

# Companies Act, 71 of 2008

## Advisory Note: Directors' duties and liabilities

### 1. INTRODUCTION

The Companies Act No 71 of 2008, as amended by the Companies Amendment Act of 2010, ('the Act') will come into **effect on 1 May 2011**. This will replace the Companies Act of 1973 in its entirety. In addition to the Act, **179 regulations** have been promulgated that form an integral part of the Act.

The Act substantially changes the landscape as far as the incorporation, administration and management of companies are concerned. Of particular importance is the potential increase in **directors' and officers' personal liability** in terms of the Act. The purpose of this document is to provide a high-level overview of some of the provisions of the Act that are of relevance to the topic of personal liability.

### 2. DIRECTORS' AND OFFICERS' PERSONAL LIABILITY

It goes without saying that all provisions of the Act have to be complied with at all times and that non-compliance may have certain consequences. Some of the material provisions in this regard are briefly discussed below.

It is important to note that for purposes of **s75 to s78** of the Act, the **definition of "director"** includes an alternate director, a prescribed officer and a person who is a member of a committee of the board, irrespective of whether the person is also a member of the board.

**"Prescribed officer"** is defined in the Regulations (Reg. 38) as "Despite not being a director of a particular company, a person is a "prescribed officer" of the company for all purposes of the Act if that person:

- exercises general executive control over and management of the whole, or a significant portion, of the business and activities of the company; or
- regularly participates to a material degree in the exercise of general executive control over and management of the whole, or a significant portion, of the business and activities of the company.

**Practical implication:** Based on the above it is important for companies to identify the prescribed officers in the company in order to ensure that the relevant individuals are appropriately informed as to their duties and responsibilities. A number of other provisions in the Act also make reference to the prescribed officers, such as disclosure of remuneration. For this reason as well, a list of prescribed officers will be required in each company.

Having considered some of the more important definitions for purposes of this document, attention is drawn to the important provisions contained in s75 to s78 of the Act as well as a number of additional provisions relating to potential liability.

## 2.1. s75: Personal financial interest

A director who has a personal financial interest in a matter to be considered at a meeting of the board (or knows that a related person has a personal financial interest):

- **must** disclose this interest at the meeting;
- **must** disclose material information known to the director and **may** disclose any observations or insights if so requested by other directors;
- **must** immediately leave the meeting after making the disclosures contemplated above;
- **must not** take part in the consideration of the matter; and
- **must not** execute any document in relation to the matter unless so directed by the board.

"Related person" is defined in s1 of the Act and further explained in s75(1)(b). There are also a number of **exceptions** to the general rule of disclosure as set out above.

In certain instances, where there is a single director but multiple shareholders, the director may have to refer the matter in which he has a personal financial interest to shareholders.

**Practical implication:** A policy on the disclosure of personal financial interest, based on the relevant provisions of the Act, need to be adopted by the board to avoid any uncertainty, misunderstandings or potential disputes.

## 2.2. s76: Standards of directors conduct

Of particular importance in this Act is s76 (standards of directors conduct) and s77 (liability of directors and prescribed officers).

s76 sets the following **standards for directors' and officers' conduct**:

- not to use the position or information obtained in that capacity for personal (or third party) gain or to harm the company;
- to disclose any material information to the board, unless it is in the public domain or the individual is prevented from disclosure based on a contractual or ethical obligation;
- to at all times act:
  - in good faith and for a proper purpose;
  - in the best interest of the company; and
  - with due care, skill and diligence.

The third bullet above, is a **codification of the fiduciary duties** of all those appointed in a position of trust, including directors and officers, as found in our common law. These duties have always been there but the inclusion thereof in the Act means that a failure in these duties may now also constitute a criminal offence with the relevant sanctions as set out in the Act.

The US concept of the **"business judgement rule"** has been included in s76(4) which states that a director will have satisfied the above obligations (duties) if:

- he has taken reasonably diligent steps to become informed about the subject matter/s; **AND**
  - does not have a personal financial interest in the subject matter of the decision and no reasonable basis to know of a related person's interest;
- OR**
- he has disclosed the interest in terms of s75; **AND**
  - he had a rational basis for believing, and did believe, that the decision/s was in the best interest of the company.

In discharging the above duties, directors are entitled to rely on:

- one or more employees, professional persons retained by the company, board and board or other committees; and
- information, opinions, reports or statements provided by the abovementioned.

In so doing, directors obviously have to be comfortable with the competency of those on which reliance is placed.

**Practical implication:** All directors, officers and members of board committees who are not directors will have to ensure that they fully **understand** the standards of conduct expected from them in their respective roles. The **implementation** of (and compliance with) the necessary processes and procedures to confirm that directors have acted reasonably and honestly will be important tools for directors and officers to not only be effective at what they do, but to also protect themselves from potential personal liability. This is where careful consideration of the various recommendations contained in the **King Report** on Corporate Governance for South Africa, 2009 ("King III") becomes non-negotiable.

### 2.3. s77: Liability of directors and prescribed officers

s77 provides for directors and officers to be **personally liable for all damages** suffered by the company in the event of such a person:

- Failing to comply with the provisions of s75 (disclosure of personal financial interests) and s76 (standard of conduct);
- Allowing the company to proceed with certain activities, such as a declaration of a dividend, without complying to the relevant requirements of the Act;
- Being a party to reckless trading (which will include trading under insolvent circumstances – s22);
- Acting outside the individual's level of authority;
- Being a party to publishing false, misleading, incomplete or non-compliant financial information.

In addition to the possible personal financial liability as referred to above, certain contraventions such as being party to the falsification of any accounting records of a company could potentially result in a **criminal offence**, punishable by a fine and/or imprisonment of a maximum of 10 years (see s214 and s216). Other contraventions of the Act could be punishable by a fine and/or imprisonment of up to 12 months.

It should also be noted that "**knowingly**" is defined in the Act to not only include a situation where an individual did in fact have knowledge of a certain matter, but also where the individual **ought to have known** by fulfilling his duties to the company.

**Practical implication:** In order to avoid personal liability for all the damages suffered by the company, directors and officers need to have an in depth understanding of the various provisions of s77 and ensure compliance at all times with the relevant provisions of the Act.

## 2.4. s78: Indemnification and directors' insurance

As with the abovementioned sections 75 to 77, the definition of "director" for purposes of s78 includes prescribed officers and members of board committees who are not directors. As a general rule, the aforementioned individuals may **not** be relieved of a duty contemplated in s75 or s76 or of liability as provided for in s77. In addition, the legal consequences arising from an act or omission may **not** be negated, limited or restricted if the said act or omission constitutes wilful misconduct or wilful breach of trust. Companies are also **not** allowed under any circumstances, whether directly or indirectly, to pay a fine imposed on a director who has been convicted of any offence in terms of any national legislation.

There are however certain instances where indemnification of directors and officers is allowed and in these instances the company is also allowed to purchase directors' and officers' liability insurance cover. Depending on the content of the company's memorandum of incorporation (replacing the memo and articles), a company **may indemnify** a director in respect of any liability **other than**:

- in terms of s77(3)(a) (acting without authority), (b) (reckless trading) or (c) (intent to defraud);
- from willful misconduct or willful breach of trust; or
- any fine.

The company may also advance expenses to a director to defend litigation in any proceedings arising out of the director's services to the company.

**Practical implication:** The board should, together with their insurers, revisit the policy on directors' and officers' liability insurance cover to ensure that it provides adequate cover. It will also be interesting to see whether there will be any adjustments to the premium payable in respect of this policy.

The board should also engage the insurer to identify ways in which the potential risk exposure of the insurer can be reduced with a, hopefully, resultant reduction in premium.

## 2.5. Other sections

In addition to the above, the following sections are also noteworthy as part of a discussion on directors' duties and potential liabilities.

- **s162: Application to declare director delinquent or under probation**

A company, a shareholder, director, company secretary or prescribed officer or a registered trade union or other representative of the employees may apply to court for an order declaring a person delinquent or under probation. The basis for such an application are spelled out in the Act as well as the possible consequences of such an order, including the possibility of a lifetime ban on being appointed as a director of a company. In addition to the order, a court may also impose other conditions such as that the person concerned has to undertake a designated programme of remedial education or carry out a designated programme of community service or pay compensation to any person adversely affected by the director's conduct.

- **s218: Civil action**

This section states that **any** person who contravenes **any** provision of the Act is liable to **any** other person for **any** loss or damage suffered by that person as a result of that contravention. This section is potentially far reaching and directors will be well advised to take cognisance thereof.

### 3. CONCLUSION

A number of the provisions of the Act have been widely criticised and the implications and effect of these and other provisions will only become evident over time. These include some of the sections that provide for potential liability of directors, officers and others. Notwithstanding the outcome of the possible challenges and drawn out legal battles regarding the interpretation, meaning and/or implications of some of these provisions, there is little doubt that directors and officers will have to "sharpen their pencils" and ensure that all aspects of the new Companies Act are complied with in full and at all times.

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**NEED ASSISTANCE WITH THE IMPLICATIONS OF THIS ACT?**

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