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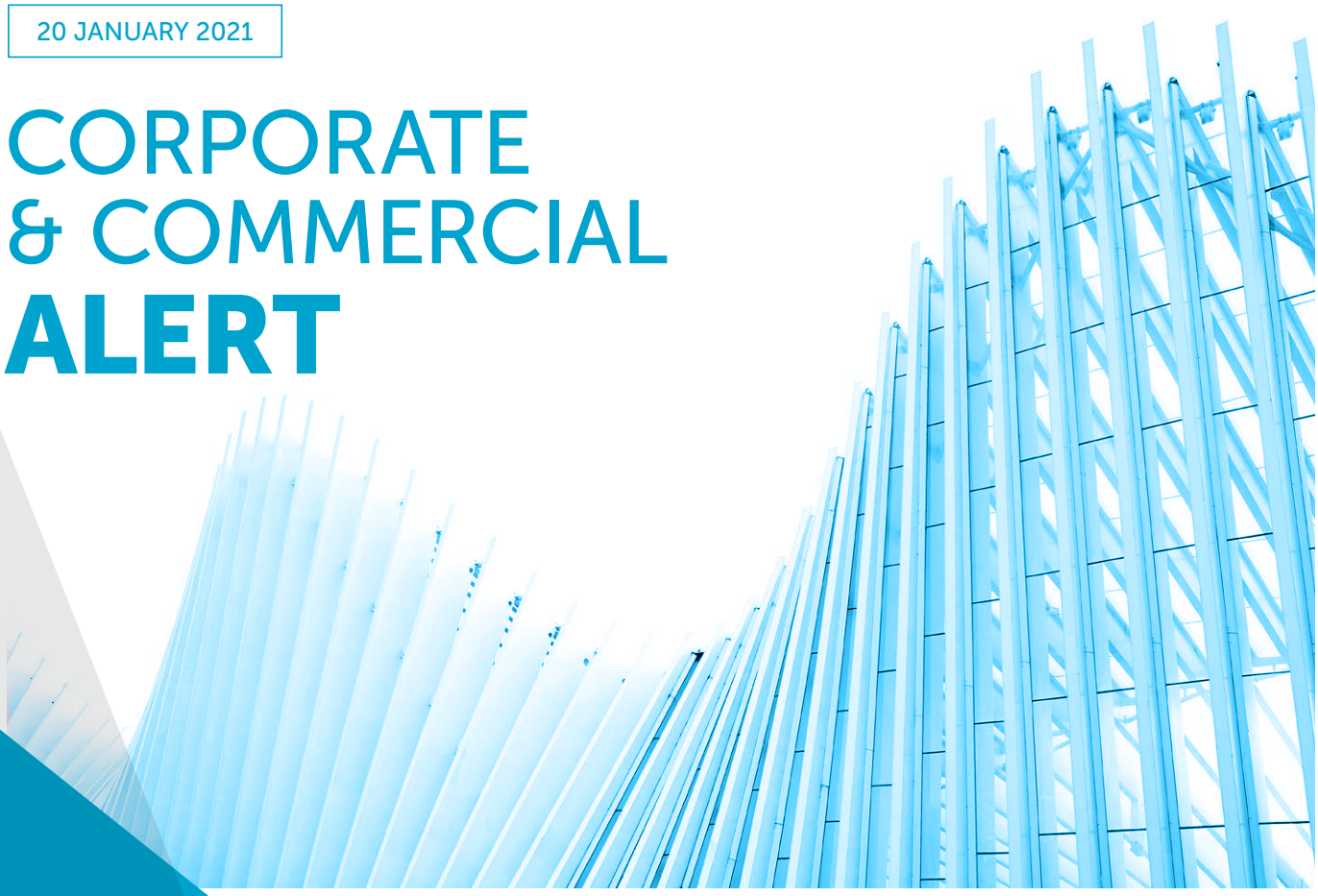
CORPORATE & COMMERCIAL ALERT



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Can shareholders be held to have "*traded recklessly*"?

It is well understood that shareholders retain power in respect of certain significant decisions relating to the company, and it is accepted that as a general rule, shareholders do not owe a fiduciary duty when exercising their rights and powers. The shares are the shareholder's property, and the rights attached thereto may be exercised at the total discretion and whim of the shareholder in disregard of consequences for others – but a recent case has indicated that there are limits to this.

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Can shareholders be held to have "*traded recklessly*"?

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Directors manage the day-to-day affairs of a company on behalf of the shareholders. Although directors have wide powers and duties, the Companies Act 71 of 2008 (Companies Act) does, and the memorandum of incorporation of a company may, reserve several decisions which materially affect the company for approval by the shareholders. The decisions reserved for shareholders include, among others, the disposal of all or a greater part of the assets or undertaking of a company.

When shareholders make decisions which affect the affairs of the company, each of the shareholders of the company should consider all the relevant facts and the prevailing circumstances before arriving at a decision. The failure to do so could in exceptional circumstances lead to undesirable consequences and could also potentially even lead to the shareholders being held personally liable, particularly, where the interests of creditors are totally disregarded. This is illustrated in the recent high court judgment of *Cooper NO and Another v Myburgh and Others* (9040/2019) [2020] ZAWCHC 174 (4 December 2020), which concerned whether a shareholder could in principle be held to have acquiesced in reckless trading.

Briefly, the facts of *Cooper* are that DPMM Transport Proprietary Limited (DPMM) was in severe financial difficulty for some time. To relieve the financial difficulty, the director of DPMM entered into a sale agreement with another related company. The sale contemplated the sale of all or a greater part of the assets of DPMM. The purchase price was payable in equal monthly instalments of R65,000 over a period of 60 months. The first 22 instalments would be paid upfront by way of set-off on the signature date of the sale agreement against the amount owed by DPMM to the purchaser. Prior to the disposal of the assets of DPMM, the sole shareholder of DPMM, being a trust acting through its trustees, adopted a special shareholders resolution approving the disposal of the assets as required by sections 112 and 115 of the Companies Act. DPMM subsequently went into insolvent winding-up.

The liquidators of DPMM applied to the court to declare that the director and the shareholder of DPMM be liable to pay the debts of DPMM in terms of section 424(1) of the Companies Act 61 of 1973 (Old Companies Act), which deals with the personal liability of those involved or acquiescing in reckless or fraudulent trading, for the debts of the company.

Can shareholders be held to have *"traded recklessly"*?*...continued*

In section 424 cases, it is typical for creditors and liquidators to pursue a company's directors and officers personally for the debts of the company, but in this case the shareholder was also pursued, which is an unusual feature.

Broadly the allegation was that the section 112 disposal and its terms were reckless. In section 424 cases, it is typical for creditors and liquidators to pursue a company's directors and officers personally for the debts of the company, but in this case the shareholder was also pursued, which is an unusual feature. (It should be noted that given the transitional provisions in Schedule 5 to the Companies Act, section 424 of the Old Companies Act survives purely for purposes of company liquidations.)

In determining the shareholder's liability, the court had to first consider whether by adopting the special shareholders resolution in terms of section 115 of the Companies Act to permit the disposal of DPMM's assets, the shareholder of DPMM could be said to be a *"party to the carrying on of DPMM's business"*. Secondly, the court had to consider whether shareholders are required to have regard not only to their own interests, but also matters related to the good governance of a company which include the interests of the company's creditors.

The court held that the sale transaction had the effect of granting the purchaser a payment holiday despite the pressing claims of DPMM's creditors. When a company finds itself in financial difficulty, and especially if it is in a state of insolvency, directors responsible for the running of the business are required, when addressing the situation, to have reasonable regard to the interests of its creditors.

The court held that the disposal of a company's assets, and in particular voting in favour of same as a shareholder, may be characterised as *"carrying on the company's business"*. Thus, a total failure by the shareholders to consider the prospects of the creditors being repaid when they resolve to approve a disposal of the assets or the undertaking of the company could amount to an abuse of the limitation of personal liability that companies afford shareholders for the company's obligations. Such failure could conceivably trigger section 424 liability for the shareholder.

In arriving at its decision, the court also considered the fact that two of the three trustees of the shareholder blindly endorsed whatever their co-trustee put before them for signature. The court held that a shareholder cannot rely on ignorance or the failure to understand the company's affairs to escape liability. The actions of the two trustees implied that they abdicated their decision powers and responsibility to their co-trustee and were content to adopt their co-trustee's knowledge as their own when they adopted the resolution.

On the facts, the court held that the trustees who supported the shareholder resolution to dispose of the assets of DPMM should be held personally liable in terms of section 424 of the Old Companies Act. However, in view that the trustees were sued in their capacity as trustees, they were not held liable in their personal capacity.

Can shareholders be held to have *"traded recklessly"*?...*continued*

The extent to which *Cooper* lays a basis for personal liability of *"reckless shareholders"* outside of section 424 remains untested and may well receive some judicial attention in the near future.

The *Cooper* case is an interesting recent illustration of the well-established principle that while the fundamental point of departure is that limited liability means that shareholders and directors cannot be held personally liable for the debts of a company, this gives way in cases of abuse.

As indicated earlier, it is important to appreciate that section 424 of the Old Companies Act applies only in the case of a liquidation. Outside of this context, there is section 22 of the Companies Act which prohibits companies from trading recklessly, and the general civil liability provision in section 218(2). The question as to whether creditors could perhaps pursue company directors and shareholders under these provisions of the Companies Act is a full blown conundrum for another day. The notion has some support in decisions like *Rabinowitz v Van Graan and Others* 2013 (5) SA 315 (GSJ) but has undoubtedly been impacted materially by some of the principles stated in *De Bruyn v Steinhoff International Holdings N.V. and Others* [2020] JOL 47482 (GJ) with regard to the exact purpose and ambit of section 218(2). Thus, the extent to which *Cooper* lays a basis for personal liability of *"reckless shareholders"* outside of section 424 remains untested and may well receive some judicial attention in the near future.

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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