Director’s liability for breach of their duties

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28th May 2018
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Being a fiduciary

_Fiduciary - what?_

Being a fiduciary…what exactly does this mean & entail?

Fiduciary duty = Faith, Trust, Holding a person in trust

As a fiduciary, the person is held in a position of trust

A fiduciary must demonstrate the highest standard of care in respect of the entity to which he owes the fiduciary duty.
What does Fiduciary mean?

- Act in Good Faith
- Put Client Interest First
- Disclose All Conflicts of Interest
- Provide Full Disclosure
- Never Mislead Clients
Being a fiduciary

What fiduciary duties do directors have?

Duty of Care
- To act with a certain level of skill
- To act with competence and diligence

Duty of Loyalty
- To act honestly and in good faith
- To act in the best interests of the organization
Director duties

_Directors have responsibility to consistently represent the best interests of the organisation._

Director duties: Introduction

• Directors are appointed as fiduciaries; as such they must direct the organisation’s affairs with a duty of diligence, loyalty & obedience.

  – directors have many fiduciary duties toward the organisation

  – they may be held personally liable for breach of their fiduciary duties

• Under the direction of the board, directors have authority to exercise all their powers & perform their duties as provided for by the Companies Act 2008, as well as the organisation’s Memorandum of Incorporation (MOI) amongst other documentation.
Directors Duties

It’s important to understand who falls in the ambit of the definition of a director.

The meaning of the word ‘director’ in the Companies Act is extended. Other persons may be regarded as directors, even though they may not officially be designated as such. These include*:

- executive director
- non-executive director (‘NED’)
- lead independent director

- the Act doesn’t make distinction between executive, NEDS & independent directors
- in practice there’s are important differences between these positions
- ex-officio director
- prescribed officer

- a person who in most instances is a senior manager of the organisation. They share the same fiduciary duties as a director

Also includes members of a board committee & alternate directors. Also see Companies Act ’08: S1, S66, S75-76 & Reg. 38. Also see King III Annex 2.3 & King IV™
A quick word about being a director

The role of a director encompasses several diverse duties

− it is impossible to dictate rules to directors that govern every situation as each issue is judged differently

• Duties are extended to various types of directors, including prescribed officers & members of the organisation’s audit committee

• Directors must allocate sufficient time to properly fulfilling their duties & responsibilities toward the organisation

− they must ensure that they are fully informed about the;

□ financial, social & political issues relative to the organisation & industry being served
The source of a director’s duties are essentially found in 4 primary areas.

Duties of South African based directors are primarily sourced in:

i. the law
   - common law
   - Companies Act 2008 (‘the Act’)
   - other statutes, including regulations which regulate organisations (as applicable)

ii. the organisation’s Memorandum of Incorporation (‘MOI’), being the primary governing document of an organisation

iii. the rules of the organisation
   - in addition to the MOI -- but not conflicting with the MOI -- the board may adopt, amend or repeal any additional rules relating to the governance of the organisation which are not addressed in the Act or the MOI

iv. King Codes on Governance for South Africa (King III & King IV™), being a set of recommended business guidelines which are recognised internationally
A distinction

Director’s fiduciary duties are underpinned by company law & the Act, whilst their additional duties owed to the organisation may be established & agreed through, for example:

- the organisation’s MOI
- the director’s Letter of Appointment
- the director’s Service Level Agreements with the organisation
- the director’s Job Description

The fiduciary duties attached to directors are mandatory, irrespective of the size of the organisation the director serves.
Common law is one of the main sources to understand a director’s duties . . .

There are essentially six (6) main common law duties, namely the duty to:

i. exercise reasonable care, skill & diligence

ii. act in the best interest of the organisation

iii. act within their powers & for a proper purpose

iv. exercise independent judgement

v. avoid conflicts of interest

vi. not accept benefits from third parties/the no-profit rules

The main purpose of the common law is to protect the organisation

Any failure to fulfill these duties could potentially result in the fiduciary being held liable for the damages suffered by the organisation or a third party as a result of such failure
Unpacking elements of common law...

1. Duty to exercise reasonable care, skill & diligence.
   - Expected to perform all their duties & functions with care & skill
   - Expected to apply the same degree of care & skill that is reasonably expected from any person with the same knowledge & skills
   - Must honestly apply their mind when making business-related decisions
   - Must ensure they are fully informed prior to making a decision regarding the business
   - Are entitled to seek opinions from their co-directors & experts outside of the organisation, but must not accept this information blindly. The director must exercise his own judgement before reaching any decision
   - Is expected to devote reasonable time to the affairs of the organisation
Unpacking elements of common law...

2. Duty to act in the best interest of the organisation & to act in good faith. Directors;
   - must make all decisions & act solely for the benefit of the organisation
   - may not use or disclose any confidential information for their own personal benefit or for anyone other than the organisation

3. Duty to act for a proper purpose & within powers. Directors;
   - may not exercise the powers granted to them for any unauthorised or improper purpose
   - may not exceed their powers & may only use them for the purposes for which they were granted

4. Duty to exercise independent judgement. Directors;
   - must always exercise independent & unbiased judgement when reaching a decision for the organisation
   - should avoid being influenced by other parties involved in the decision making process
5. Duty to avoid conflict of interest. Directors;

- should not place themselves in positions in which their personal interests conflict with the organisation’s interests
- must fully disclose facts related to what they believe may become a conflict
- may never place their own interests before the organisation’s interests
- must not compete with the organisation in any way

6. Duty to not accept benefits from third parties/the no-profit rules

- directors may not profit in their personal capacity using their position as directors to do so (with the exception of full disclosure & consent from shareholders)
Director’s common law duties have been partially codified in the Companies Act

There’s significant overlap of a director’s fiduciary duties found in common law; some of them being partially codified in the Companies Act.

• Common law duties have not been altered by this codification in the Act

− codification of duties in the Act is intended to make these duties more accessible to directors (and others) sharing similar liabilities, and shareholders who would want to hold directors to those duties

− the common law duties in the Act prevail over any conflicting common law duties

□ if there is no conflict, the common law remains applicable
Most important statutory duties by directors are to:

− act in good faith & proper purpose
− act in the best interests of the organisation
− avoid using their position as director or using corporate information for their own advantage where they knowingly cause harm to the organisation
− convey information to organisation which may be of importance
− exercise reasonable care, skill & diligence in performing their duties
− declare any personal financial interests such where the organisation may be affected and / or interested

The Act categorically places onerous legal duties upon the shoulders of non-directors (e.g. senior management & certain key employees), despite them not having decision-making powers such as the case with directors
The Act makes directors more accountable & liable for their actions than ever before. The Act:

- requires increased transparency, accountability & corporate governance requirements. Accordingly, the director duties have increased with greater risks

- has given directors powers, which were previously reserved for shareholders, increasing directors' exposure to greater risks & liability

• Directors must avoid conflict between their duties, their personal interests & those of the organisation, providing further consideration to the:

i. No Profit Rule

ii. Corporate Opportunity Rule

iii. Post Resignation Rule
One of the most important statutory duties is ensuring directors act in best interests of the organisation . . .

The Act specifically does not spell out what is meant by a director acting in the organisation’s best interests, but leaves this for the courts to decide based upon our common law

—the Act places emphasis on corporate social responsibility, as well as constitutional rights & obligations

—accordingly, directors are expected to apply their good judgement, coupled with the self-regulating principles of the King III / IV Reports.

King IV™ replaces King III; however much of the context & detail of King III remains relevant.
King IV™ makes specific reference to the duties of directors

Other principles in King IV™ which speak directly to the duties of directors include that the governing body (board) should;

—“govern the ethics of the organisation in a way that supports the establishment of an ethical culture” (Principle 2)

—“ensure that the organisation is & is seen to be a responsible corporate citizen” (Principle 3)

—“appreciate that the organisation’s core purpose, its risks & opportunities, strategy, business model, performance & sustainable development are all inseparable elements of the value creation process” (Principle 4)

—“ensure that reports are issued by the organisation to enable stakeholders to make informed assessments of the organisation’s performance, and its short, medium & long-term prospects” (Principle 5)

—“serve as the focal point & custodian of corporate governance in the organisation” (Principle 6)
The Companies Act holds directors & POs liable in numerous circumstances where they fail to comply with their duties . . .

Where directors & prescribed officers (‘POs’) fail in their fiduciary duties toward the organisation (or are at fault in the organisation they serve) which causes losses to the organisation, they may be held personally liable to the organisation, with consequences attached to their non-performance and or negligence to act.
Director liability

Liability may occur in any one of the following circumstances:

i. breaking the law (statute)

ii. breaching or violating a legally enforceable contract

iii. when an act, or failure to act (whether intentionally or not) results in any form of damage, loss, cost or injury to another party

iv. being negligent

v. being reckless
The Companies Act sets out numerous circumstances wherein directors & prescribed officers (POs) may be held personally liable, including:

– breaching their fiduciary duties
– breaching their duty to act with reasonable care & skill
– acting without authority
– directly or indirectly agreeing to a matter / action despite knowing that it was prohibited by the Act
– defrauding a creditor, employee or shareholder
– knowingly signing, issuing, authorising or consenting to untrue, false or misleading financial statements or prospectuses
– when attending or participating in a meeting, or when required to make a decision, and knowingly failing to vote against:

☐ issuing of unauthorised shares or securities
... acting recklessly, or with gross negligence may also attract liability

- granting of options despite knowing that the options were unauthorised in terms of the Act’s provisions
- providing financial assistance to acquire the organisation’s shares despite knowing that the assistance contravenes the Act or the organisation’s MOI
- a resolution being approved for a distribution despite knowing that the distribution contravenes the Act & does not meet the solvency & liquidity test
- acquiring the organisation’s own shares -- or that of its holding company -- despite knowing that it contravened the organisation’s own share re-purchase requirements
- share allotments to the public despite knowing that it contravened the requirements of the Act

• The Act further states that an organisation is prohibited from:
  - conducting its business recklessly, with gross negligence or for any fraudulent purpose
  - trading its business under insolvent circumstances
The Companies Act ’08 contains a number of sections setting out the liability imposed on directors. (briefly listed a few)

- Sec 19 - Legal status of companies status of Company
- Sec 20 – Validity of company actions
- Sec 22 Reckless Trading
- Sec 38 – issuing shares
- Sec 45 – Loans and other Financial assistance
- Sec 55 – uncertified securities
- Sec 104 – Liability for untrue statements in prospectus
- Sec 137 – Business rescue
- Sec 165 – Derivative action
- Sec 214 – false statements, reckless conduct, non compliance
while there are some criminal penalties found in the Act, most penalties rely on administrative enforcement

The Companies Act 2008 (‘the Act’) largely decriminalises company law, relying more upon an administrative enforcement with a minimum number of criminal sanctions, which is expected to:

– promote & improve compliance with the Act

– make it easier for smaller organisations to become compliant with the Act

There are, however some criminal offences found in the Act, such as:

– making false statements

– breaching confidence relating to disclosure of confidential information

– falsifying any accounting records of a company

– knowingly providing false or misleading information, with a fraudulent purpose, in circumstances in which a person is required by the Act to provide information or give notice to another person
Directors who continue trading whilst aware that the organisation is unable to meet its financial obligations, are guilty of a criminal offence.

The Companies Act 2008 (‘the Act’) makes provision for directors to have a defence against the claim that they acted recklessly, so long as they can prove their actions were done on a “honest or reasonable basis” & that the director’s actions were not, inter alia:

– willful

– done with a willful breach of trust

if the director has sound grounds for his action, and provided all the provisions of the Act were complied with and the director acted honestly & reasonably, the court may offer the director either full or partial relief from any liability.

The Act furthermore defines the word “knowing”, as is the case when the director knowingly trades in the organisation & they actually know the organisation will be placed in financial distressed position, or possibly liquidated.

Source: Companies Act 2008 (Sections 76, 77)
Courts can ‘flush out’ directors who hide behind the organisation, in an attempt to escape liability . . .

Piercing the corporate veil

Courts have the power to “lift the corporate veil” in order to:

– ‘flush out’ those who try to hide behind the organisation in an attempt to escape liability

– hold the natural entities personally liable (severally and/or jointly) for the obligations made by the organisation, both legally and/or financially
As the organisation has no ability to protect itself, a derivative action can be brought against the board, its directors or POs for their wrongful actions . . .

**Derivative action**

In order to proceed with a derivative action, the shareholder or the other applicants must follow the procedures as outlined in Section 165 of the Act.

—the distinction between a derivative action and a personal action is that any damages awarded in a successful personal action will accrue to the shareholder personally, whilst any damages awarded in the derivative action will accrue to the organisation

—a derivative action is brought about for the direct benefit & interests of the organisation, not the applicant

—Source: Section 165 of The Companies Act 2008 Revokes The Common Law Derivative Action
Directors who -- amongst other -- act fraudulently, recklessly, or with gross negligence incur liability with great consequences . . .

There are four (4) reasons a director or PO faces greater personal financial risk under the Companies Act 2008 (“the Act”) than ever before:

i. directors’ statutory duties have increased, making it more difficult for them to properly discharge their fiduciary duties & causing them to pay more attention to their increased liabilities

ii. powerful remedies are available to aggrieved shareholders & other stakeholders against directors who do not properly discharge their duties

iii. remedies against directors are wider in their scope & easier to implement (e.g. creditors, or any person who has suffered a loss or damages at the hands of a director who was reckless or fraudulent, may institute action against the director)

iv. the enforcements are efficient & effective, thereby making it more difficult for errant directors to avoid personal liability

Companies Act 2008: Sections 66, 69, 71, 162
liability against directors may be joint or several

Directors may be held liable, jointly or severally.

The Act almost entirely replaces criminal sanctions with administrative & personal fines, including civil sanctions. Consequences include:

– paying a fine

– restricting the rights or privileges of the director or PO

– rendering the director or PO delinquent or being placed under probation

– imposing a jail sentence (depending on circumstances, up to ten (10) years imprisonment & a fine)
Managing the duties & liabilities in an organisation

What contributes to successful governance?