

# AANTEKENINGE

## RECKLESS TRADING AND BUILDING CONTRACTS\*

### OPSOMMING

#### Roekelose bestuur en bou-ooreenkomste

In *McLuckie v Sullivan* 2011 1 SA 365 (GSJ) is artikel 424(1) van die Maatskappywet 61 van 1973 as remedie toegepas. Die hof het bevind dat die direkteur persoonlik aanspreeklik gehou kan word vir terugbetaling van die eisbedrag. Die bedrag is betaal as skikking vir 'n opeis- en betaalbare bedrag vir bouwerk wat ingevolge 'n bou-ooreenkoms voltooi is. Die doel van hierdie aantekening is om te bepaal of artikel 424(1) die geskikte remedie was aangesien die eiser geen skade of verlies gely het nie.

#### 1 Introduction

Section 424 of the Companies Act 61 of 1973 (hereafter the 1973 Act) is regarded by some as probably the most important provision in South African company law (Havenga *Fiduciary duties of company directors with specific regard to corporate opportunities* (LLD thesis Unisa 1995) 33). Section 424(1) provides as follows:

“When it appears, whether it be in a winding-up, judicial management or otherwise, that any business of the company was or is being carried on recklessly or with the 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 debts or other liabilities of the company as the Court may direct.”

The aim of this note is to determine whether section 424(1) was the appropriate remedy in *McLuckie v Sullivan* 2011 1 SA 365 (GSJ), a case concerning mal-performance under a building contract (see para 6 below). To this end, the general principles of section 424(1) that have a direct influence on *McLuckie* are set out, followed by a discussion of sections 22 and 218(2) of the Companies Act 71 of 2008 (hereafter the 2008 Act). Finally, these principles are compared with the facts in *McLuckie* in order to determine whether section 424(1) was the appropriate remedy in the specific circumstances.

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## 2 Section 424(1)

### 2.1 Purpose

In order to determine whether section 424(1) of the 1973 Act is the appropriate remedy in a specific situation, the purpose of the section should be considered. In *Ebrahim v Airport Cold Storage (Pty) Ltd* 2008 6 SA 585 (SCA) it was held that the function of the provision shapes the application thereof. Some cases describe the function or purpose of section 424(1) as a supplement to the common law where a new remedy or “right” becomes available to a creditor in the circumstances set out in the section and to simplify the evidential requirements of a delictual claim which might be difficult if not impossible to prove due to, for example, causality (*Ex parte Lebowa Development Corporation Ltd* 1989 3 SA 71 (T); *Body Corporate of Greenwood Scheme v 75/2 Sandown (Pty) Ltd* 1999 3 SA 480 (W) 488; and *Kalinko v Nisbet* [2002] 3 All SA 294 (W) 303). Others describe it as a provision to enable creditors and ultimately the court to exercise a restraining influence on optimistic directors and to bring reckless and fraudulent persons to book (*Gordon and Rennie v Standard Merchant Bank Ltd* 1984 2 SA 519 (C); see also Havenga “Creditors, directors and personal liability under section 424 of the Companies Act” 1992 *SA Merc LJ* 63–69 and authorities cited).

### 2.2 When does section 424(1) apply?

Section 424(1) is invoked where any business of a company was or is being carried on in a reckless or fraudulent manner. In determining the application of section 424(1), it should be established whether a single transaction can attract liability under section 424(1) (*Ex parte Lebowa supra*; *Re Gerald Cooper Chemicals Ltd* [1978] 2 All ER 49 (Ch); *Gordon and Rennie supra* 524–525; *Body Corporate of Greenwood supra* 488). The equivalent of the South African section 424(1) in the English Companies Act 1948 was section 332(1). In *Re Murray-Watson Ltd* (an unreported decision on s 332(1) delivered on 6 April 1977 as referred to in *Re Gerald Cooper Chemicals Ltd* 52) it was stated that the section is not aimed at the execution of individual transactions in the course of carrying on business but at the carrying on of a business. However, Templeman J held that it

“does not matter for the purposes of [the section] that only one creditor was defrauded, and by one transaction, provided that the transaction can properly be described as fraud on the creditor perpetrated in the course of carrying on business” (*ibid*).

In *Gordon and Rennie* 528 De Kock J held that there is no difference between a director committing a massive fraud on one occasion and a director stealing small amounts of money over a period of time. It was further held that there is no reason to interpret the words of this section in a way which excludes a single reckless or fraudulent transaction (see also *Ex parte Lebowa* 110; *Morphitis v Bernasconi* [2003] 2 BCLC 53 (CA) 70).

For purposes of this discussion, it is also necessary to determine exactly what is meant by “carrying on business”. In *In re Sarflax Ltd* [1979] 1 All ER 529 it was held that “carrying on business” is not synonymous with “actively carrying on business”. The meaning of a company’s business being carried on involves not only an active trading by a director. A director can also be held accountable where there was no active trading going on. This action includes for example the realisation of assets and the dealing with their proceeds (*idem* 534) as well as

tampering with financial statements for the benefit of the company (*Nel v Mc Arthur* 2003 4 SA 142 (T) 158). In *Ex parte Lebowa* 109 it was held that an isolated reckless or fraudulent transaction by a director doesn't necessarily occur in the course of the carrying on of the business of the company. And if it does not occur within the course of the carrying on of the business of the company, the transaction does not fall within the ambit of section 424(1) and the effected person is unable to obtain any assistance from section 424(1). According to Delpport *Henochsberg on the Companies Act 71 of 2008* (2011) 294, the question is not whether the transaction constituted the carrying on of a business; the question is whether, having regard to the transaction, any business of the company was carried on, or is being carried on, in any of the manners envisaged by section 424(1).

After the commencement of the 2008 Act on 1 May 2011, the application of section 424(1) was terminated under certain circumstances. An aggrieved party is able to institute action based on section 424(1) as a remedy for a period of three years after 1 May 2011 (Item 13(1)(c)(i) and (ii) of Schedule 5 of the 2008 Act). (In *Tourvest Holdings (Pty) Ltd v Nonkam* (14371/2011) [2014] ZAGPPHC 720 (26 September 2014) para 33 Bertelsmann J held that "[t]his action was instituted prior to the commencement of the 2008 Companies Act and therefore the provisions of sections 423 and 424 of Act 61 of 1973 apply to the present set of facts".) In respect of an insolvent company, Item 9(1) of Schedule 5 provides for section 424(1) of the 1973 Act to apply in respect of the winding-up and liquidation of insolvent companies under the 2008 Act until a date when the Minister is satisfied that alternative legislation has been brought into force providing for the winding-up and liquidation of insolvent companies (see *Alliance Mining Corporation Limited (In Liquidation) v De Kock* 48387/11 8 February 2013 (GSJ); *Minnaar v Van Rooyen* (27788/04) [2013] ZAGPPHC 375 November 2013; *Grancy Property Limited v Gihwala*; *In Re: Grancy Property Limited v Gihwala* (1961/10; 12193/11) [2014] ZAWCHC 97 26 June 2014; *Nampak Wiegand Glass (Pty) Ltd v Finlayson* (1074/2009) [2014] ZAWCHC 137 8 September 2014). In terms of the 2008 Act reckless trading is also regulated by section 22 (*Kukama v Lobelo* 38587/2011 12 April 2012 (GJ), confirmed on appeal [2013] ZAGPJHC 72 (31 May 2013); *Rabinowitz v Van Graan* 2013 5 SA 315 (GSJ)).

### 3 Section 22

Section 22 of the 2008 Act prohibits a company from carrying on its business recklessly, with gross negligence or with the intent to defraud any person or for any fraudulent purpose (*Kukama v Lobelo supra*). Previously the court declared the guilty party personally liable for debts of the company but under the new dispensation the Companies and Intellectual Property Commission may issue a notice to the company to show cause why the company should be permitted to continue carrying on its business or trade (s 22(2)). This will only happen if the Commission has reasonable grounds to believe that a company is engaging in conduct prohibited by section 22(1), or is unable to pay its debts as they become due and payable in the normal course of business. The company must deliver proof to the Commission that it is not engaging in conduct prohibited by section 22(1) or that it is able to pay its debts as they become due and payable in the normal course of business within 20 business days after the first notice was delivered. The Commission may issue a compliance notice to the company requiring it to cease carrying on its business or trading if the company does not deliver the required proof. (See, eg, *Rabinowitz supra*.)

#### 4 Liability

In terms of section 424(1), a director or any person who was knowingly a party to the reckless and negligent conduct is guilty of an offence whereas the 2008 Act only makes provision for the liability of a director under section 77. The liability of directors and prescribed officers for actions which occurred contrary to section 22(1) is regulated in terms of section 77(3)(b) which provides for a director of a company to be liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director having *acquiesced* in the carrying on of the company's business despite knowing that it was being conducted in a manner prohibited by section 22(1). With regard to the wording of section 77(3)(b), the emphasis is on the word "acquiesced" which includes any conduct, whether the directors actually participated in the conduct or only acquiesced to the manner in which the company's business is conducted. This interpretation is supported by, *inter alia*, section 46(7) which provides for a director of a company to be held liable if the director was present at a meeting when the board approved a distribution as contemplated in section 46, or participated in the making of such a decision in terms of section 74 and failed to vote against the distribution (acquiesced), despite knowing that the distribution was contrary to the provisions of the Act. This entails that a director would be liable in terms of section 46(7) if he knew something was not right, but did not explicitly say that he does not agree. The same principle should apply to section 77(3)(b) with regard to the fact that the word "participate" is not included in the section. The aim of the legislature was not to exclude a director who participated in reckless or negligent trading. (For a detailed discussion, see Delpont *Henochsberg* APP 1 290 notes on s 424 and, more specifically, "knowingly a party" under Appendix 1–305.)

A director can be held personally liable for damage, loss or costs sustained by a company as a direct or indirect consequence of reckless or fraudulent trading activities. A director is furthermore guilty of an offence in terms of section 214(1)(c) of the 2008 Act. Section 214(1)(c) provides that a person who was knowingly a party to an act or omission by a company calculated to defraud a creditor or employee of the company, or a holder of the company's securities, or with another fraudulent purpose is guilty of an offence. A fine or imprisonment for a period not exceeding 10 years can be imposed on a party who is found guilty in terms of section 214(1)(c). A party other than a director or prescribed officer will thus not be liable for any loss, damages or costs sustained by the company but a fine or imprisonment may be imposed.

It is also argued that the company, as party to the business described in section 22(1), may be held liable (Delpont *Henochsberg* 100). Third parties who suffer loss or damage must use section 218(2) as a remedy because sections 22 and 77 only provide for loss, damage or costs suffered by the company.

#### 5 Section 218(2)

Section 218(2) provides that any person who contravenes any provision of the 2008 Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention. In this specific instance, a third party may be found liable in terms of section 218(2) because of a contravention of section 22 of the 2008 Act. A third party may institute action if he suffers loss or damage as a result of reckless and fraudulent trading as described in section 22. This section provides a general remedy to any person (person is defined in section 1

of the 2008 Act and includes a juristic person) to institute action against any other person who contravenes any provision of the 2008 Act for any loss or damage suffered as a result of the contravention.

Two uncertainties exist when a person wants to impute liability based on section 218(2) to another person. The uncertainty includes the question as to whether liability can be imputed to a director based on section 218(2) if he is not found liable in terms of section 77(2)(a) for contravening section 22 of the 2008 Act. In *Sanlam Capital Markets (Pty) Ltd v Mettle Manco (Pty) Ltd* [2014] 3 All SA 454 (GJ) the court confirmed section 218(2) as alternative remedy for breach of section 76 by a director. The *Oxford dictionary* explains the word “alternative” as “available as another possibility or choice”. It is submitted that the plaintiff has a choice between the remedy in terms of sections 424(2) and 218(2) if the decision and statement in *Sanlam Capital Markets (Pty) Ltd supra* is accepted as correct. However, in *Rabinowitz* para 17 the impression is created that section 218(2) is only applicable if a director was found guilty of an offence. The court held that a director contravenes a provision of the 2008 Act for purposes of section 218(2) if he is found guilty of an offence created by the 2008 Act (*ibid*). Du Plessis AJ furthermore observed that “to hold otherwise would result in a finding that a director can be guilty of an offence in terms of the Act without having contravened any provision thereof” (*ibid*). Also, it should be noted that “contravene” does not only refer to an offence in terms of the 2008 Act as it includes any prohibition that is not complied with and which may not qualify as an offence in terms of the 2008 Act (*Rabinowitz* para 22; Delpont *Henochsberg* 640; see, eg, s 22).

The second uncertainty is whether the causation element must be proven in a claim based on section 218(2). Loss and damage sustained by the third party must be “as a result of” the contravention of the 2008 Act (*Rabinowitz*; Delpont *Henochsberg* 640). The insertion of the words “as a result of” makes way for the necessity to prove causation before a claim can succeed. In *Rabinowitz* para 25 the court held that the damage which results from the complained acts can be claimed in terms of section 218(2). This decision confirmed that proof of causation as an element of a delictual claim is a requirement for a claim based on section 218(2). Therefore, a third party must prove that the damage or loss is suffered due to the fact that the company carried on its business recklessly. In terms of section 424, a director can attract liability for the debts of the company without proof of a link between his sanctioned conduct and the debts of the company (*Philotex (Pty) Ltd v Snyman* 1998 2 SA 138 (SCA) 142; *Nel* 155; *Kalinko v Nisbet* 303; *Terblanche v Damji* 2003 5 SA 489 (C) 511; *Saincic v Industro-Clean (Pty) Ltd* 2009 1 SA 538 (SCA); *Fourie v Firstrand Bank Ltd* 2013 1 SA 204 (SCA) para 30).

## 6 *McLuckie v Sullivan*

### 6.1 *Facts*

McLuckie (“plaintiff”) instituted action against Sullivan as the sole director of Dansk Design (Pty) Ltd (“Dansk”) for the payment of R522 278.12 which was paid by the plaintiff to Dansk as a settlement amount for money due and payable for building work done in terms of a building agreement. Before Dansk entered into the initial building agreement with the plaintiff, it was a dormant company which had an assessed loss and was financed by Sullivan either from his own funds or that of a trust controlled by him. Sullivan did not know anything about

building and was forced to use other contractors because the shareholder who initially contributed his skills left the company by mutual agreement. Sullivan appointed Mr Smith as contractor of Dansk in an attempt to conclude the building agreement between himself and the plaintiff. Disputes arose between the plaintiff and Dansk. Dansk claimed an amount of R900 000 for work allegedly done in terms of the initial building agreement. According to the plaintiff, the work was incomplete and defective and he refused to pay the R900 000. After letters were exchanged between the attorneys of Dansk and the plaintiff, a settlement agreement was concluded in terms of which the plaintiff would pay the amount of R522 278.12 in full and final settlement of any and all claims and Dansk would properly repair all snags as discussed with the architect, complete all outstanding work at the premises and honour all guarantees applicable to the agreement. The plaintiff performed in terms of the settlement agreement, but Dansk refused to deliver performance as agreed in terms of the settlement agreement. Repudiation of the agreement occurred after a heated confrontation between the parties. During the confrontation, Sullivan was not aware of the fact that the plaintiff had paid the agreed amount on the morning of the confrontation. Dansk was effectively closed down, the creditors were paid and Sullivan applied for an order to wind up Dansk. The application brought by Sullivan, as sole director of Dansk, stated that the settlement agreement regarding the completion of the building work was completed. However, the building work was not completed in terms of the settlement agreement. Dansk received payment from the plaintiff, but did not perform its duties in terms of the settlement agreement. The creditors of Dansk as well as Sullivan were paid from the money paid by the plaintiff while knowing that Dansk would not be able to perform in terms of the settlement agreement without Sullivan financing any work to be done by Dansk.

Dansk was wound up while Sullivan was fully aware that Dansk was unable to perform in terms of the settlement agreement without his financial input. Sullivan also knew that the plaintiff would not receive any dividend from the insolvent estate of the company in respect of the moneys paid in terms of the repudiated agreement (*McLuckie* 373). The court found Sullivan guilty of reckless conduct of the affairs of the company, as envisaged in section 424(1) of the 1973 Act, and held him liable to the creditor (the plaintiff) for the debts incurred. The court's decision was based on the fact that it held that Sullivan acted recklessly by allowing the company to keep the moneys paid, while knowing that the company (Dansk) would not be able to pay back the money unless Sullivan paid it personally (*supra* 372).

## 6.2 Evaluation

Before the winding-up of Dansk, Sullivan in his capacity as sole director of Dansk, demanded payment of R900 000 from the plaintiff for partial fulfilment of his duties in terms of the initial building agreement concluded on 28 June 2004. Dansk received R522 278.12 as full and final settlement of the claims in terms of the settlement agreement concluded on 21 November 2005. The plaintiff did not suffer loss in the amount of R522 278.12 because the money was paid for work performed in terms of an initial building agreement. Therefore, Dansk was not liable for debts in the amount of R522 278.12. Dansk had partially performed its duties in terms of the initial agreement and was entitled to the amount paid in terms of the settlement agreement. The company cannot be expected to pay back the money which was received in terms of a claim that was due and payable. An initial amount of R900 000 was claimed from the plaintiff as due

and payable whereafter a settlement agreement was reached for the payment of R522 278.12 as full and final payment of any and all claims. The plaintiff referred to case law confirming that money paid in anticipation of work to be completed can be reclaimed if the other party refuses to do the work (371). It is submitted that these cases do not apply to the present facts because the money was paid as full and final settlement of any and all claims, which in my view includes the initial amount of R900 000 that was due and payable for work partially performed in terms of the initial agreement. The money was not paid in anticipation of Dansk performing its obligations and therefore, could not be reclaimed.

The statutory remedy in terms of section 424(1) presupposes the existence of debts or other liabilities on the part of the company (*Ex parte Lebowa* 109). The only claim which the plaintiff might have had is for the debts and liabilities which were suffered due to the non-performance of the settlement agreement to properly repair all snags and non-completion of all the outstanding work. Such a claim would not have amounted to R522 278.12. The debt and liabilities suffered due to the non-performance of the settlement agreement should have been properly quantified before a claim was instituted in terms of section 424(1).

### 6.3 Application of theory to facts

#### 6.3.1 Was any business being carried on?

The first question to be considered is whether there was any business being carried on by the company after Sullivan used the money which was paid by the plaintiff to pay all the outstanding creditors and effectively closed the business of the company down (*McLuckie* 369). It must be determined whether the application to wind-up the company qualifies as “business being carried on”. In *Sarflax* 534 it was held that “carrying on business” is not synonymous with “actively carrying on business”. A director can be held liable in terms of section 424(1) even if there is no active trading going on (*ibid*). Carrying on of business includes the realisation of assets and dealing with the proceeds as well as the tampering with financial statements for the benefit of the company (*Nel* 158). In *Kelvin Park Properties CC v Paterson* 2001 3 SA 31 (SCA) 35 it was held that “[t]rading or carrying on of a business does not cease when ‘the shutters are put up’, but continues until sums due are collected and debts are paid”. The act of applying for a winding-up order constitutes a carrying on of business. It was therefore correctly held that there was a carrying on of business by Sullivan.

It is submitted, with reference to the purpose of the section and the intention of the legislature, that the conduct as described in *McLuckie* will not be excluded from the meaning of “any business being carried on”. However, it is furthermore submitted that the plaintiff did not have a valid claim for R522 278,12 against the estate of the defendant. The plaintiff cannot have a claim for money which was paid by the plaintiff to Dansk which was due and enforceable for work already done in terms of the initial building agreement (see also Kunz, Delpont and Vorster *Henochsberg on the Companies Act* (loose leaf) APPI 299). The only claim that the plaintiff had was for delivery of a service in terms of the settlement agreement – which was not rendered. However, it could be argued that the claim arose as a consequence of non-performance which can be regarded as a debt or liability of the company if properly quantified.

### 6 3 2 Can section 424(1) be used to claim a service?

Although it is concluded that “business was carried on”, the amount of R522 278.12 was due and payable to Dansk for work done in terms of the original building agreement. The amount differs substantially from the original amount of R900 000 which was claimed by Dansk as due and enforceable in terms of the initial building agreement. Section 424(1) is used to hold a director personally liable for the debts and liabilities of a company where a director acted fraudulently or recklessly. In terms of the building agreement, there was no debt or liabilities due to the plaintiff. The amount of R522 278.12 was paid by the plaintiff for work already done. In terms of the settlement agreement, a service should have been delivered by Dansk and section 424(1) cannot be used to enforce a service to be rendered. The plaintiff should have used ordinary contractual remedies to claim damages suffered due to non-performance in terms of the settlement agreement. The consequences (damages suffered) due to non-performance must have been properly quantified and could then have been regarded as a debt or liability of the company.

### 6 3 3 Sections 22, 77(3)(b) and 218(2)

If *McLuckie* were decided under the 2008 Act, the plaintiff would not have been entitled to institute action based on section 22 read with section 77(3)(b) because these sections only provide for the liability of directors if the company sustained damage, loss or costs. If a third party sustained damage, loss or costs, action must be instituted based on section 218(2) (see discussion above). However, it is submitted that the plaintiff did not suffer loss or damage because of the payment that was due and enforceable in terms of the initial building agreements. Furthermore, the plaintiff did not prove loss or damage suffered due to the non-performance in terms of the settlement agreement. The payment to Dansk, the company of which Sullivan was the sole director, was made in terms of a legal obligation and cannot be reclaimed from Sullivan as damage, loss or costs incurred by the plaintiff. However, if the plaintiff quantified his claim for damages due to non-performance in terms of the settlement agreement, a claim in terms of section 218(2) would have been possible if the court were to accept the *dicta* in *Sanlam Capital Markets (Pty) Ltd* (see para 5 above). If the position in *Rabinowitz* is followed and accepted as correct, Sullivan must first be found liable in terms of section 77(3)(b) or guilty of contravening section 22 before a claim can be instituted based on section 218(2).

## 7 Conclusion

The decision in *McLuckie* is not in accordance with the general principles of company law. Section 424(1) provides for personal liability of a director where any business of a company was or is being carried on recklessly, with gross negligence or with the intent to defraud creditors for any debts and liabilities of a company. The money paid by the plaintiff in *McLuckie* was neither a debt nor a liability and therefore, cannot be reclaimed from Sullivan. Section 424(1) cannot be invoked where a person wants to enforce an agreement to render services. Sullivan should not have been ordered to pay the plaintiff the sum of R522 278.12.

Considering the differences with regard to liability in terms of the 1973 Act and the 2008 Act, it should be noted that the company itself is prohibited from acting recklessly, with gross negligence, with the intent to defraud any person or for any fraudulent purpose in terms of section 22 of the 2008 Act. The 1973 Act



specifically regulates the conduct of directors where the 2008 Act regulates the conduct of the company. Section 218(2) is available as a remedy to third parties who suffer loss or damage due to a contravention of the 2008 Act. Section 216 provides for a fine or imprisonment if section 214 is contravened. However, it does not provide for the recovery of loss and damage suffered by a third party. It is submitted that the object of section 218(2) might have been noble in nature to provide third parties with an alternative remedy but was not properly thought through. Some clarification is needed in relation to the uncertainties discussed in para 5 above. If causality needs not be proven, an unreasonably high expectation will be placed on the company and directors.

With regard to the general interpretation of the 2008 Act, it should be noted that it must be interpreted and applied in a manner that gives effect to the purposes set out in section 7 of the 2008 Act and, more specifically in this regard, section 7(j) which provides that the purpose of the 2008 Act is to encourage the efficient and responsible management of companies. Furthermore, section 158 of the 2008 Act provides that a court must develop the common law as necessary to improve the realisation and enjoyment of rights established by this Act.

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