REPUBLIC OF SOUTH AFRICA

THE SUPREME COURT OF APPEAL OF SOUTH AFRICA

Case number 229/05

Reportable

In the matter between:

IVAN SAINCIC
FIRST APPELLANT
SHARON JEAN SAINCIC **SECOND APPELLANT**
CRISM WATER SYSTEMS CC **THIRD APPELLANT**

and

INDUSTRO-CLEAN (PTY) LTD **FIRST RESPONDENT**
INDUSTRO-CLEAN (NORTH WEST) (PTY) LTD **SECOND RESPONDENT**

CORAM: HARMS, STREICHER, FARLAM, HEHER et VAN HEERDEN JJA

HEARD: 15 MAY 2006

DELIVERED: 31 MAY 2006

SUMMARY: Company Law – s 424, Companies Act 61 of 1973 – declaration of liability where business of company conducted fraudulently or recklessly by director – insufficient evidence to bring case within ambit of section.

Neutral citation: This judgment may be referred to as *Saincic v Industro-Clean (Pty) Ltd* [2006] SCA 77 (RSA).

JUDGMENT

FARLAM JA

INTRODUCTION

[1] The two respondents in this matter instituted action against the three appellants in the Pretoria High Court. Three of the four claims in their summons were upheld by the trial judge, Basson J. Only one of them, claim A, is on appeal before us.

[2] The first plaintiff (the first respondent before us) is a company Industro-Clean (Pty) Ltd, which carries on business as a supplier and distributor of cleaning machinery, equipment and consumables. Since 1999 it has been the holder of 80% of the issued share capital in a company known as Industro-Clean (North West) (Pty) Ltd, the second plaintiff (the second respondent before us). In terms of an agreement between the two respondents the second respondent had the exclusive right to market certain products supplied to it on credit by the first respondent in the North-West region.

[3] The first defendant (the first appellant before us) was the sole director of the second respondent from January 2002 to 19 March 2003. He was responsible for the day-to-day running of the business during that period. The second defendant (the second appellant) was previously employed by the second respondent as its bookkeeper or accountant: she is married in community of property to the first appellant. The third defendant (the third appellant) is a close corporation of which the second appellant was the sole member at the relevant time of the trial.

[4] Claim A was brought in terms of s 424 of the Companies Act 61 of

1973. Although a declaration in respect of a larger amount was claimed in the summons the sum in respect of which the first respondent obtained judgment against the appellants was R572 507.98, being the amount by which the debit balance on the second appellant's trading account with the first appellant increased during the period from 1 March 2002 to 19 March 2003.

[5] One of the other claims in the summons was for payment by the first appellant to the second respondent of an amount of R322 979.53 being the profits which it was alleged that the second respondent would have earned during the period January 2002 to 19 March 2003 but for the breach by the first appellant of the fiduciary duties which he owed to the second respondent. In his judgment Basson J found that the second respondent had established that the first appellant had breached the fiduciary duties he owed to it and had in the process indirectly made secret profits totalling R148 665.92. In consequence, so the judge held, the second respondent had suffered damages in that amount which the first appellant was ordered to pay to the second respondent.

RELEVANT STATUTORY PROVISION

[6] Section 424(1) of Act 61 of 1973, in terms of which the appellants were held liable to pay to the first respondent the sum of R572 507.98, reads as follows:

'(1) 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 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.'

FACTS

[7] It was common cause at the trial that the appellants conducted the business of the second respondent recklessly within the ambit of s 424 of Act 61 of 1973 from 1 January 2002 to 19 March 2003. The first appellant, who was the managing director of the second respondent during the relevant period, indirectly made a secret profit at the expense of the second respondent. This he did by permitting the second respondent to sell goods

which it had purchased on credit from the first respondent virtually at cost price to the third appellant so that it, instead of the second respondent, could make a profit from on-selling them. The first appellant benefited indirectly from this because, at the time the profits were made, the only member of the third appellant was his wife, the second appellant, to whom he was (and is) married in community of property. Furthermore the sales of the goods concerned by the third appellant were made in direct competition with the second respondent. At the trial, as has been said above, the trial judge computed the secret profits indirectly earned by the first appellant at R148 665.92 and accordingly held that the second respondent had suffered damages in that amount.

[8] The main witness who testified on behalf of the first respondent in respect of claim A was its managing director, Mr Edward Arthur Bath. It emerged from his evidence that the trading account whose increased balance formed the basis for computing the amount awarded to the first respondent on claim A had been operative since 1999 and was still operative at the date of the trial. In essence there had been no change in the operation of the account since 1999. At the time of the trial the balance on the account was greater than R572 507.88. It further appeared from Mr Bath's evidence that the debts incurred by second respondent on the trading account during the period from 1 January 2002 to 19 March 2003 might well have been discharged in the interim by the second respondent as a result of the continuous trading operations between the respondents since 19 March 2003. Of course, as goods purchased on credit before 19 March 2003 were paid for, further credit purchases took place so that the balance on the account always exceeded R572 507.88.

[9] Mr Bath also testified that during 1999 prior to the first respondent's acquisition of a majority shareholding in the second respondent the quantum of the latter's indebtedness on the account was in excess of R400 000.00. Before 1 March 2002 it was over R1 000 000.00 It then increased, as I have said, by R572 507.98 between the period 1 March 2002 and 19 March 2003 and it increased substantially during the subsequent period up to the date of

the trial.

[10] It was also established at the trial that from 1999 onwards the second respondent has been technically insolvent but had been able to continue trading because the first respondent has subordinated its claim to the other creditors' claims. The first respondent could at any time from 1995 onwards have taken steps to liquidate the second respondent. Instead it kept it afloat, as it were, by extended credit and extra funding. Mr Bath expressed the view that, although there had not been what he called an immediate turnaround in the business, there was a reasonable possibility in the long term that the company would be able to pay its debts. He explained that the first respondent had had a strategic imperative to maintain a position in the North West market to meet its national distribution requirements with its customers who trade all over the republic.

JUDGMENT OF COURT *A QUO*

[11] The trial judge found that the conduct of the appellants had not only been reckless but also fraudulent. He also held that the first respondent did not have to prove a causal link between the appellants' fraudulent and reckless conduct and the debt for which it sought to hold them personally liable. Nevertheless, he said:

'the figure of R572 507.98 is related to the period of fraudulent conduct and I therefore agree with the argument that it would be just and equitable if the [appellants] are held liable for this amount. Even though Bath testified that the said debt might have been paid on the basis that the oldest debts are paid first, the amount outstanding on the trade balance today is even bigger with the result that the running up of the debt during the period in question played an indispensable and vital part in the debt that still remains today.'

[12] He rejected a submission, based on the decision of this court in *L & P Plant Hire BK v Bosch* 2002 (2) SA 662 (SCA), that as the first respondent was only suing as creditor and had not proved that it was a member of the second respondent, it was not entitled to an order under s 424 of Act 61 of 1973. In this regard the trial judge held that the *L & P Plant Hire* case could be distinguished on six grounds.

[13] The *L & P Plant Hire* case dealt with s 64 of the Close Corporations Act

69 of 1984, the section which may be regarded as the counterpart of s 424. This court held that it had to be interpreted restrictively as far as creditors were concerned and that it could not be relied on by a creditor where the corporation, in spite of the fact that its business had been conducted in a reckless or grossly negligent manner, was still able to meet the creditor's claim. The first reason given (at 677E-F) was that a creditor whose claim the corporation was able to discharge had no interest in the manner in which the corporation's business is conducted. The second reason given (at 677I-678A) was that it was not the intention of s 64 to provide creditors of a corporation whose business had been conducted recklessly or grossly negligently with co-debtors of the corporation against whom they might proceed. The court, however, left it open (at 677J) whether the position might not be different where the corporation's business had been conducted fraudulently.

[14] The first ground of distinction on which the trial judge relied was his finding that the business of the second respondent had been conducted not only recklessly but also fraudulently. The second ground of distinction was the fact that the first respondent was not merely a creditor but also held 80% of the shares in the second respondent and had a large loan account with it. The third ground of distinction was the fact that the evidence established that the second respondent was in fact insolvent and unable to pay its debts while, in the *L & P Plant Hire* case, it had been said (at 677C) that there was no evidence as to the financial position of the close corporation under consideration. The fourth ground of distinction was the use in s 424 of the words 'or otherwise' after the words 'winding up, judicial management', which words do not appear in s 64 of Act 69 of 1984. The fifth ground of distinction relied on was stated as follows:

The first [respondent] is not seeking to hold the first [appellant] liable as a co-principal debtor. The second [respondent] has not been sued simultaneously and, in any event, is unable to pay its debt to the first [respondent].'

The final ground relied on in the judgment of the court *a quo* was the apparent acceptance of a submission advanced by counsel for the respondents that: 'the decision in *L & P Plant Hire* makes no reference to overturning the decisions applicable (referred to above) [the reference is to *Body Corporate of Greenwood Scheme v 75/2 Sandown (Pty) Ltd* 1999 (3) SA 480(W) and *Harri and Others NNO v On Line Management*

CC and Others 2001 (4) SA 1097 (T)] which held that s 424 is applicable even where the company is in a sound financial position.'

SUBMISSIONS ON BEHALF OF THE APPELLANTS

[15] Counsel for the appellants submitted that the judgment of the trial judge in so far as it related to claim A was erroneous and should be set aside. He contended that it had not been proved that the business of the second respondent had been conducted fraudulently. He also argued that the first respondent had not proved or been able to quantify the debts of the second respondent during the relevant period, viz the period from January 2002 to 19 March 2003 and that the amount referred to in the order, viz the nett movement on the trading account during that period, was not a 'debt' within the meaning of s 424.

[16] Counsel also submitted that the grounds upon which the *L & P Plant Hire* decision had been distinguished were not correct and that the ratio in that decision accordingly applied. In this regard he contended that s 64 of Act 69 of 1984 and s 424 of Act 61 of 1973 are essentially identical. He pointed to the fact that the omission of the words 'or otherwise' (which were used in s 424) from s 64 took the case no further because s 64 began with the words '[i]f *at any time'* which clearly indicated that s 64 could be used where a company was able to pay its debts. He submitted further that the two cases to which the judge referred in support of his sixth ground for distinguishing the *L & P Plant Hire* case were incorrectly decided. Finally it was argued that when regard was had to the amount awarded to the second respondent under claim D, namely an amount equivalent to the damage it had suffered, it was clear that the court *a quo* had not exercised its discretion under s 424 in a judicial fashion.

SUBMISSIONS ON BEHALF OF THE RESPONDENTS

[17] Counsel for respondents supported the reasoning contained in the trial court's judgment. He also argued that the *L & P Plant Hire* decision was clearly incorrect and should not be followed. The court's error, he contended,

lay in elevating what should have been regarded as one of the factors to be considered in exercising the court's discretion under s 64 of Act 69 of 1984 (and by extension under s 424 of Act 61 of 1973) to the status of a jurisdictional fact which had to be established in the case of a creditor's claim under the section before the court was vested with a discretion to hold a person knowingly a party to the conduct described in the section liable for all or any of the debts or other liabilities of the corporation.

DISCUSSION

[18] In view of the conclusion to which I have come it is not necessary in my view to consider whether the *L & P Plant Hire* decision is correct or distinguishable. I say this because, for the reasons that follow, I think that the order made on claim A cannot be upheld.

[19] In my view the evidence before the court was too incomplete to enable the court to conclude - purely on the basis that because the nett balance on the trading account increased by the sum in question during the period of fraudulent and reckless conduct (as found by Basson J) - that it would be just and equitable for the appellants to be held liable for the amount of the nett balance.

[20] It will be recalled that the first appellant was ordered to compensate the second respondent for the damage it suffered as a result of his conduct. The second respondent will be able, if the first respondent considers it appropriate, to use the amount so awarded to reduce the balance on the trading account. It is true, as this court held in *Philotex (Pty) Ltd v Snyman , Braitex (Pty) Ltd v Snyman,* 1998 (2) SA 138 (SCA) at 142 H-I, that it is not necessary to prove a causal link between the relevant conduct and the debts or liabilities for which there is a declaration of personal liability in terms of s 424. But the absence of such a proven link is a factor to be taken into consideration by the court in the exercise of its discretion and in order to decide whether such a declaration is, in all the circumstances, just and equitable. Here, where the conduct relied on consisted of breach of fiduciary duty through unlawful competition, and damages are to be paid to compensate the second respondent for the harm caused thereby, more evidence is required as to how and why the nett balance on the trading account increased during the relevant period. In so far as it may have been caused by the unlawful competition and breach of fiduciary duty this has been addressed by the damages award. We do not know, however, why the increase, or at least that part of it that was not caused by the conduct complained of, came about. What were the trading conditions

in the area of operation of the second respondent during the relevant period? Were the first and second respondents' other (lawful) competitors getting a bigger share of market for some reason unrelated to the activities (or lack thereof) of the first appellant? And what about the stock? Was the increase perhaps attributable to an increase in stock, which was available to be sold to the second respondent's customers in the period after 19 March 2003? No attempt was made to suggest even tentative answers to these questions.

[21] Although I am of the view that the section is wide enough to cover a declaration of personal liability for debts incurred after the period when the offending conduct took place and that such an order would not be inappropriate where the new debts take the place, as it were, of old debts incurred during the period because the balance owing on the running account does not decrease, I am still unable to say that it is just and equitable that the declaration sought should be made. Because the trial judge does not appear to have addressed his mind to the questions set out above and also failed to give consideration, in the context of justice and equity, to the effect of the damages award he made in favour of the second respondent I am satisfied that he misdirected himself and that this court is obliged to consider the matter afresh and award such amount as we consider to be just and equitable in the circumstances.

[22] For the reasons I have given it is not possible for this court on the scanty information before it to exercise the discretion conferred by the section in favour of the first respondent.

[23] I am accordingly of the view that the appeal must succeed with costs and that the order granted by the trial court on claim A should be set aside and replaced by an order dismissing the claim.

[24] I have read the judgment prepared by my colleague Harms and agree with it.

ORDER

[25] The following order is made:

The appeal succeeds with costs.

The order made by the court *a quo* in respect of claim A is set aside and

replaced by the following:

‘Claim A: This claim is dismissed with costs.’

……..

IG FARLAM

JUDGE OF APPEAL

[26] I agree that the appeal should be upheld for the reasons given by Farlam JA but I wish to add some comments.

[27] Section 424 of the Companies Act 61 of 1973 is for all intents and purposes identical to s 64 of the Close Corporations Act, at least as far as the underlying philosophy is concerned. The difference in wording is for present purposes of no consequence. It is true that s 424 can apply by virtue of the words ‘or otherwise’ irrespective of whether the company has been wound up or is under judicial management. But that does not affect the underlying philosophy as expressed in *L & P Plant Hire BK v Bosch* 2002 (2) SA 662 (SCA), namely that the object of the provision is not to create a joint and several liability between the delinquent director and the company in the interest of creditors. If the company cannot pay, the creditor is entitled to claim from the director without having to place the company in liquidation or under judicial management. This does not mean that the creditor has to excuss the company before proceeding against the director but only that there must be evidence

of the company's inability to pay. I find it contrived to distinguish *L & P Plant Hire*, as the high court did, on the ground that in the instant case the company and director were not sued jointly and severally. The question is not how they were sued or not sued, the question is whether the provision creates that kind of liability.

[28] Part of the ratio in *L & P Plant Hire* was contained in these statements:

'By oorweging van hierdie vraag moet in gedagte gehou word dat 'n skuldeiser, anders as 'n lid, se enigste belang by die bedryf van die beslote korporasie se besigheid geleë is in sy vordering teen die beslote korporasie. Solank die beslote korporasie die skuldeiser se vordering ten volle kan betaal, het die skuldeiser gevolglik geen belang by die wyse waarop die korporasie se besigheid bedryf word nie.' (Para 39.)

'So gesien moet art 64 [of the Close Corporations Act], wat skuldeisers betref, beperkend uitgelê word om slegs betrekking te hê op 'roekelose' en 'grof nalatige' bedryf van die beslote korporasie se besigheid wat 'n nadelige effek op die skuldeiser se vordering teen die beslote korporasie het.' (Para 40.)

[29] These statements imply, at the least, that, as far as creditors are concerned, there must be some or other causal link between the fraudulent conduct and the inability to pay the debt. In other words, it must be due to the fraudulent conduct that a particular creditor's debt cannot be repaid. In this regard the statements appear to be in conflict with some generalized earlier dicta that the section applies irrespective of causation. These conflicting approaches should be seen in context. Take the example of company A that incurs a liability towards creditor B for debt C while the business of A was conducted in a fraudulent manner. The fraud did not affect the solvency of the company and debt C was paid. Thereafter A incurs debt D at a time when the business was properly conducted. Due to other circumstances A cannot pay this

amount to B. There can be little doubt that B would not be entitled to rely on s 424(1) in these circumstances. This example illustrates that the provision could not have intended that causation does not play any role at least as far as creditors are concerned. Whether the matter should rather be considered as part of the general discretion (as Farlam JA has done) or as a pre-requisite (as *L & P Plant Hire* has done), makes no difference to the outcome of this case.

[30] The high court misquoted the following statement in *L & P Plant Hire*:

> 'Wat skuldeisers betref is die bedoeling van art 64 (afgesien - moontlik - van bedrog) immers nie om vir hulle mede-hoofskuldenaars met die beslote korporasie te skep nie. Die bedoeling is om hulle te beskerm teen nadeel wat die roekelose of grof nalatige bedryf van die beslote korporasie se sake vir hulle mag meebring.' (Para 39.)

By rendering the words between brackets as 'afgesien van moontlike bedrog' the high court thought that the dictum excluded cases of fraud while it simply posited the question whether they might be excluded. I do not find in the provision any difference between cases of fraud and other wrongdoings for purposes of liability and I would suggest that the qualification was unnecessary. Obviously, when turning to the exercise of the ultimate discretion the presence of fraud and its nature and extent may be material considerations in determining the scope of the delinquent director's liability.

[31] I agree with Farlam JA that there is nothing on record why, in the circumstances of the case and the nature of the fraud, the first appellant should be held liable. No connection between the fraud and an inability to pay the amount or debt for which he is being sought to be held liable has been proved.

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LTC HARMS

JUDGE OF APPEAL

CONCURRING
STREICHER JA
HEHER JA
VAN HEERDEN JA