

TOPIC 1

Interpretation, purpose, application and formation of a company

TOPIC OVERVIEW

The aim of this topic is to explain and apply the requirements regarding the interpretation of certain words and concepts used in the Companies Act, as well as those applying to the incorporation and legal status of companies.

Topic 1 is divided into the following learning units:

Learning unit	Title
1.1	Interpretation, purpose, application and formation of a company (sections 1–6 and 8)
1.1.1	Related and interrelated persons, and control (sec 2) and subsidiary relationships (sec 3)
1.1.2	Solvency and liquidity test (sec 4)
1.1.3	Categories of companies (sec 8 and 10 – also, refer to Regulations 26 and 27)
1.2	Incorporation and legal status of companies
1.2.1	Memorandum of Incorporation (MOI) (sec 11, 13, 15–16,19–20; also, refer to Regulation 15)
1.2.2	Pre-incorporation contracts (sec 21 – also, refer to Regulation 35)
1.2.3	Reckless trading (sec 22)

Section 1 of the Companies Act (herein later referred to as the Act) includes the definitions relevant to the Act and is therefore very important to every person who has to read and apply the Companies Act. *(Note: Whenever you are unfamiliar with a term used in the Act, you should refer back to section 1 for its definition.)* Specific definitions are also provided in sections 2 to 5 of the Companies Act. These definitions are important for the application of the different sections of the Act.

For example, in section 4 of the Companies Act, the solvency and liquidity test is explained. Section 46 of the Act (needs to be studied later), which deals with distributions, provides that a company may not make a distribution unless it reasonably appears that the company will satisfy the solvency test. If you did not study the definition in section 4, you will not know how the test is done and what is taken into account.

TEXTUAL AMENDMENTS AND ADDITIONS

Before proceeding with the study of this topic, please refer to Tutorial Letter 102 for this module to acquaint yourself with any textual amendments and additions that may have been indicated.

LEARNING OUTCOMES

Learning unit	On completion of this topic you should be able to:	Level
1.1 Interpretation	<ul style="list-style-type: none">• Give advice, discuss concerns, and apply the interpretation of the Companies Act concerning related and interrelated persons, and control, subsidiary relationships, the solvency and liquidity test, anti-avoidance, and categories of companies.	2
1.2 Incorporation and legal status of companies	<ul style="list-style-type: none">• Give advice, discuss concerns and apply the criteria for names, the right to incorporate and register a company, and the Memorandum of Incorporation.• Give advice on the legal status of companies, the validity of company actions, pre-incorporation contracts, and reckless trading prohibited.	2 2

LEARNING UNIT 1.1

INTERPRETATION, PURPOSE, APPLICATION AND FORMATION OF A COMPANY

INTRODUCTION

In this learning unit, the definitions of related and interrelated persons and control, subsidiary relationships, the solvency and liquidity test, and the different categories of companies will be discussed. The application of these definitions will also be explained by means of activities that you should attempt to complete.

1.1.1 RELATED AND INTERRELATED PERSONS, AND CONTROL (SEC 2) AND SUBSIDIARY RELATIONSHIPS (SEC 3)



STUDY

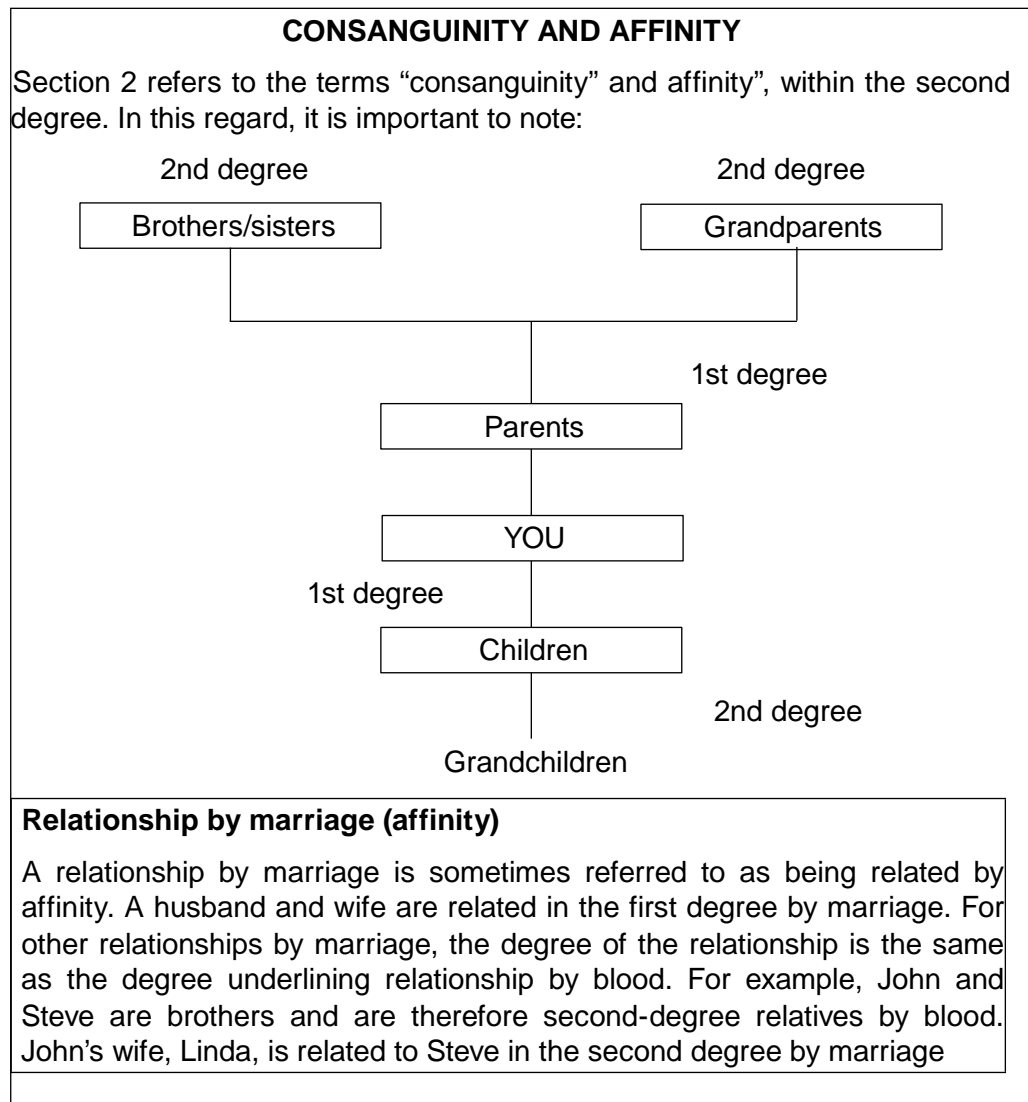
Study sections 2 and 3 of the Companies Act. Familiarise yourself with related-party relationships between individual persons and with subsidiary relationships (relationships between companies).

Section 2 and section 3 of the Companies Act deal with related and interrelated persons and with control and subsidiary relationships. These two sections are very important since a number of other sections in the Companies Act refer to related persons and subsidiary relationships (for example, sec 45 that regulates loans or other financial assistance to directors). Later, we will deal in greater detail with section 45, which not only provides [in subsection 45(2)] that a company may assist its directors financially, but also refers to financial assistance provided to “a related person”. Understanding the concept of “related persons” is therefore necessary to interpret the requirements of a section such as section 45 of the Act.

The following mind map in diagram 1.1.1 below will assist you in your studies. It explains two concepts that are dealt with in section 2 of the Act. These are “consanguinity”, which means “blood relationship”, generally speaking, and “affinity”, which is a relationship that exists due to a valid marriage. In terms of the Act, a person is related to another if such a person is related to the other

person, within the second degree of “consanguinity” or “affinity”.

Diagram 1.1.1 Consanguinity and affinity



Your brothers, sisters, grandparents and grandchildren are thus related to you in the second degree of consanguinity (second degree of blood relationship). In other words, there is at least one other generation between you and a person related to you in the second degree. The persons who are related to you in the first degree of consanguinity are your children or your parents.

ACTIVITY 1

After you have studied section 2 and section 3, you should try to answer the following questions to test your knowledge. This will help you identify the specific relationships in a given scenario.

Please indicate whether the following persons are related to each other, by answering Yes or No. Give reasons for your answers.

- (a) **Don and Sandra:** Don and Sandra have been married for several years and they live in Cape Town. Because Don works in Johannesburg from Monday to Friday, he lives in a separate apartment in Melville during those days. Are Don and Sandra related to each other? Give a reason for your answer.
- (b) **Lynette and Master Locks (Pty) Ltd:** Lynette owned 100% of the shares in Master Locks (Pty) Ltd before she recently transferred all her shares in Master Locks (Pty) Ltd to her adopted son, Peter. Are Lynette and the company, Master Locks (Pty) Ltd related to each other? Give a reason for your answer.
- (c) **Anglo Ltd and Naidoo Cash & Carry (Pty) Ltd:** Johnny and his brother Kumar both own 50% shares in a company called Naidoo Cash & Carry (Pty) Ltd. Kumar recently purchased R5 000 worth of shares in Anglo Ltd, a company listed on the JSE Limited. Kumar does not control Anglo Ltd directly or indirectly. Are the two companies, Anglo Ltd and Naidoo Cash & Carry (Pty) Ltd, related to each other? Give a reason for your answer.
- (d) **Blue Hills (Pty) Ltd and Wollongong (Pty) Ltd:** Blue Hills (Pty) Ltd appointed Mr Patrice Lumumba and Mr Eugene Wollongong as the directors of Wollongong (Pty) Ltd. Mr Lumumba and Mr Wollongong control the majority of the votes at board meetings. Are the two companies, Blue Hills (Pty) Ltd and Wollongong (Pty) Ltd, related to each other?
- (e) **Sonny and Cher:** Sonny and Cher are not married, but they have been living together for several years with their two children. Are Sonny and Cher related to each other?

FEEDBACK ON ACTIVITY 1

Reference: Section 2 of the Companies Act

- (a) Yes – They are married. It is irrelevant that they are not permanently living together **[sec 2(1)(a)]**.
- (b) Yes – Peter directly controls Master Locks (Pty) Ltd and Peter is related to Lynette in the second degree of consanguinity **[sec 2((1)(a–b))]**. Thus, Lynette is related to Master Locks (Pty) Ltd. (Note: It does not matter that Peter is adopted; in terms of the law, his relationship with his mother is exactly the same, whether he was adopted or not.)
- (c) No – Although Kumar is a shareholder of both entities, he does not have control over Anglo Ltd **[sec 2(1)(c)]**. Therefore, Anglo Ltd and Naidoo Cash & Carry (Pty) Ltd are not related persons in terms of being controlled by the same person.
- (d) Yes – Blue Hills (Pty) Ltd has **indirect** control over Wollongong (Pty) Ltd **[sec 2(1)(c)]**.
- (e) Yes – Sonny and Cher are living together in a relationship similar to marriage **[sec 2(1)(a)]**. (This is a more difficult concept to remember!)

1.1.2 SOLVENCY AND LIQUIDITY TEST (SEC 4)



STUDY

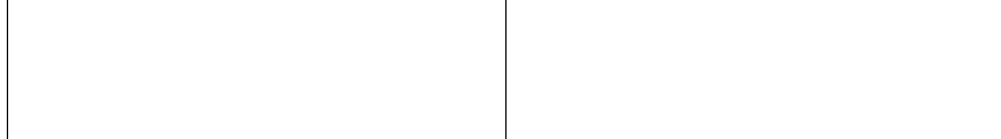
Study section 4 of the Companies Act.

You will see from the mind map/diagram below that, in terms of various sections of the Companies Act, the solvency and liquidity test must be applied to particular transactions. Conducting the solvency and liquidity test forms part of the requirements for that transaction to be valid, and it must be proved before resolutions can be passed.

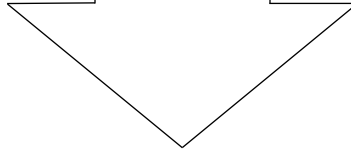
Diagram 1.1.2 below will assist you in your studies.

Diagram 1.1.2: Solvency and liquidity tests

Solvency test	Liquidity test
Assets, fairly valued, are equal to, or exceed, liabilities of the company, or group of companies [sec 4(a)] .	<ul style="list-style-type: none">— The company will be able to pay its debts as they become due [sec 4(b)]— in the ordinary course of business,— for a period of 12 months after the date of the test.



These tests
are used for
the following:



- Share capital reduction (share buyback) **[sec 46 & 48]**
- Share capitalisation **[sec 47]**
- Financial assistance for purchase of own shares **[sec 44]**
- Financial assistance to directors or related persons **[sec 45]**
- Issue of dividends **[sec 46]**
- Other compensations

1.1.3 CATEGORIES OF COMPANIES (SEC 8 AND 10 - ALSO REFER TO REGULATIONS 26 AND 27)

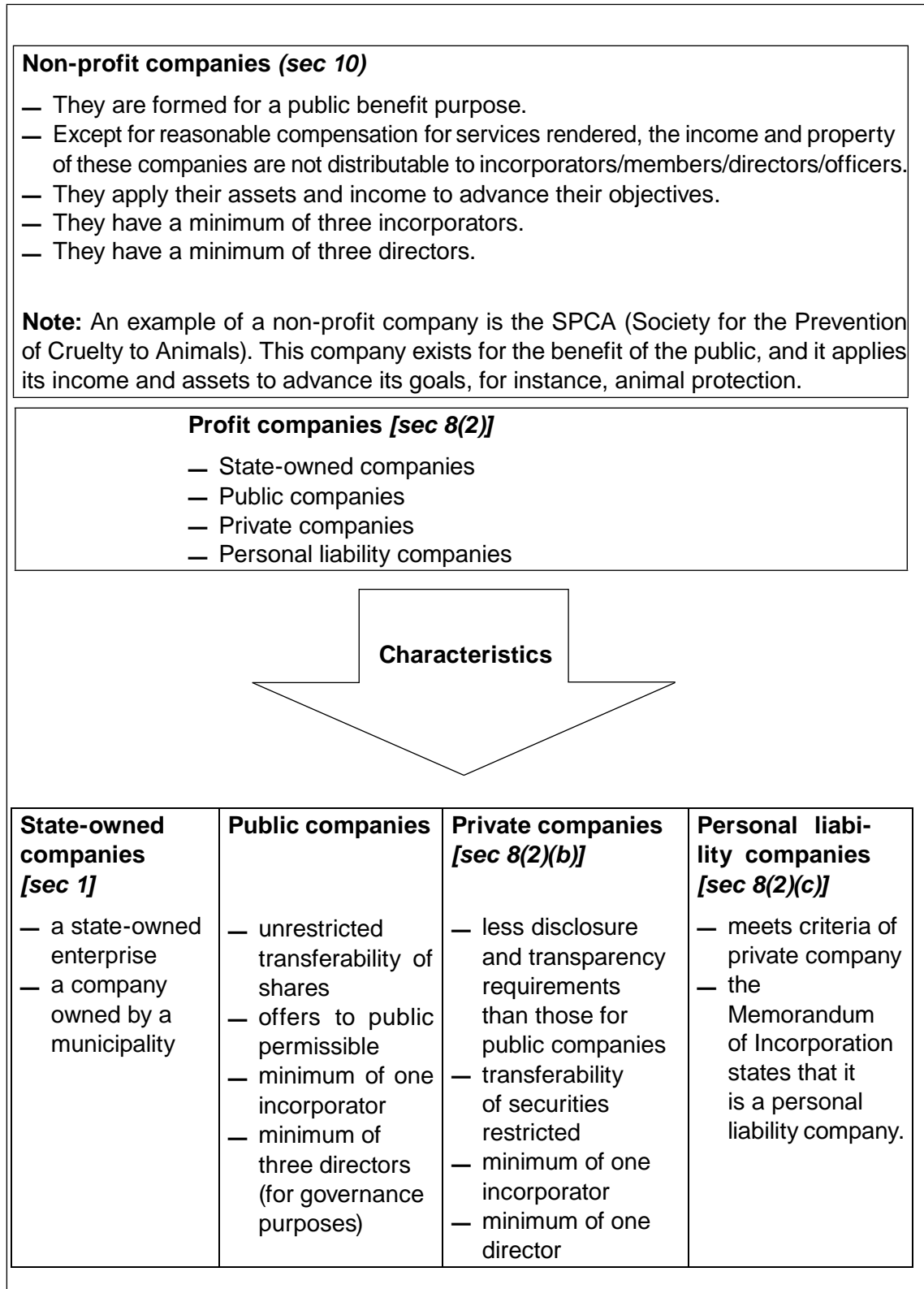
STUDY

Study sections 8 and 10 of the Companies Act as well as Regulations 26 and 27.

The Act provides for two categories of companies, namely non-profit and for-profit (or profit) companies. You must know the different type of companies, as each of them has different characteristics, and different requirements may apply to each of them in terms of the Act.

Diagram 1.1.3 below will assist you in your studies.

Diagram 1.1.3:
Categories of companies



In order to understand the diagrams above fully, look up the **definitions** of the following terms in section 1 of the Companies Act: “incorporator”; “**Memorandum of Incorporation**”; and “securities”.

ACTIVITY 2

Answer the following question on the characteristics of a private and public company:

Distinguish between a public and a private company in respect of the following:

- 3.1 name (2)
- 3.2 number of directors (2)
- 3.3 offer of shares to the public (2)
- 3.4 company secretary (2)
- 3.5 audit committees (2)

FEEDBACK ON ACTIVITY 3

Reference: Section 4 of the Companies Act

- 3.1 A private company must include the words “proprietary” and “limited” or the abbreviation of the words in its name, that is, (Pty) Ltd.
A public company must not include the word “proprietary” or its abbreviation, but must include only “limited” or its abbreviation in its name. (2)
- 3.2 A private company must have a minimum of one director. No maximum is stipulated in the Act.
A public company must have a minimum of three directors. No maximum is stipulated. However, the company’s Memorandum of Incorporation (MOI) may stipulate a higher number. (2)
- 3.3 A private company may not offer its shares for sale to the public under any circumstances and the transferability of its shares is restricted.
A public company may offer its shares to the public under the conditions stipulated in the Act and in terms of its Memorandum of Incorporation (MOI). (2)
- 3.4 A private company is not required to have a company secretary but may appoint one.
A public company must appoint a company secretary. (2)
- 3.5 A private company is not required to appoint an audit committee unless its Memorandum of Incorporation (MOI) indicates that the company elects to.
A public company must appoint an audit committee annually. (2)

SUMMARY

In this learning unit, we explained and applied the interpretation of the Act, including definitions, related and interrelated persons and control, subsidiary relationships, the solvency and liquidity test, anti-avoidance, and categories of companies.

After having worked through the learning unit and the references to the prescribed study material determine if you are able to:

Give advice, discuss concerns, and apply the interpretation of the Companies Act, including definitions, concerning related and interrelated persons and control, subsidiary relationships, the solvency and liquidity test, anti-avoidance, and categories of companies.

LEARNING UNIT 1.2

INCORPORATION AND LEGAL STATUS OF COMPANIES

1.2.1 MEMORANDUM OF INCORPORATION (MOI) (SEC 11, 13, 15–16, 19-20 – ALSO, REFER TO REGULATION 15)



STUDY

Study sections 11, 13, 15, 16, 19 and 20 of the Companies Act as well as Regulation 15, which deals with the Memorandum of Incorporation (MOI) of a company.

The founding document of a company under the Companies Act is the MOI. It is important to know that sections 15 and 16 do not only deal with the MOI, but that they include rules of a company and shareholder agreements.

The Companies Act, 2008, provides that a company's MOI is subject to the Act and must be consistent with the provisions of the Act. To the extent that a provision of the MOI contravenes or is inconsistent with the Act, it is void [**sec 15(1)**].

However, the Companies Act recognises that not all its provisions are suitable for all companies and therefore, **section 15(2)** permits a company's **MOI** to

- include matters that are not dealt with in the Act
- alter the effect of any “alterable” provision (these are provisions that are allowed to be altered)
- impose on the company a higher standard, greater restriction, longer period, or any similarly more onerous requirement, than would otherwise apply to the company in terms of an unalterable provision of the Act
- contain any restrictive conditions applicable to the company or changes to any such conditions, in addition to the requirements for amendments of MOIs set out in section 16
- prohibit the amendment of any particular provision of the MOI, provided that the MOI does not include any provision that negates, restricts, limits, qualifies, extends or otherwise alters the substance or effect of an unalterable provision of the Act, except to the extent contemplated in the third bullet point above

An “alterable” provision is a provision of the Act “in which it is expressly contemplated that its effect on a particular company may be negated, restricted, limited, qualified, extended or otherwise altered in substance or effect by that company's MOI” (sec 1).

Some examples of alterable provisions are as follows:

- Annual financial statements – *“The annual financial statements must ... be ... audited voluntarily if the company's Memorandum of Incorporation, or*

a shareholders' resolution, so requires or if the Company's board has so determined ..." [sec 30(2) (b)(ii)(aa)].

- Notice of shareholder meetings – *"A company's Memorandum of Incorporation may provide for longer or shorter minimum notice periods than required by subsection (1)"* [sec 62(2)].
- Special resolutions – *"A company's Memorandum of Incorporation may permit*
 - (a) a lower percentage of voting rights to approve any special resolution; or*
 - (b) one or more lower percentages of voting rights to approve special resolutions concerning one or more particular matters, respectively, provided that there must at all times be a margin of at least 10 percentage points between the highest established requirement for approval of an ordinary resolution on any matter, and the lowest established requirement for approval of a special resolution on any matter"* [sec 65(10)].

(Adapted from Webber & Wentzel 2011 – a list of alterable provisions as published on SAICA's website.)

Section 15(3) provides that, unless the MOI states otherwise, the board of the company may make, amend or repeal any necessary or incidental rules relating to the governance of the company in respect of matters that are not addressed in the Act or in the MOI. The steps, which the board must follow in this regard, are set out. An example would be a company that does not need to be audited in terms of the Act, but which the board voluntarily decides must be audited.

The steps that must be followed in amending a MOI are included in section 16. Regulation 15 provides for the various forms (including a long and short form) to be completed when registering or amending the MOI.

1.2.2 PRE-INCORPORATION CONTRACTS (SEC 21 – ALSO, REFER TO REGULATION 35)

Pre-incorporation contracts are exactly what they say they are: a contract entered into with, or by a company who is not yet incorporated. Naturally, parties would be hesitant to conclude a contract with a party not yet incorporated, but this section of the Companies Act makes it possible.



STUDY

Study section 21 of the Companies Act as well as Regulation 35. Familiarise yourself with the requirements of the Act in order to enter into a pre-incorporation contract legally.

ACTIVITY 1

You are an accountant and must advise Lionel Lester and Wendell Webb who have made an appointment to see you about a private company they want to form.

The company will operate from a factory, which they believe will be suitable for lease. The owner of the factory wants to tie up the lease as soon as possible.

Lester and Webb asked you the following question:

Is it possible for the proposed company to enter into the lease contract before the company is incorporated? (6)

(Adapted – Gower & Jackson 2010)

FEEDBACK ON ACTIVITY 1

Suggested solution

1. In terms of the Companies Act (sec 21), Lester or Webb **may** enter into an agreement in the name of, or on behalf of, the proposed company. (1)
 2. Within **three months** after the date on which the company is incorporated, Lester and Webb, as the board of the company, must **ratify (confirm)** the contract. (1)
 3. If they do **not actively ratify or reject** the contract, the contract **will be deemed to have been ratified**. (1)
 4. If, for some reason, the company is **not incorporated**, then Lester and Webb will be jointly and severally **liable** for all liabilities, for example, the lease payments arising from the agreement. (1)
 5. If the agreement **is ratified**, it is enforceable against the company and Lester and Webb's **liabilities** as individuals are **discharged**, that is, the contract and performance in respect thereof will be between the lessor and the company. (1)
 6. The pre-incorporation contract **must be in writing**. (1)
- 6

1.2.3 RECKLESS TRADING (SEC 22)

This section also links to other sections of the Companies Act and it is rather important.

In terms of **section 22**, "*a company must not carry on its business recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose; or trade under insolvent circumstances*". Obviously, a fair amount of subjectivity is involved in determining whether the directors have been reckless, but the key will be to establish whether the directors have acted as reasonable persons.

A director may be liable to the company for any loss suffered by the company while trading under insolvent circumstances [**sec 77(3)**], and a director may also be liable to third parties who have had dealings with the company and suffered a loss.

The question here is whether a reasonable person would have acted in the same manner in a situation of factual insolvency. An example may illustrate this better:

- (a) If you assume that the company is factually insolvent, would it be reasonable for it to enter into a lease agreement for a very expensive fleet of company vehicles for its directors?
- (b) Alternatively, would it be reasonable for three or four directors to embark on an extensive overseas trip to visit trade fairs when one director could have taken the trip?
- (c) Would it be reasonable for the directors to vote in favour of large bonuses for themselves or substantial salary increases?
- (d) Would it be reasonable for the directors to continue incurring debt when there is, to the knowledge of the directors, no reasonable prospect of the creditors ever receiving payment for those debts?

All of the above will constitute reckless trading – thus, a breach of **section 22** would have taken place.

ACTIVITY 2

The following is an extract from Distillique Limited's annual financial statements as at 30 June 20Xx:

	20Xx R
ASSETS	
Total non-current assets	4 000 000
Total current assets	<u>2 000 000</u>
	<u>6 000 000</u>
LIABILITIES	
Total non-current liabilities	6 000 000
Total current liabilities	<u>5 000 000</u>
	<u>11 000 000</u>

REQUIRED

Marks

With reference to the extract from Distillique Limited's annual financial statements as at 30 June 20Xx, evaluate if Distillique Limited is trading recklessly in terms of the requirements of the Companies Act.

(6)

FEEDBACK ON ACTIVITY 2

Theory

According to section 22, a company may not carry on its business recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose. (1)

If the Commission (Companies and Intellectual Properties Commission) has reasonable grounds to believe that a company is engaging in prohibited conduct as stated in the above paragraph, or is unable to pay its debts as they become due and payable in the normal course of business, the

Commission may issue a notice to the company. The company will then have to give reasons why it should be permitted to continue with its business or with its trade, as the case may be. (1)

Should the company fail to satisfy the Commission within 20 business days that it is not engaging in conduct prohibited by the first paragraph above or that it is able to pay its debts as they become due and payable in the normal course of business, the Commission may issue a compliance notice to the company requiring it to cease carrying on its business or trading, as the case may be. (1)

Application

In this instance, Distillique Limited will not be able to satisfy the Commission if it receives the notice indicated above, because of the following:

- Distillique Limited does not satisfy the solvency test, since after considering all reasonable foreseeable financial circumstances of the company, the assets (R6 000 000) of the company fairly valued, do not exceed the liabilities (R11 000 000) of the company fairly valued. (1½)
- Distillique Limited is not liquid, since the current liabilities (R5 000 000) exceed the current assets (R2 000 000). (1½)
- Distillique Limited is trading recklessly; it is therefore in contravention of the Companies Act. (1½)

Maximum marks (6)

SUMMARY

In this learning unit, we explained and applied the criteria for names, the right to incorporate and register a company, and the Memorandum of Incorporation. We also gave advice on the legal status of companies, the validity of company actions, pre-incorporation contracts, and reckless trading prohibited.

After having worked through the learning unit and the references to the prescribed study material, determine if you are able to:

- | |
|---|
| <ul style="list-style-type: none">• Give advice, discuss concerns, and apply the criteria for names, the right to incorporate and register a company, and the Memorandum of Incorporation.• Give advice on the legal status of companies, the validity of company actions, pre-incorporation contracts, and reckless trading prohibited. |
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CONCLUSION

In this topic about the **interpretation, purpose, application and formation of a company**, we explained and applied the requirements in terms of the Companies Act and certain Regulations regarding the interpretation of the Act as well as the incorporation and legal status of companies. In the following topic, we will discuss company records, which refer to all records that should be kept by a company.