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Members' Personal Liability for the Debts of a Close Corporation after Deregistration

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A corporation formed under the Close Corporations Act 69 of 1984 becomes a juristic person upon registration. Subject to the provisions of the Act, it continues to exist as a juristic person despite changes which may occur in its membership until it is deregistered or dissolved (s 2(2)). As a legal person, the corporation may own assets and incur liabilities in its own name. The members do not, merely by reason of their membership, incur liability for the liabilities or obligations of the corporation (s 2(3)). But the Act provides that members may forfeit their protection by incurring personal and concurrent liability, with the corporation, in various instances (see HS Cilliers, ML Benade, JJ Henning, JA du Plessis, PA Delpont, L de Koker & JT Pretorius *Corporate Law* 2 ed (2000) 638–643; SJ Naudé 'Beslote Korporasie: die Voorgestelde Ondernemingsvorm vir Kleinsake' (1983) 5 *Modern Business Law* 62 at 67).

One such instance is provided for in section 26(5): it render members jointly and severally liable for outstanding liabilities that existed at the time of the corporation's deregistration. The liability incurred under this subsection, and the effect of the corporation's reregistration on such liability, were the main issues under consideration in *Boland Bank Ltd v Mouton & another* [1997] 4 All SA 67 (C), discussed by David M Matlala 'Liability for the Debts of a Close Corporation after Deregistration' (2001) 13 *SA Merc LJ* 429). The decision was confirmed on appeal in *Mouton & another v Boland Bank Ltd* 2001 (3) SA 877 (SCA).

The facts are uncomplicated (see the summary by Schutz JA in *Mouton v Boland Bank Ltd* supra at 879F–H). Mouton was a member of a close corporation when it was deregistered. At the time of deregistration, the corporation owed money on overdraft to Boland Bank Ltd ('the bank'). The bank sued Mouton personally under section 26(5). He admitted liability, but put the bank to the proof of the amount owed. After close of pleadings, Mouton successfully applied to the Registrar of Close Corporations for reregistration of the corporation. He then delivered an amended plea in which he alleged that the circumstances had changed since he had last pleaded, and that he had been released from any former liability under section 26(7). The court held that the Close Corporations Act did not provide for the limitation of section 26(5) in this way and held Mouton liable for the amount outstanding on the overdraft.

The decision by Schutz JA raises some interesting issues with regard to a members' liability in the event of a close corporation's deregistration.

Before considering them it is necessary to consider the relevant provisions of the Close Corporations Act.

'Deregistration' of a close corporation is defined as the cancellation of the registration of the corporation's founding statement (s 1). The provisions with regard to deregistration are found in section 26. The section provides that if the Registrar has reasonable cause to believe that a corporation is not carrying on business or is not in operation, she may deregister it after having served notice on the corporation to that effect. Subsections (4) and (5) deal with the continuation of the liability of the members and of the corporation respectively. Section 26(4) states that the deregistration of a corporation does not affect the liability of a member of a corporation to the corporation or to any other person. Such liability may be enforced as if the corporation were not deregistered. So a member who is liable to the corporation under section 50 in respect of, for example, the non-payment of her contribution, remains liable despite the deregistration of the corporation.

When a corporation is deregistered, its liabilities in existence at the date of deregistration (which is deemed to be the date of publication of the notice of deregistration in the *Government Gazette*: s 26(3)) are not extinguished (*Barclays National Bank Ltd v Traub; Barclays National Bank Ltd v Kalk* 1981 (4) SA 291 (W); confirmed on appeal in *Barclays v Traub* 1983 (3) SA 619 (A)). But because the corporation has been deregistered and no longer exists as a separate entity, it cannot be sued in its own name for outstanding liabilities that existed at the time of deregistration. The result of section 26(5) is that those liabilities can be recovered from any person who was a member at the time of the deregistration of the corporation.

Section 26(5) states:

'If a corporation is deregistered while having outstanding liabilities, the persons who are members of such corporation at the time of deregistration shall be jointly and severally liable for such liabilities.'

Section 26(5) has no counterpart in the Companies Act 61 of 1973, and I was unable to find any specific motivation by the drafters of the Close Corporations Act for its initial inclusion in the Act. Presumably, it was aimed at the protection of creditors who, when the corporation was deregistered, would have been unable to recover their claims from the entity itself, nor under the normal consequences of limited liability, from its members. Its result is also analogous to the position in the law of partnership, which exercised considerable influence on the shaping of our close corporations law. Originally, the subsection provided that after deregistration present and former members would be jointly and severally liable for liabilities incurred while they were members of the corporation. The far-reaching consequences imposed on former members were generally regarded as a legislative oversight (see, for example, 1984 *Hansard* col 7564; also D Viljoen 'Die Wysigingswet op Beslote

Korporasies, 1986 in die Algemeen' (1986) 3 *Transactions of the Luyt Centre for Business Law* 50 at 57), hence the substituted wording that imposes such liability only on people who were members at the time of deregistration (see s 6(1) of the Close Corporations Amendment Act 38 of 1986).

Section 26(6) allows for restoration of registration by the Registrar on application by any interested person, if she is satisfied that the corporation was at the time of its deregistration carrying on business or was in operation, or if she otherwise considers it just that the registration of the corporation be restored.

Section 26(7) obliges the Registrar to give notice of the restoration of the registration of a corporation in the *Government Gazette*, and states that 'as from the date of such notice the corporation shall continue to exist and be deemed to have continued in existence as from the date of deregistration as if it were not deregistered'. The effect of the restoration is that the corporation is to be regarded as never having been deregistered at all (PM Meskin assisted by Jennifer A Kunst *Henochsberg on the Close Corporations Act* vol 3 (1997) Com-55; *Ex parte Sengol Investments (Pty) Ltd* 1982 (3) SA 474 (T) at 477-478). This entails that all parties who have by deregistration of the corporation or later acquired rights to assets which the corporation had upon deregistration will lose those rights, as the assets will revert to the corporation. This includes assets that have become bona vacantia and as such have accrued to the State. Likewise debtors and creditors of the corporation at the time of deregistration may upon restoration find their obligations or rights restored.

The question arises whether the restoration of a close corporation's registration affects a member's liability which arose under section 26(5) for a debt of the corporation where at the date of the restoration of the registration the liability remains undischarged. Precisely this was the issue in the *Mouton* decisions.

Both the lower court and the Supreme Court of Appeal confirmed that if members allow their corporation to be deregistered in circumstances where it has assets and liabilities, personal liability for the debts of the corporation arises under section 26(5). Rose Innes J, in the lower court, regarded this liability as a penalty for failing to apprise the Registrar of the true state of affairs of the corporation (*Boland Bank Ltd v Mouton* supra at 75f). In the Supreme Court of Appeal, Schutz JA, correctly, pointed out that a member who procures registration while stating that the corporation has no assets is not necessarily at fault and as such deserving of a civil penalty (*Mouton v Boland Bank Ltd* supra at 881F). But the judge held that, generally, a member of a relatively small business should know what it owns, and that there is reason in policy for attaching personal liability for ignorance, and even more so for deliberate falsehood (supra at 881H). Another policy reason for holding a member personally liable was considered to be the fact that creditors will,

generally, be in a far less favourable position upon reregistration than they would have been in had a liquidator been appointed in a winding-up (supra at 881J). This may be so, but whether it justifies the negation of an important consequence of the separate legal personality of a close corporation, is open to question. Whether it also provides a basis for continuing to hold a member liable after reregistration of the corporation in the absence of any specific provision to that effect, as indicated by the judge (ibid) is, to me, even less certain.

The next issue considered in both courts was the effect of section 26(7) on the member's liability under section 26(5). Schutz JA agreed with Rose Innes J that reregistration under section 26(7) did not have the effect of terminating this liability. The lower court held that the wording of the section was clear and unambiguous and that the liability which it imposes upon members was unqualified by any reference as to the duration of their liability, or as to any later contingency (*Boland Bank Ltd v Mouton* supra at 74b and 76e). It held further that there is nothing in the wording of section 26(5) to support an interpretation that the liability which it imposes is extinguished upon subsequent reregistration of the corporation, and that, had that been the intention, one would have expected some indication in section 26(5) that it was subject to the provisions of section 26(7) (at 76f-g). Since section 26(5) deals with deregistration and the liability resulting from it, I agree with Matlala (op cit at 434) that it cannot be expected that this subsection should govern liability associated with the restoration of registration. Both courts further indicated that since section 26(7) contains no provision limiting the liability incurred under section 26(5), it could be inferred that the intention was not to limit it (see *Boland Bank Ltd v Mouton* supra at 77h; *Mouton v Boland Bank Ltd* supra at 882B).

There may be a logical reason for the lack of any provision in section 26(7) regarding the member's liability. This subsection provides that the corporation is from the moment of reregistration deemed to have continued in existence *as if it have not been deregistered*. If the corporation was never deregistered, the members were never personally liable. In other words, it was unnecessary to limit liability that did not exist. So I agree with the authors of *Henochsberg* that, in respect of undischarged debts, the member's liability automatically ceases upon the restoration of the registration, retrospectively to the date of deregistration (*Henochsberg* op cit Com-56). They suggest that 'if a creditor of the deregistered corporation has instituted action against a member to enforce the liability under subs (5), and the registration of the corporation is restored prior to judgment ... the fact of the restoration of the registration will constitute an effective defence to the institution of the action, although the fact that it arose, *ex hypothesi*, subsequently to the institution of the action, may affect the court's conclusion as to liability for the costs of the proceedings.'

It is true that situations can arise where, for example, the member has already paid the corporation's debt, or where judgment may have been obtained and the member's goods attached and sold in execution, or that following an attachment and a nulla bona return, the member may have been sequestrated (*Mouton & v Boland Bank Ltd* supra at 882E). I believe that in these circumstances the court may be required to make an appropriate order. This is required in, for example, section 420 of the Companies Act, which provides that the court may declare the dissolution of a company void upon such terms as the court thinks fit.

The Supreme Court of Appeal's decision was applied in *Commissioner, South African Revenue Service v Mendes & another* 2001 (4) SA 934 (SE), where Ludorf J stated that it was not in his view necessary to postulate an underlying notion of an intended penalty in respect of section 26(5). The court deemed it sufficient that the legislation simply does not provide either expressly or by implication for the extinction of the members' liability once having arisen by the operation of the subsection. So it is clear how the courts will interpret the extent of the personal liability incurred by members when the corporation is deregistered. I am not sure that this reflects the original intention of Parliament, but if it is to be applied differently, the section will have to be amended.

To conclude: I think the *Mouton* decisions are wrong in holding that the members continue to be personally liable after the restoration of the corporation's registration in terms of section 26(7). If section 26(5) is to remain in the Act, I suggest that the decision of the Supreme Court of Appeal requires amending section 26 to limit members' liability. A provision could be added to section 26(7) to confirm that the joint and several liability of any member which arose on the deregistration of a close corporation terminates on the date of the restoration of the corporation's registration (see also Matlala op cit at 436), and to allow the court, on application by any interested party, to make an appropriate order in connection with the termination of that liability (for example, in respect of the stay of a sale in execution).

It is interesting to note that section 73 of the Companies Act, which deals with the deregistration of a company, contains no provision similar to section 26(5). This may be because a company must first be liquidated before it is deregistered. Still, one wonders whether it is really necessary to retain this provision in the Close Corporations Act. I believe that one of the consequences of this subsection has been that many corporations have been rather unnecessarily kept on the register or re-instated at the request of former members for fear of incurring personal liability. Section 26 provides for deregistration by the Registrar when 60 days have lapsed after service of her notice at the postal address of the corporation, or upon receipt of a written notice signed by all the members that the corporation is carrying on business, or is in operation (s 26(2)). In the former case, one or more of the members who may arguably not even

be aware of the Registrar's notice, may incur personal liability for the outstanding debts of the corporation.

Rather than insert a provision similar to section 73 in the Companies Act (as suggested by Matlala *op cit* at 437), I argue for the repeal of section 26(5) of the Close Corporations Act. One of the primary considerations when this Act was introduced was to provide a business form for smaller businesses that would carry the benefit of legal personality, and so restrict the risk of members being held personally liable for the debts of the business entity (see Naudé *op cit* at 63–64; SJ Naudé 'The Need for a New Legal Form for Small Business' (1982) 4 *Modern Business Law* 5 at 10). To impose personal liability on members at the time of deregistration in instances where fault seems to be immaterial militates directly against this consideration, and seems to be an unnecessary deprivation of the benefit of separate legal personality. There are, of course, several instances where the Close Corporations Act provides for a member to incur personal liability while the corporation is registered: such liability will arise if the member has disregarded certain restrictions or duties (s 63), if there was gross negligence in the carrying on of the corporation's business (s 64), or if the corporate form has been abused (s 65; see further Naudé 1982 *Modern Business Law* at 11). I believe that creditors are adequately protected by these sections which would remain at their disposal should they apply for restoration of the corporation's registration under section 26(6).
