmen' would seem wide enough to embrace from the most naive, inexperienced and uneducated to tycoons of huge concerns. He states that: "Can a single unvarying, objective standard be distilled from such disparate elements."<sup>19</sup> He admits, however, that Fagan J may not have intended to convey that the criterion for recklessness is

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<sup>17</sup> 1980 (1) SA 269 (c) at 271 H.

<sup>18</sup> Ibid p272 A.

<sup>19</sup> R C Williams: Liability for Reckless Trading by Companies: The South African Experience in (1984) 33 The International and Comparative Law Quarterly 684 at 695.

wholly objective as the judge stated that, as quoted above, the plain meaning of the word 'recklessly' does not limit it to dolus eventualis.

Williams<sup>20</sup> argues that the maximum effectiveness would be achieved if recklessness were construed as connoting either a subjective or an objective appreciation of the risk. When one uses this test for recklessness, a person is regarded as having acted 'recklessly' either if he subjectively foresaw the possibility of the harm in question or if a reasonable person would have done so.

Fagan J in his judgment also stated that there was no need to prove dishonesty in order to gain a conviction under Section 424(3) and stated that:

"It is reasonably possible that the offence was committed, not through dishonesty, but by reason of appellant's blind faith in his own ability to pull the company straight. The optimism was unfounded, but it may have been honest."<sup>21</sup>

Fagan J, as noted, left open the question whether any negligence less than gross negligence could amount to

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<sup>20</sup> Ibid p 692.

<sup>21</sup> 1980 (1) SA 269 (c) at 274 C.

recklessness. In Fisheries Development Corporation v Jorgenson and Another,<sup>22</sup> Margo J answered this question in the negative holding that:

"'Negligence' as a general concept embraces everything from culpa levissima to culpa latissima but 'recklessness' in the ordinary sense, connotes at least culpa lata, and 'recklessly' has a corresponding meaning."<sup>23</sup>

In this regard Margo J referred with approval to the views of A Hyman where he said:

"if gross negligence is required as an element of recklessness (as it almost certainly is) the tests will vary greatly from case to case. The criteria will be in the scope of operations of the company concerned, the role, functions and powers of the director, the amount of the debt, the extent of the company's financial difficulties and the prospects, if any, of recovery and many other factors particular to 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 closer definition of gross negligence is

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<sup>22</sup> 1980 (4) SA 156 (WLD).

<sup>23</sup> 1980 (4) SA 156 at 170 C-D.

feasible or advisable."<sup>24</sup>

In *Cronje NO v Stone en 'n Ander*<sup>25</sup> the court was concerned with liability under s 424(1) of a director, who did not participate in the daily management of the company, which was left to a managing director. When it came to assessing the conduct of the director concerned, Le Roux J stated:

"Ek is bereid, en ek dink dit is die regte benadering, dat 'n Hof, wanneer hy iemand se nalatigheid moet beoordeel homself tot 'n mate in die posisie van daardie persoon moet stel, en, hoewel dit nie 'n subjektiewe oordeel is nie, meen ek moet 'n Hof homself plaas in die posisie van die redelike persoon met dieselfde agtergrond en opvoedingskwalifikasies as die een wat hy moet beoordeel."<sup>26</sup>

Le Roux J. thus was prepared to take into account the director's experience and educational background and also certain personal tragedies which had befallen her. However, le Roux J. stated that ultimately, like the director who had 'blind faith in his own ability to pull the company straight'

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<sup>24</sup> A Hyman: Directors Liability for Company's Debts in 1980 SA Company Law Journal E-1 at E-7.

<sup>25</sup> 1985 (3) SA 597 (T).

<sup>26</sup> 1985 (3) SA 597 at 615 E-F.

in Goertz's case, the director concerned had blind faith in the reassurances of the managing director, Stone, who in many respects misled her and gave her wrong information and concluded that, "sy nie voldoende op haar hoede was soos van haar verwag was nie, gesien haar posisie en gesien haar ervaring as 'n sakevrou nie".<sup>27</sup> Le Roux J. stated further that she should have either resigned as a director to safeguard herself or put a stop to the conduct of the managing director in charge of the company by bringing an application for liquidation herself. She was consequently found to have been knowingly a party to the carrying on of the business recklessly.<sup>28</sup>

Luiz<sup>29</sup> notes that it is interesting to see that the general approach adopted by Le Roux J. in assessing the recklessness of the conduct of the director who was not involved in the daily management of the company is largely in line with that laid down in s 214 of the English Insolvency Act which imposes civil liability on directors for wrongful trading. The liability for wrongful trading arises if the director knew or ought to have concluded that there were no reasonable prospects that the company would avoid going into insolvent

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<sup>27</sup> Ibid at 616 I.

<sup>28</sup> Ibid p617 F.

<sup>29</sup> Stephanie Luiz: Extending the Liability of Directors in (1988) 105 South African Law Journal 788 at 793.

liquidation.

In *Ozinsky NO v Lloyd and Others*<sup>30</sup> the plaintiff argued that certain trade debts of a company (by then in liquidation) were incurred fraudulently or recklessly in that the defendants (who were the directors of the company) knew that there existed no reasonable prospect of payment of these debts on due date or had no reasonable grounds to believe that the debts incurred would be paid on due date. It appeared that the directors had been advised by their auditor that the company, which was financed largely by way of shareholders' loans, was trading in insolvent circumstances. However, the auditor did not advise that the company should be liquidated largely because of the financial resources of the managing director (first defendant) which, as in the past, she was willing to make use of in order to assist the company. In addition to this, an increase in the authorised share capital of the company and a conversion of all shareholders' loan accounts to paid-up share capital was planned as part of a capital reconstruction scheme which would restore the solvency of the company when implemented. Unfortunately, the company was placed in liquidation on the advice of first defendant's attorney before the capital reconstruction scheme was implemented due to the fact that it was rumoured that one of their creditors was to apply for the

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<sup>30</sup> 1992 (3) SA 396.

liquidation of the company.

Van Deventer J considered the question of recklessness and stated that the plaintiff bore the onus of proving at least gross negligence by the standard. He confirmed that the test to be applied is an objective one; namely the standard of care that would be observed by a reasonable businessman in conducting the company's business in similar circumstances.<sup>31</sup> The learned judge then stated that in ascertaining whether there had been gross negligence:

"regard should be had to all factors particular to the company concerned, such as the scope of its business operations, its assets and liabilities, working capital, cash flow, access to capital and the prospects of payment when particular debts were incurred. Lastly, the Court should always be careful in adjudging conduct with the benefit of hindsight."<sup>32</sup>

Van Deventer J held further that:

"if a company continues to carry on business and to incur debts when in the opinion of reasonable businessmen, standing in the shoes of the directors,

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<sup>31</sup> 1992 (3) SA 396 at 414 C.

<sup>32</sup> Ibid at 414 D.

there would be no reasonable prospect of the creditors receiving payment when due, it will in general be a proper inference that the business is being carried recklessly."<sup>3</sup>

The learned judge concluded that, in his opinion, such an inference would not be justified due to his findings that the first defendant had personal resources at her disposal and would have continued to finance the company from her personal funds if necessary. A further question which the court had to consider arose from the fact that it was common cause at the conclusion of the trial that the defendants did not advise their prospective creditors that the company's liabilities exceeded its assets before purchasing goods on credit. The plaintiff argued that there is a general duty in these circumstances to disclose the insolvency of the company and non-disclosure in these circumstances would constitute fraudulent conduct.

This submission was based on certain dicta made by Stegmann J. in *Ex parte Lebowa Development Corporation Ltd* 1989 (3) SA 71 (T) at 104H-J, 106G-H, and 112I - 113A and in the subsequent judgment in *Singer NO v MJ Greef Electrical Contractors (Pty) Ltd* 1990 (1) SA 530 (W) at 538G-H. The dictum at 106G-H in *Ex parte Lebowa Development Corporation*

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<sup>3</sup> Ibid at 414 G.

was as follows:

"As indicated above when dealing with fraud, obtaining credit for a company without disclosing a known risk (such as must always be present when a company trades in insolvent circumstances) that the terms of payment may not be honoured is fraud on the creditor, even if the company's representative honestly believed that the risk was not great and that the creditor would ultimately be paid. The fraud is the dishonest exposure of the creditor's economic interests to unauthorised risk. The honest belief that the creditor would not be prejudiced is no answer. The potential prejudice in exposing him to risk is enough."

Van Deventer J interpreted Stegmann J dicta as laying down three general propositions. First, that trading by a company when it is insolvent is dishonest and unlawful unless the company either pays cash or discloses its insolvency before accepting goods on credit. Secondly, that directors or officers who know that a company's liabilities exceed its assets have a duty to disclose this fact whenever they buy on credit on behalf of the company. Thirdly, that failure by a director of a company to disclose the insolvency or to point out the relevant risks to creditors in such circumstances would per se amount to a fraudulent misrepresentation,

irrespective of the state of mind of the director.<sup>34</sup>

Van Deventer J stated that if the three aforementioned propositions is what Stegmann J intended to lay down he would have to disagree with him. With regard to the proposition, Van Deventer J agreed with Professor Christie's suggestion that the test adopted by Vieyra J in Pretorius and Another v Natal South Sea Investment Trust Ltd (under judicial management) 1965 (3) SA 410 (W) at 488 is helpful. Vieyra J stated that there is a duty to disclose where there is an "involuntary reliance of the one party on the frank disclosure of certain facts necessarily lying within the exclusive knowledge of the other such that, in fair dealing, the other's right to have such information communicated to him would be mutually recognised by honest men in the circumstances."

According to Van Deventer J, suppliers do not involuntarily rely on the customers factual solvency whenever they supply on credit, they rely on the company's future ability to pay basing their assessment of this on trade references and credit records. Van Deventer stated further in regard to Stegmann J's views:

"It seems to me, with respect, that Stegmann J in

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<sup>34</sup> 1992 (3) SA 396 at 417 B-D.

proceeding from the premise that non-disclosure of insolvency will as a rule amount to breach of a duty to disclose, which in turn will constitute 'dishonest exposure of the creditors economic interests' to unauthorised risk concluded that the latter element, namely dishonest exposure, would ipso iure establish intent to defraud. The learned judge thus overlooked the requirement of proof of conscious deceit involving the inevitable subjective test which he had in fact so clearly set out elsewhere in his judgment."<sup>33</sup>

Van Deventer J. stated with regard to Stegmann J's third above-mentioned proposition, that a party who relied on a material misrepresentation with intent to defraud as the plaintiff did, bore the onus of proving materiality and conscious deceit on a balance of probabilities. There was no general rule in our law that all material facts had to be disclosed prior to the conclusion of the contract. Thus, according to the learned judge, a failure to disclose a material fact would constitute fraudulent misrepresentation only when there was a duty to disclose and that the representor was aware of and appreciated its existence, and yet deliberately refrained from the disclosure in order to deceive (according to Trollip J. in *S v Heller* 1964 (1) SA 524 at 537).

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<sup>33</sup> Ibid at 418 D.

"KNOWINGLY A PARTY"

Section 424(1) provides that the Court may declare that "any person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be personally responsible, ... for all or any of the debts or other liabilities of the company as the Court may direct". In the recent case of *Howard v Herrigel and Another* NNO<sup>16</sup> Goldstone JA stated that in his opinion the word knowingly had to be given the same meaning in both Section 424(1) and s 424(3) being the criminal offence. The learned judge referred to *S v Parsons en 'n Ander* 1980 (2) SA 397 (D) at 400F where Leon J held that the word meant "met kennis van die feite" and held that:

"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

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<sup>16</sup> 1991 (2) SA 660 (AD).

knowledge of the legal consequences of those facts."<sup>37</sup>

Goldstone JA, however, held that knowledge of the aforesaid facts was not on its own sufficient. It was further necessary that the person in question was a 'party to the carrying on of the business in the manner aforesaid'. Here Goldstone JA distinguished the case of *Re Maidstone Building Provisions Ltd* [1971] 3 All ER 363 where the person sought to be held liable was a company secretary and Pennyquick V C had said of the then s 332(1) of the Companies Act 1948:

"The expression 'party to the carrying on of a business' is not, I think, a very familiar one but, so far as I can see, the expression 'party to' must on its natural meaning indicate no more than 'participates in', 'takes part in' or 'concur in'. And that, it seems to me, involves some positive steps of some nature. I do not think it can be said that someone is party to carrying on of a business if he takes no positive steps at all."<sup>38</sup>

Goldstone JA held that, a director, in turn had an affirmative duty to safeguard and protect the affairs of a company and that it followed that when the person sought to

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<sup>37</sup> 1991 (2) SA 660 at 673 I-J and 674 A.

<sup>38</sup> [1971] 3 All ER 363 at 368 f-g.

be held liable under section 424(1) was 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 in the carrying on of the company's business. His supine attitude may ... 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."

"PERSONAL RESPONSIBILITY ... FOR ALL OR ANY OF THE DEBTS"

The final question to be addressed concerns the sanction in Section 424, as such, which is a declaration that the person concerned "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." The question concerns, essentially, the application of moneys paid by a person pursuant to a declaration of personal responsibility for the company's debts. If the court makes an order imposing personal liability on a director, to whom must the money be paid? Can it be paid directly to the creditor who instituted the action or to the liquidator, or directly into the coffers of the company? Again, here, assistance can be gained from English law which assistance is necessarily limited to claims made in the course of winding-

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" 1991 (2) SA 660 at 674 H.

up.

It was held by Eve J in *Re William C Leitch Brothers Ltd (No. 2)*<sup>40</sup> that the then Section 275 of the Companies Act 1929, "... is not a section which regulates the procedure of an ordinary winding-up or controls the administration of the assets of the company. It is directed solely to the particular offence of fraudulent trading and to attaching personal responsibility therefor to directors who knowingly have been parties thereto. It composes a liability, but does not purport to create any new rights for the creditors. It cannot, in my opinion, be regarded as a section involving any departure from the general scheme of all modes of winding-up ... that is to say, a *pari passu* distribution of the assets. It may well be that the liability it imposes is measured by the debts of the defrauded creditors. But this is not of itself a ground for holding that the ordinary rules of equality are to be disregarded and a preference created in favour of the defrauded class."<sup>41</sup>

Thus Eve J ordered that the moneys recovered by the liquidator under a declaration of personal liability were to be dealt with as general assets of the company and applied

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<sup>40</sup> [1932] All ER 897.

<sup>41</sup> *Ibid* at 898.

accordingly.<sup>42</sup> Thus, presumably under Section 424(1), payment would be made either to the liquidator or into the coffers of the company.

The decision of Eve J in *Re William C Leitch Brothers (No. 2)* was followed by Lord Russell in *Re Cyona Distributors Ltd*<sup>43</sup> where he held that "the right to apply under Section 332 is an asset of the company and that a creditor applying is trustee in so doing for the company".<sup>44</sup> However, Lord Denning in turn, (supported by Lord Danckwerts) was of the opinion that, "the Court has full power to direct its destination and the Court can order the sum to go in discharge of the debt of any particular creditor; or that it shall go to a particular class of creditors, or to the liquidator so as to go into the general assets of the company."<sup>45</sup> Lord Danckwerts stated that any creditor who brings the proceedings at his own expense should be entitled to his reward.<sup>46</sup> It is important to note, however, that the views of all three judges in *Re Cyona Distributors Ltd* are obiter.

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<sup>42</sup> Ibid.

<sup>43</sup> [1967] 1 All ER 281 (C.A.).

<sup>44</sup> Ibid at 288 C.

<sup>45</sup> Ibid at 284 B.

<sup>46</sup> Ibid at 285F.

In Re Gerald Cooper Chemicals Ltd," Templeman J. accepted that the Court could direct payment to a creditor but, at the same time, held that it was essential for the creditor to advise the liquidator of the proceedings in order to give him an opportunity to intervene for the purpose of seeking payment to himself.

It is submitted, with respect, correctly by the learned editors of Henochsberg," that in respect of s 424(1), the intention is that the Court should make a declaration in respect of a particular debt (or debts) and not in respect of a particular amount. Thus the learned editors submit that if a creditor obtains a declaration that the delinquent is personally responsible for the company's debt to such creditor, the Court can only direct payment to such creditor, whether or not the company is in liquidation or under judicial management. Where the company is in liquidation or under judicial management, payment will usually be directed to the liquidator or judicial manager in order to protect all interested parties.

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" [1978] 2 All ER 49.

" Phillip M Meskin (Gen. Editor) Henochsberg on the Companies Act Vol II p 747-748.

AUSTRALIA

As stated above," the Australian fraudulent trading provisions were, like Section 424 of the Companies Act, inspired by the provisions of the United Kingdom Companies Legislation. Accordingly, s 374c(2) of the Uniform Companies Act 1961 made it an offence to be knowingly a party to an applicable company carrying on business with intent to defraud its creditors or for any other fraudulent purpose. Where officer was convicted of such an offence the court might declare that officer to be personally responsible "without any limitation of liability" for payment to the company of an amount sufficient to satisfy all or such of the debts of the company as the court should direct.

The Corporations Law of 1990 retains the principal structural elements of this provision. Thus, s 592(6) of the Corporation Law provides:

"Where:

- (a) a company has done an act (including the making of a contract or the entering into of a transaction) with intent to defraud creditors of the company or of any other person or for any other fraudulent purpose; and

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" Vide p 2.

(b) the company was at the time when it does the act, or becomes at a later time, a company to which this section applies;

any person who was knowingly concerned in the doing of the act with that intent or for that purpose contravenes this subsection".

The first observation is that the section is confined to a "company to which this section applies". Section 589(1) defines the companies to which s 592(6) refers. It declares that the section applies to companies which have been wound up, are in the course of being wound up, have been or are under official management, whose affairs have been or are under investigation, to whose property a receiver or receiver and manager has at any time been appointed, which have ceased to carry on business or are unable to pay their debts, or have entered into a compromise or arrangement with creditors.

Thus, unlike Section 424 of the Companies Act, which applies to companies whether or not they are in the process of winding up, the Australian fraudulent trading provisions are confined to companies in certain prescribed circumstances. This restriction is strengthened by the fact that certain deeming provisions apply. Thus, for example, in terms of Section 589(3) of the Corporations Law a company is deemed to

have ceased to carry on business if and only if the Corporate Affairs Commission has:

"(a) sent to the company by post a letter under s 572(1) and has not, within the next succeeding period of one month from the date of the letter, received an answer to the effect that the company is carrying on business; or

(b) published a notice under s 572(3)".

A consequence of this restricted definition is that significant delays are faced. In this case, for instance, it is at a minimum one month from the time the s 572(1) letter is posted, that the requirements of s 592(6) are met.

Section 592(6) makes provision merely for a criminal offence. The imposition of personal liability of a director requires further court proceedings and, is in fact made dependent upon the prospective defendant first having been convicted of the criminal offence provided for in the aforesaid section. Section 593(2) of the Corporations Law accordingly provides:

"Where a person has been convicted of an offence under Section 592(6) the Court ... may, if it thinks it proper to do so, declare that the ... person shall be

personally responsible without any limitation of liability for the payment to the company of the amount required to satisfy so much of the debts of the company as the Court thinks proper."

Thus, if there is no prosecution and hence no conviction, the civil remedy is altogether lost. Once again, considerable delays are created in that the civil proceedings must wait until the slow-turning wheels of criminal justice have completed their work.

It is also strange as noted by Herzberg<sup>90</sup> that s 592(1) of the Corporations Law imposes automatic civil liability for the unreasonable incurring of a debt while this is not the case with the more serious offence of fraudulent trading under Section 592(6).

Rogers J. in *3M Australia Pty Ltd v Watt* (1985) 9 ACLR 203 at 207 also pointed to another drafting difficulty which potentially exposes directors to double liability. The learned judge noted that under s 557(2) of the Companies Code, the predecessor of s 593(2), a fraudulent director can be ordered to make payment to his company to satisfy its debts. It is possible that the director could also be

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<sup>90</sup> A Herzberg: *Insolvent Trading in* (1991) 9 *Company and Securities Law Journal* 285 at 287.

subject to an earlier civil claim by a creditor under s 556 of the Companies Code (now s 592(1) of the Corporations Law) in respect of the same debt. Thus, Rogers J. noted:

"Again, s 557 deals with an obligation to pay the company. Is this additional to the obligation imposed upon say a director by s 556 to make payment direct to the creditor? Is on payment a discharge of the other obligation?"<sup>31</sup>

As far as the central element of fraudulent trading is concerned, namely the intent to defraud or fraudulent purpose Kitto J. in *Hardie v Hanson*<sup>32</sup> held that:

"an actual purpose, consciously pursued of swindling creditors out of their money had to be established".<sup>33</sup>

The Australian law thus adopts a purely subjective standard and as noted above,<sup>34</sup> genuine optimism on the part of directors, though completely confounded, will negate an intent to defraud. Thus, in *Hardie v Hanson*, the director escaped liability since his intent was shown to be no more

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<sup>31</sup> (1985) 9 ACLR 203 at 207.

<sup>32</sup> (1960) 105 CLR 451.

<sup>33</sup> Ibid at 463.

<sup>34</sup> Vide p9.

sinister than an attempt to trade out of the company's difficulties for the general benefit of members and creditors.

A further anomaly in the Australian fraudulent trading provisions is that if a company incurs a debt fraudulently, Section 593(2) lays down that where a person has been convicted of an offence under s 592(6), the court may declare that person to be personally responsible for the payment to the company of that debt, while, on the other hand, s 592(1) and 593(1) of the Corporations Law provide that where a company incurs a debt in circumstances where there are no reasonable grounds to expect that the company will be able to pay all its debts as they fall due, the court may declare a person convicted of an offence under s 592(1) to be personally responsible to the particular creditor for payment of that debt. Thus, the Corporations Law treats a creditor who is a victim of the less heinous wrong more generously than a victim of the more heinous wrong, namely fraudulent trading.

Thus, as Williams notes,<sup>33</sup> the creditor has scarcely any incentive to make use of the fraudulent trading provisions of the Corporations Law. He obtains no financial advantage from

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<sup>33</sup> R C Williams: *Fraudulent Trading* in (1986) 4 *Company and Security Law Journal* 14 at 21.

a criminal prosecution under s 592(6) and any money recovered from the defendant in further civil proceedings under Section 593(2) afterwards is paid to the company. Consequently the creditor would be well advised to allege the lesser wrong, namely the unreasonable incurring of a debt rather than fraudulent trading.

In one respect, the provisions of the Australian Corporations Law with respect to fraudulent trading are clear. Section 592(6) applies to "any act". Thus it can apply to a single transaction. As noted above,<sup>56</sup> however, the South African courts have in *Gordon NO and Rennie v Standard Merchant Bank Ltd and Others*<sup>57</sup> held that the words 'any business' in s 424 cover a single transaction.

The concept of reckless trading was not introduced into Australian Law but s 592(1) and 593(1) of the Corporations Law which impose criminal and civil liability have considerable common ground with the concept of reckless trading. It is the presence of an intent to defraud which chiefly distinguishes fraudulent trading from reckless trading. It is also the main feature distinguishing fraudulent conduct under s 592(6) of the Corporations Law from the unreasonable incurring of a debt under s 592(1).

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<sup>56</sup> Vide p5.

<sup>57</sup> 1984 (2) SA 519 (C).

Thus s 592(1) of the Corporations Law provides:

"Where:

- (a) a company has incurred a debt
- (b) immediately before the time when the debt was incurred;
  - (i) there were reasonable grounds to expect that the company will not be able to pay all its debts as and when they become due; or
  - (ii) there were reasonable grounds to expect that, if the company incurs the debt, it will not be able to pay all its debts as and when they become due; and
- (c) the company was, at the time when the debt was incurred, or becomes at a later time, a company to which this section applies:

any person who was a director of the company, or took part in the management of the company, at the time when the debt is incurred contravenes this subsection and the company and that person ... are jointly and severally liable for the payment of the debt".

One of the major differences between the present unreasonable incurring of debt provisions and their Uniform Companies Act 1961 predecessors, is that conviction of the s 592(1) offence is not a necessary condition for the imposition of personal liability of directors for the debt. Section 592(1), in addition to creating a criminal offence, declares that directors are jointly and severally liable with their company for the debt incurred where the requirements of that section otherwise apply.

However, the fact that s 592(1) gives rise to both criminal and civil consequences has given rise to problems, as even though s 592(4) makes it clear that civil liability is established on a balance of probabilities, the construction of s 592(1) in civil proceedings has, in some cases, been coloured by the fact that it is also a penal provision. For example, in *Metal Manufacturers v Lewis*,<sup>39</sup> Hodgson J. at first instance held that s 556(1) of the Companies Code, the predecessor and equivalent of s 592(1), requires the same strict construction in civil cases as would apply in a prosecution of a person for the offence. For this reason, if the section is capable of differing interpretations the approach adopted by the courts in civil proceedings will be the one which favours the defendant.

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<sup>39</sup> (1986) 4 ACLC 739 at 747.

A further observation is that prima facie liability in a director can be established under s 592(1) without proof that the individual had any personal knowledge of, let alone involvement in, the incurring of the relevant debt as there is no requirement that the director was 'knowingly a party' as laid down in s 424. Proof by the plaintiff of the substantive elements of s 592(1) shifts onto the director the burden of exculpation. It is only here that questions arise as to the director's knowledge of and participation in the incurring of the relevant debt. Thus, it is a defence to proceedings under the subsection if the director proves:

- (a) that the debt was incurred without his or her express or implied authority or consent; or
- (b) that when the debt was incurred he or she did not have reasonable cause to expect either that the company would not be able to pay all its debts as and when they became due or would be unable to do so if the debt was incurred."

Section 592(1) sets three requirements before a creditor's cause of action is complete. The first is contained in Section 592(1)(a) which requires proof that "a company has incurred a debt". Previous provisions referred to

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" s 592 (2) of the Corporations Law.

"contracting (rather than incurring) a debt". Williams<sup>60</sup> argues that the expression "incurs a debt" means that the section is unequivocally confined to debts which a company incurs voluntarily, as a matter of choice, and that only contractual obligations involving the payment of money fall within its scope. By way of contrast, the reference in s 424 of the Companies Act to debts or other liabilities is generally assumed to extend beyond contractual debts.

The substantive element for the imposition of both criminal and civil liability under the unreasonable incurring of a debt provision is set out in s 592(1)(b). This requires proof that immediately before the time when the debt was incurred:

"(i) there were reasonable grounds to expect that the company will not be able to pay all its debts as and when they became due; or

(ii) there were reasonable grounds to expect that, if the company incurs the debt, it will not be able to pay all its debts as and when they become due".

The question whether a company has the ability to pay its

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<sup>60</sup> R C Williams: *Fraudulent Trading* in (1986) 4 *Company and Securities Law Journal* 14 at 23.

debts is not determined simply on the basis of a surplus of assets over liabilities at any particular instant. A creditor has the onerous burden of providing evidence of the company's financial position at the time when the debt was incurred. As Mahoney JA in *Dunn v Shapowloff*<sup>61</sup> stated:

"What will constitute an ability to pay must be determined in a realistic way, by reference to the facts of the particular case, after taking into consideration, inter alia, the company's assets and liabilities and the nature of them, and the nature and circumstances of the company's activities ... The cash expected to be available at the particular time will be relevant, but not necessarily determinative. It will, for example, be relevant to consider whether the company could be expected to pay the debt, by borrowing; whether, if it must realise assets to raise the money to pay the debt, it can be expected to do this by the relevant time and at what price; and whether what it will have to do in paying and being able to pay the debt will involve the company or its officers in voidable transactions, improper preferences, or breach of obligations under the general law or relevant legislation. It would, I think, be proper in a particular case, for account to be taken

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<sup>61</sup> [1978] 2 NSWLR 235.

appropriately of a promise, legally binding or otherwise, to provide money or financial assistance, by loan, subscription for share capital, or by the provision of a guarantee".<sup>42</sup>

Section 592(1)(b) also specifies that there must be "reasonable grounds" to expect the company's inability to pay. This wording indicates that a company's inability to pay its debts is determined on objective criteria of reasonableness. The section does not, however, state what standard of reasonableness applies. Foster J. in *3M Australia v Kemish*<sup>43</sup> held that the reasonableness of the grounds relied upon by the prosecution and/or civil plaintiff had to be judged by the standard appropriate to a director of ordinary competence. Foster J. held that:

"Clearly material that could provide 'reasonable grounds' for expectation by a person with the qualifications of an auditor, could be very different from material that would provide such grounds for an office boy. I am satisfied from a reading of the whole of the subsection, and having regard to the fact that it prescribes an offence, that the reasonableness of the grounds relied on by the prosecution and/or civil

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<sup>42</sup> Ibid at 244.

<sup>43</sup> (1986) 10 ACLR 371.

plaintiff, must be judged by the standard appropriate to a director or manager of ordinary competence".<sup>44</sup>

This formulation was not, however, followed in a recent decision of Tadgell J. in the Supreme Court of Victoria in the Commonwealth Bank of Australia v Friedrich and Others.<sup>45</sup> Tadgell J. decided that s 556 (the predecessor of s 592(1)) was drafted on the assumption that directors would comply with their general law and statutory duties. Accordingly, the ascertainment of whether there existed reasonable grounds of expectation was to be considered from the perspective of a director properly performing his or her duties. Tadgell J. held that in relation to a claim made against a non-executive director:

"the plaintiff must prove facts which, immediately before the time when the company incurred the relevant debt, gave a person seeking properly to perform the duties of a non-executive director of that company reasonable grounds to say: 'I expect that the company will not be able to pay all its debts as and when they become due'".<sup>46</sup>

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<sup>44</sup> Ibid at p373.

<sup>45</sup> (1991) 5 ACSR 115.

<sup>46</sup> Ibid at 124.

Tadgell J stated in relation to the test laid down in 3M Australia v Kemish that:

"To speak of a director of ordinary, reasonable or average competence or prudence, or indeed of an ordinary reasonable or average director, is to give no very useful description whereas a person seeking properly to perform the duties of a director of a particular company can be identified by reference to more specific criteria of which ordinariness, reasonableness and averageness are, or may be, merely ingredients."<sup>47</sup>

Tadgell J. noted that while the question of what constitutes the proper performance of the duties of a director of a particular company will be dictated by a host of circumstances, every director was now expected by law to be capable of understanding his company's affairs to the extent of actually reaching an informed opinion of its financial capacity. Tadgell J. stated that:

"I think it follows that he is required by law to be capable of keeping abreast of the company's affairs, and sufficiently abreast of them to act appropriately if there are reasonable grounds to expect the company will not be able to pay all its debts in due course and he

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<sup>47</sup> Ibid at 125.

has reasonable cause to expect it".

Tadgell J. concluded that the plaintiff had proved that on or after 31 May 1988 immediately before the time when each relevant debt was incurred, the requirements of s 556(1) (now Section 592(1) of the Corporations Law) were met. Directors acting properly would have demanded the preparation of, and would have considered, adequate management accounts. Tadgell J. noted further that most, if not all, of the statutory requirements of the Companies Code were breached in relation to the company's 1986 and 1987 accounts and that the directors did not become aware of the qualified auditor's reports in relation to these accounts until December 1988. Tadgell J. stated:

"I cannot countenance the notion that a director should be heard legitimately to say that he carried on as a director, and involved himself in the company's affairs in that capacity, for any appreciable time after an annual general meeting had received, approved and adopted annual accounts and an auditor's report thereon and yet did not know the substance of what both the accounts and the auditor's report had to say. It is of the essence of the responsibilities of the directors of a company such as the National Safety Council Victorian

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" Ibid at 126.

Division that they should take reasonable steps to place themselves in a position to guide and monitor the management of the company by reference to information appropriate for the purpose".<sup>69</sup>

Where the requirements of s. 592(1)(a) and (b) are satisfied, Section 592(1)(c) then specifies that liability, whether civil or criminal, arises only where "the company was, at the time when the debt was incurred, or becomes at a later time, a company to which this section applies".

As with the Australian fraudulent trading provisions, Section 589(1) defines the companies to which s. 592(1)(c) refers. Again, the section is confined to companies in certain prescribed circumstances and the same deeming provisions apply as discussed above.<sup>70</sup>

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<sup>69</sup> Ibid at 184.

<sup>70</sup> Vide p30.

CONCLUSION

Section 424, in particular in comparison to the Australian fraudulent trading and unreasonable incurring of debt provisions, seems to be a "potent weapon in the hands of creditors" as stated by Professor Gower in relation to the fraudulent trading section of the United Kingdom legislation.<sup>71</sup> The section applies to all companies without restriction and not to companies, like the Australian provisions, in certain prescribed circumstances.

The emphasis in the Australian unreasonable incurring of a debt provisions on incurring debts favours trade creditors over other types of creditors and, in this regard, it is to be regretted that although the Australian Law Reform Commission has proposed that s 556 of the Companies Code (now s 592 of the Corporation Law) be totally restructured, the same inherent design defect occurs.

It is strange, in the light of the fact that our courts have expressed a willingness to give the words of s 424 "their full width", that the section has not been seized upon more often by creditors, particularly in these harsh economic times. It is true that at the moment uncertainty exists

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<sup>71</sup> Gower: The Principles of Modern Company Law 14th Edition p115.

between the views of Stegmann J. in the Transvaal and Van Deventer J. in the Cape. In this regard, it is to be noted that an appeal has been noted from the judgment of Van Deventer J. in the Cape to the Appellate Division. It is hoped that by clarifying the confusion and providing certainty, s 424 might truly become the "potent weapon" its English counterpart has been described as.

G M HARPER

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