DEPARTMENT OF MERCANTILE LAW

ENTREPRENEURIAL LAW

Only study guide for

MRL2601

University of South Africa
Pretoria

Printed and published by the
University of South Africa
Muckleneuk, Pretoria

3B2

MRL2601/1/2011

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INTRODUCTION

DEAR STUDENT

This study guide supplements your prescribed textbook, *Companies and other business structures in South Africa* by Dennis Davis, Farouk Cassim et al (2009) Oxford University Press Southern Africa. Hence, whenever we refer to the prescribed textbook in this study guide, we are referring to the above book. Further details about your prescribed study material, including the textbook, are provided in Tutorial Letter 101 for this module.

It is imperative that you use this study guide when working through the textbook because the study guide

- tells you exactly which chapters and parts of chapters in the textbook are prescribed for this module, as well as any additional cases you will need to study from the prescribed casebook
- contains additional information which you also have to study for the examinations
- explains a number of difficult concepts in more detail
- sometimes gives you a different perspective from the one adopted in the textbook

Bear in mind therefore that the study guide also forms part of your study material although the textbook is the primary source.

WHAT ENTREPRENEURIAL LAW IS ALL ABOUT

In this module we will teach you about the main business forms, namely companies, close corporations, partnerships and trusts. You will see that each business form has its own particular requirements in terms of membership and the way in which it is constituted. There are also specific consequences attached to each business form. For example, a partnership does not enjoy separate legal personality.

This means that every partner is liable, in his or her personal capacity, for the partnership's debts. In other business forms this is not the case. In this module you will learn which business forms have the advantage of limited liability.

Every would-be entrepreneur needs to consider the advantages and disadvantages of the various business forms in order to decide which one will best suit the commercial needs of the specific business he or she has in mind. In this module you will learn how to advise such a person, taking into account the relevant legislation, the common-law principles and appropriate case law.

Our focus is on profit-oriented businesses and the major part of this module deals with companies as the primary business form. Companies will become even more important in the future since the registration of new close corporations will not be allowed once the Companies Act of 2008 (see below) comes into effect, although existing close corporations will be allowed to continue doing business for the foreseeable future.

On completion of this module, you should have a sound knowledge of the principles of law governing the main business forms in South Africa. In addition, you should be able to apply the legal principles and solve practical problems that may arise in the context of these business forms.

COMPANY LAW IN SOUTH AFRICA

The new Companies Act 71 of 2008 was signed into law by the President in April 2009 and is expected to come into effect during 2011. When this happens, this Act will repeal and replace the Companies Act 61 of 1973, except for chapter 14 of the 1973 Act which will continue to regulate the winding up of insolvent companies. (The winding-up of companies is not included in the prescribed work for this module.)

In the study units dealing with companies, we are primarily concerned with the provisions of the new Companies Act of 2008.

However, some principles of our common law are also discussed since it will continue to apply in so far as the principles are not repealed by the new Companies Act. Our common law is featured mainly in decided cases of the High Court, the Supreme Court of Appeal and the Constitutional Court. The Companies Act of 2008, like its predecessors, is therefore not a complete codification of our company law. It will sometimes also be necessary to refer to the provisions of the Companies Act of 1973 to help you understand the provisions of the new Act.

Although chapter 1 in the textbook is not prescribed, we strongly advise you to read through it because it contains a brief history of company law in South Africa. It also provides an explanation of the background on and development of the new Companies Act 71 of 2008. This chapter highlights important objectives, key concepts and the structure of the new Companies Act which will help you understand and interpret the provisions of the Act.

HOW TO USE THIS STUDY GUIDE

At the beginning of each study unit, we refer you to the prescribed chapters or parts of chapters that you need to read for that study unit. Study units are subdivided into smaller sections with smaller divisions of the prescribed paragraphs for each particular subdivision. Please note that when, for example, paragraph 3.3 in your textbook is prescribed for a particular part, it means that you must study the whole of paragraph 3.3, including all its subparagraphs in other words, you need to study the material from the beginning of paragraph 3.3 up to the end of 3.3.9.

Remember that you must study everything in the prescribed parts of the textbook and in the study guide, including the decided cases discussed there. In addition, you must study the prescribed cases listed at the beginning of each study unit. These cases are contained in the prescribed casebook (see Tutorial Letter 101/2010 for details of this book) and the number of each prescribed case as found in the casebook is supplied in square brackets after the name and reference of the case.

Although the Companies Act 71 of 2008 is not prescribed separately, you obviously need to study the sections of the Act discussed in the prescribed parts of the textbook and in this study guide. At the beginning of each study unit, we have listed those sections of the Act which are relevant for that study unit. We believe that it will often be helpful for you to read these sections in the Act itself as this remains the primary source. We therefore advise you to either obtain a copy of the Act or to gain access to it on the internet. A fairly inexpensive copy of the Act is available (for about R85) under the title, *Juta's Pocket Statutes Series: Companies Act 71 of 2008*.

When you start working on a study unit, we suggest that you first read the prescribed part in the textbook for the whole study unit to give you an overview of what exactly the study unit deals with.

The next step is to work through each subdivision of the study unit by reading the notes in the study guide on that part of the work, and then rereading the prescribed part of the textbook for that particular subdivision. We have tried to use the same headings as the textbook for subdivisions in the study guide. However, in some instances we have combined more than one heading.

After reading the section in the textbook, you should read the additional prescribed cases. By studying only one part of a study unit at a time, the work is broken up into more manageable chunks, which should be easier to cope with.

Bear in mind that the feedback after each activity only provides you with guidelines on how to approach the specific question asked in the activity. The feedback is not a model answer to the question.

We trust that you will enjoy studying this module and that you will find the knowledge you gain in the process invaluable.

Kind regards

Your lecturers

Study unit 1

LEGAL PERSONALITY

PRESCRIBED STUDY MATERIAL

- Study paragraphs 2.1 to 2.5 and 11.7 in the textbook.
- Study sections 13, 14, 19(1) and 163(4) of the Companies Act.

Prescribed cases for this study unit

Read these cases in the case book. You only need to study the other cases referred to in the prescribed paragraphs of the textbook in so far as they are discussed in the textbook.

- *Salomon v Salomon & 38; Co Ltd* [1897] AC 22 (HL) [43]
- *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530 [44]
- *Cape Pacific Ltd v Lubner Controlling Investments (Pty)Ltd* 1995 (4) SA 790 (A) [47]
- *Hülse-Reutter v Gödde* 2001 (4) SA 1336 (SCA) [48]
- *Dhlomo v Natal Newspapers (Pty) Ltd* 1989 (1) SA 945 (A) [49]

1.1 INTRODUCTION

In the introduction in the textbook, your attention is drawn to the development of company law in South Africa, particularly through legislation, up to and including the new Companies Act and its implications. In this study unit you will learn that the incorporation or registration of a company (by the issuance of a registration certificate) confers upon the new entity legal personality. This means that the new entity can acquire its own rights and duties separate from its members. You will also learn about the limitations on the principle of separate legal personality to avoid abuse. This process is called "lifting" or "piercing the corporate veil".

You will therefore know that you understand this study unit if you are able to answer the following **key questions**:

- What are the advantages of incorporating a business?
- What is legal personality? What is its implication for shareholders?
- What does lifting the corporate veil entail? What is its purpose and under what circumstances can it occur?
- Do branches, divisions and units of a company have their own separate legal personality?

This study unit will follow the structure indicated below.

- **Why incorporate a business?**
- **Legal personality**
- **Lifting the corporate veil**
- **Legal personality of branches and divisions**
- **A summary of key issues on legal personality**

1.2 WHY INCORPORATE A BUSINESS?

Prescribed study material

- Paragraph 2.1 in the textbook

Although it is not a legal requirement that everyone wishing to conduct business must form or incorporate a company or close corporation, most business people prefer to operate in a formalised business environment. However, prior to incorporating a business there are a number of issues that require careful consideration. These include, but are not limited to the following:

- the number of persons who will be involved in the business and the extent of their involvement
- the capital required to commence the business
- the sources of capital
- customer and client requirements
- tax issues
- the strategic objectives of those involved

Only after consideration of these and other issues will it be possible to decide whether a business should be run in the form of a sole proprietorship, a partnership, a company or a business trust. (As you will see in study unit 11, the registration of a new close corporation will no longer be an option once the Companies Act of 2008 comes into effect. However, it may be possible to buy an existing [or shelf] close corporation to run a new business.)

Activity 1.1

Activity

List and briefly discuss three advantages of incorporating a business.

Feedback

Feedback

See paragraph 2.1 in the textbook and ensure that you understand why certain people would decide to incorporate a company.

1.3 LEGAL PERSONALITY

Prescribed study material

- Paragraph 2.2 in the textbook
- Sections 8(3), 14(4) and 19(1) of the Companies Act
- *Salomon v Salomon & Co Ltd* [1897] AC 22 (HL) [43]
- *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530 [44]
- *Dhlomo v Natal Newspapers (Pty) Ltd* 1989 (1) SA 945 (A) [49]

One important attraction for business people in forming a corporation is the principle of legal personality which provides for the limitation of their liability. In essence, a company is deemed to have capacity to acquire its own rights and obligations separate from its members. Section 8(3) of the Companies Act 2008 repeats the provision found in section 31 of the Companies Act of 1973 that no association of persons formed for the purpose of the acquisition of gain (ie to make a profit) will be recognised as a legal person unless it is registered as a company under this Act or formed in terms of another Act.

Activity 1.2

Activity

In 2005, Pat and Tracy Morgan established NetMedia (Pty) Ltd which offered internet-based news, until it went into liquidation when the company could no longer pay its creditors. During the winding-up of the company, the liquidator discovered that Mr and Mrs Morgan, the only shareholders and directors of NetMedia (Pty) Ltd, had made a loan of R10 million to the company as a start-up cash injection. This loan was secured by a mortgage bond over the immovable property owned by NetMedia.

The liquidator argued that there was no real distinction in law between the Morgans and NetMedia, and the proceeds of the sale of the company's assets therefore had to be utilised to settle all debts owed by the company to its other ordinary creditors. Mr and Mrs Morgan believed that NetMedia's separate legal identity entitled them to have their secured claim against the company settled first and vowed to take their fight to the highest court in the land.

Advise both parties about their respective positions.

Feedback

Refer back to paragraph 2.2 in the textbook. Before answering the question, make sure you understand the relevant principles thoroughly.

1.4 LIFTING THE CORPORATE VEIL

Prescribed study material

- Paragraphs 2.3 and 11.7 in the textbook
- Section 163(4) of the Companies Act
- *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* 1995 (4) SA 790 (A) [47]
- *Hülse-Reutter v Gödde 2001* (4) SA 1336 (SCA) [48]

While the principle of separate legal personality remains intact, it is the abuse of the principle which is not tolerated. Courts have made it clear that they will not allow the use of any legal entity to justify wrong, to protect fraud or to defend or hide crime. Hence the courts will pierce or lift the corporate veil and hold directors and others personally liable for acts committed in the name of the company. However, to preserve the integrity of the principle of legal personality, the courts have said that they will only pierce or lift the corporate veil in exceptional circumstances, namely where there is no alternative remedy available and piercing the corporate veil will prevent an injustice.

The textbook is not quite correct when it states (in par 2.3) that the Companies Act 2008 is silent on piercing the corporate veil. Section 163(4) of the Act which deals with remedies and enforcement, provides that if a court finds that the incorporation of a company or any act by or use of a company constitutes an unconscionable abuse of its juristic personality, the court may declare that the company will be deemed not to be a juristic person in respect of the rights, liabilities and obligations relating to the abuse. The wording of this provision is a combination of section 65 of the Close Corporations Act and the judgment in *Botha v Van Niekerk* (referred to in the textbook). It ignores the view expressed in *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd.* In *Cape Pacific* the Court held that the test to determine whether an "unconscionable injustice" was done as applied in *Botha v Van Niekerk* was too rigid.

The courts will probably continue to use the existing case law dealing with the common law rule of piercing the corporate veil when deciding what would constitute an unconscionable abuse. Section 164(4) is discussed in chapter 11, paragraph 11.7 in the textbook, which is part of the prescribed material for study unit 9. It falls under the wider topic of remedies provided by the Act to various interested parties. You should therefore study paragraph 11.7 for both this study unit and study unit 9.

Activity 1.3

Discuss the principle of lifting the corporate veil and indicate the circumstances, if any, under which this principle becomes relevant.

Feedback

See paragraph 2.3 in the textbook. Before answering the question, make sure you that you fully understand the applicable principles.

1.5 LEGAL PERSONALITY OF BRANCHES AND DIVISIONS

Prescribed study material

- Paragraph 2.4 in the textbook

A modern company usually operates through various divisions which, although they have a single controlling mind or board, might in some cases even compete with each other. Questions about their separate legal personality might legitimately be raised. However, if such branches and divisions are not registered entities themselves but merely operate separately for practical purposes, for purposes of law, they do not have their own separate legal personality.

1.6 A SUMMARY OF KEY ISSUES ON LEGAL PERSONALITY

Prescribed study material

- Paragraph 2.5 in the textbook.

The principle of separate legal personality has various implications, as highlighted below.

- Incorporation means limited liability of members.
- The assets of the company are its exclusive property.
- Where a company is wronged, the company must itself seek redress.
- Managerial and executive powers are to be exercised by directors.
- Shares in a company entitle holders certain interests in the company.

REFLECTION

Legal personality entails various rights and privileges. You should be able to say when a company acquires legal personality and what the nature and implications of legal personality are. Can you identify instances in which the legal personality of a company will be disregarded and responsible persons in the company will be held personally liable?

REVIEW

In this study unit, the concept of legal personality was investigated. Legal personality is acquired by companies upon incorporation. Companies are afforded most of the rights and attributes of natural persons. It is evident that the company's separate existence has many implications in the effective operation of companies.

There are certain circumstances in which the ‘‘corporate veil’’ will be lifted, or the legal personality disregarded, to hold individuals in the company accountable for wrongs committed by them. Furthermore, separate legal personality will cease upon deregistration of the company after winding-up.

Please ensure that you are able to answer the questions at the beginning of this study unit.

In the next study unit you will be introduced to the different types of companies and the distinguishing characteristics of the various types of recognised South African companies.

Study unit 2

TYPES OF COMPANIES

PRESCRIBED STUDY MATERIAL

- Study paragraphs 2.6 to 2.8 in the textbook.
- Study sections 8, 9, 10 and 19(3) and read Schedules 1, 2 and 3 of the Companies Act.

No prescribed cases for this study unit

2.1 INTRODUCTION

In study unit 1we learnt that a company acquires legal personality as soon as a registration certificate has been issued. A legal person is regarded as an entity that can acquire rights and duties separate from its members. However, it was stated that this principle of legal personality should not be abused and the corporate veil can therefore be lifted in certain instances. In this study unit we will explain the different types and forms of companies that can be incorporated in terms of the Companies Act.

You will know that you understand this study unit if you are able to answer the following **key questions:**

- What types of companies does the Act provide for?
- Which four entities are classified as profit companies? What are their characteristics?
- What is the distinction between profit companies and nonprofit companies?
- What is the future of close corporations?
- What is an external company?

This study unit will follow the structure indicated below.

Profit companies

- **A public company**
- **A state-owned company**
- **A personal liability company**
- **A private company**

Nonprofit companies

External companies

2.2 TYPES OF COMPANIES

Prescribed study material

- Paragraph 2.6 in the textbook
- Sections 8 to 10 and 19(3) of the Companies Act

The Act provides for profit and nonprofit companies.

The purpose of a **profit company** is financial gain for its shareholders. A profit company may be incorporated by one or more persons and there is no limit to the number of shareholders it may have. This is different from the situation under the Companies Act of 1973, which requires a public company to have at least seven members, while a private company may be incorporated with only one member but is not allowed to have more than 50 members.

Four entities qualify as profit companies, namely a public company, a state-owned company, a personal liability company and a private company.

A public company

- Shares may be offered to the public and are freely transferable.
- This company can be listed on the JSE Limited.
- The Memorandum of Incorporation (MOI) is the governing document of this company.

A state-owned company

- It falls under the meaning of "state-owned enterprise" as determined in the Public Finance Management Act, or it is owned by a municipality.
- It is a National Government Business Enterprise.
- It is not financed by the National Revenue Fund, tax, levy or other statutory money.
- Examples of state-owned companies are Eskom, Telkom and Transnet.

A personal liability company

- This is a private company mainly used by professional associations (such as attorneys).
- The directors are jointly and severally liable along with the company for debts and liabilities contracted during their term of office. Section 19(3) uses the word "contracted" and not "incurred", which was held by the court in *Fundtrust (Pty) Ltd (In Liquidation) v Van Deventer* 1997 (1) SA 710 (A) to limit this liability to contractual debts, and to exclude delictual and statutory liabilities.
- See *Sonnenberg McLoughlin Inc v Spiro* 2004 (1) SA 90 (C) (in par 2.6.3 in the textbook) on a section 53(b) company in terms of the Companies Act of 1973.This company is similar to the new personal liability company.

A private company

- Its MOI prohibits the offering of shares to the public and it cannot freely transfer shares.
- See *Smuts v Booysens; Markplaas (Pty) Ltd and another v Booysens* 2001 (4) SA 15 (A) on this requirement not to transfer shares freely to the public (par 2.6.4 in the textbook).

A **nonprofit company** is a company previously registered under section 21 of the Companies Act of 1973. Its objects must relate to social activities, public benefits, cultural activities or group interests. A nonprofit company must have directors, but they are not allowed to obtain any financial gain from the company other than remuneration for the work they have performed. A nonprofit company does not have to have members. If these companies have members, some of them may enjoy voting rights while others may not.

Activity 2.1

Gugu wishes to incorporate a company. She comes to you for advice on the differences between a profit and a nonprofit company.

Complete the following table, indicating the advice you would give her:

	Profit	Non profit
(1) Types and abbreviations after name	– State-owned ( ) – Private ( ) – Personal Liability ( ) – Public ( )	Non profit ( )
(2) Object		
(3) Required number of persons and directors	State-owned: Private: Personal liability: Public:	

Feedback

See paragraph 2.6 in the textbook and make sure you understand the difference between a profit and a nonprofit company.

2.3 TRANSITIONAL PROVISIONS

Prescribed study material

- Paragraph 2.7 in the textbook

Existing close corporations will continue to exist. After the promulgation of the new Companies Act it will no longer be possible to register new close corporations. Likewise, companies will not be permitted to convert to close corporations.

Activity 2.2

It is the year 2015. Danny wishes to incorporate a close corporation. He does not want a company, because it is much cheaper to form a close corporation. Advise Danny on whether or not this would be possible.

Hint: Refer to the transitional provisions in the Act.

See paragraph 2.7 in the textbook as well as Schedules 2 and 3 of the Act dealing with the amendments to the Close Corporations Act 69 of 1984 and the conversion of a close corporation to a company.

Feedback

Existing close corporations will continue to exist, but after the promulgation of the new Companies Act, new close corporations may no longer be formed.

Danny will not be able to form a new close corporation. He needs to use of one of the business forms permitted in terms of the new Companies Act.

2.4 EXTERNAL COMPANIES

Prescribed study material

- Study paragraph 2.8 in the textbook

This is a foreign company conducting business or nonprofit activities in South Africa. It must always have at least one office situated in the Republic. For example, AERO BENIN is a company registered in Germany. It is established as an external company in South Africa. It is known here as AERO BENIN SA. The words or abbreviation for "South Africa" after the name of a company indicates that it is an external company.

REVIEW

In this study unit the different types of companies and their distinguishing features were highlighted. There are two main types of companies, namely profit and nonprofit companies. You should note that some foreign companies that are also registered in South Africa, namely external companies, are also recognised.

Profit companies are further divided into four different types of companies with a share capital, namely public, private, state-owned and personal liability companies.

Each of these different types of profit companies has distinctive features and characteristics. Make sure that you know the abbreviation written behind the names of each of these types of companies. This can be used as a simple tool to identify the type of company in a set of facts.

You should be able to identify which type of company you are dealing with once you know the distinctive characteristics of each category. This should enable you to advise a client on what requirements need to be adhered to in order to form a specific type of company.

Please ensure that you are able to answer the questions at the beginning of this study unit.

In the next study unit you will be introduced to the process to be followed to incorporate the different types of companies.

Study unit 3

COMPANY FORMATION

PRESCRIBED STUDY MATERIAL

- Study paragraphs 2.9 to 2.11 in the textbook.
- Study sections 1, 7, 11, 13, 14 and 15 of the Companies Act.

Prescribed cases for this study unit

Read these cases in the case book. You only need to study the other cases referred to in the prescribed paragraphs in the textbook in so far as they are discussed in the textbook.

- *Ben-Tovim v Ben-Tovim and Others* 2001 (3) SA 1074 (C) [67]
- *McCullough v Fernwood Estate Ltd* 1920 AD 204 [65]
- *Nine Hundred Umngeni Road (Pty) Ltd v Bali* 1986 (1) SA 1 (A) [56]
- *Botha v Carapax Shadeports (Pty) Ltd* 1992 (1) SA 202 (A) [53]
- *Peregrine Group (Pty) Ltd v Peregrine Holdings Ltd* 2001 (3) SA 1268 (SCA) [57]

3.1 INTRODUCTION

In study unit 2 we learnt about the various types of companies that may be formed in terms of the Companies Act. Before a company is recognised as a legal person, various steps need to be taken such as the registration of the company and of the name of the company. Moreover, there may be a need for pre-incorporation contracts to be entered into. In this study unit we will explain the process of incorporation of a company. We will also discuss pre-incorporation contracts and the registration of company names.

You will know that you understand this study unit if you are able to answer the following **key questions:**

- What documents need to be filed to inform the Commission of the intention to register a company?
- What steps must be followed for incorporation to take place?
- What role does the Commission play in the incorporation of a company?
- What may be included in the Memorandum of Incorporation?
- What are pre-incorporation contracts?
- Who is bound by pre-incorporation contracts?
- What does the registration of a company's name entail?
- Under what circumstances must a company make use of its full name?

This study unit will follow the structure indicated below.

Incorporation of a company

- **The Notice of Incorporation and the Memorandum of Incorporation**
- **The incorporation of a company: steps to be taken**
- **The incorporation of a company: the role of the Commission**
- **Registration of a company**
- **Memorandum of Incorporation: flexibility**
- **Rules made by the board of directors**
- **Legal status of the Memorandum of Incorporation and the rules developed by the board of directors**
- **Amending the Memorandum of Incorporation**
- **Alterations to a Memorandum of Incorporation or rules to correct errors**
- **Translations of a Memorandum of Incorporation**
- **Consolidation of a Memorandum of Incorporation**
- **Authenticity of versions of the Memorandum of Incorporation**
- **Shareholders' agreements**

Pre-incorporation contracts

- **Definition**
- **Requirements**

Registration of company names

- **Criteria for names of companies in terms of the Act**
- **Change of name**
- **Use of name and registration number**
- **Reservation of a name for later use**

3.2 INCORPORATION OF A COMPANY

Prescribed study material

- Paragraph 2.9 in the textbook
- Sections 7 and 13 of the Companies Act

The key objectives of the Companies Act as found in section 7(b) include the promotion of the development of the South African economy via

- the creation of flexibility in the formation and maintenance of companies
- simplicity in the formation and maintenance of companies
- the encouragement of corporate efficiency
- the encouragement of transparency
- the provision of a predictable regulation of companies

When dealing with the formation of companies, the objectives of flexibility and simplicity are clear. The Act makes it possible to incorporate both simple and extremely complex business structures.

Note that the heading of section 13 is "Right to incorporate company". When it comes to incorporation, the flexibility and simplicity of the Act make it easier for people to exercise the right to incorporate companies. When comparing the 1973 Act with the 2008 Act it is clear that the requirements for incorporation are less stringent than they used to be.

Note of the practical issue raised in paragraph 2.9 (p 29) in the textbook.

3.2.1 The Notice of Incorporation and the Memorandum of Incorporation

Prescribed study material

- Paragraph 2.9.1 in the textbook
- Sections 1 and 13 of the Companies Act

When incorporating a company, the Notice of Incorporation plus a copy of the Memorandum of Incorporation must be filed with the Commission. In addition, the prescribed registration fee must be paid.

The Notice of Incorporation is defined in section 1 as "the notice to be filed in terms of section 13(1), by which the incorporators of a company inform the Commission of the incorporation of that company, for the purposes of having it registered". It serves as notification to the Commission of the incorporation of the company. It is therefore the way in which promoters of a company let the Commission know about the company being formed and the fact that they wish to register the company. In section 1 of the Act, the Memorandum of Incorporation is defined, inter alia, as

> *"the document, as amended from time to time that sets out rights, duties and responsibilities of shareholders, directors and others within and in relation to a company and other matters as contemplated in section 15."*

The Memorandum of Incorporation is the founding document of the company. It is a document that sets out the relationship between the company and its shareholders; the company and the directors; the company and other parties in the company, and the company and third parties. As you will see below, provisions in the Memorandum of Incorporation may be amended from time to time.

Under the 1973 Act, there were two documents that had to be submitted for incorporation. These were the Memorandum of Association and the Articles of Association. Incorporation was not possible if both documents were not filed with the Registrar of Companies.

In line with its objective of simplicity, the 2008 Act requires only one founding document, the Memorandum of Incorporation.

Activity 3.1

Muofhe and Tau wish to start a business. They do not want to form a partnership as they prefer a business that will have its own legal personality. They consider forming a company, but they are worried because they want the simplest business structure. They have been told that if they want a simple structure, they must forget about the possibility of incorporation because (1) the incorporation of a company is a privilege that is reserved for certain people only, and (2) a company must have a complex business structure. They want to know why the law makes it impossible for them to form a company.

Feedback

When advising Muofhe and Tau did you consider

- the Act's objectives of simplicity and flexibility, which would allow them to form a company
- the fact that we all have the right to incorporate a company
- the fact that the incorporation of a company with the simplest business structure is possible

3.2.2 The incorporation of a company: steps to be taken

Prescribed study material

- Paragraph 2.9.2 in the textbook
- Section 13 of the Companies Act

One or more persons may incorporate a profit company. For the formation of a nonprofit company, three or more persons are required. Each of these people must complete and sign the Memorandum of Incorporation.

The Act provides a standard form for the Memorandum of Incorporation. However, the use of the standard form is optional. Since the Act allows for flexibility, the Memorandum of Incorporation may be in the form provided for in the Act or it may be in a form unique to the company.

As mentioned above, the Notice of Incorporation and a copy of the Memorandum of Incorporation must be filed with the Commission, together with the prescribed fee.

Activity 3.2

Thuli, Neo and Vasti live in the same area. They each run a spaza shop selling food items to their neighbours. They serve the same market and they realise that there is an increasing need for more stock. They decide to form a supermarket. Because they would like the supermarket to have juristic personality, they decide to establish it as a company.

They have no idea how to go about doing this. Thuli informs them that she knows that you are studying LLB through Unisa. They approach you and request you to provide them with advice on how to go about forming a company.

Explain the procedure to them. In your explanation set out the steps that need to be taken, the documents that need to be filed and who must sign the documents.

Feedback

You will need to refer to paragraph 2.9.2 in the textbook. By now you will have realised that the Act is flexible. It makes it possible for each company to have its own unique Memorandum of Incorporation. The process of incorporation is also simple.

In your advice remember to note that a profit company requires a minimum of one person for incorporation, while a nonprofit company requires at least three persons.

3.2.3 The incorporation of a company: the role of the Commission

Prescribed study material

- Paragraph 2.9.3 in the textbook
- Sections 6(8), 13(4) and 66(2) of the Companies Act

Once the two documents (the Notice of Incorporation and a copy of the Memorandum of Incorporation) have been filed with the Commission and the prescribed fee paid, the Commission may either accept or reject the Notice of Incorporation.

The Notice of Incorporation **may be** rejected by the Commission under the following circumstances:

- if it has not been completed in full (s 13(4) (a))
- if it has not been properly completed (s 13(4) (a))

The Commission **must** reject the Notice of Incorporation in the following circumstances:

- if the initial number of directors is fewer than the prescribed minimum number (s 13(4) (b))
- where as a result of a director's disqualification, the initial number of directors becomes fewer than the prescribed minimum number (s13(4)(b))

In terms of section 66(2), a private company must have at least one director and a nonprofit company a minimum of three directors. If the Commission realises that one of the directors does not qualify to be a

director, this will reduce the number of directors. If the reduction leads to the number of directors being fewer than the prescribed number, the Commission has no choice but to reject the Notice of Incorporation!

The flexibility of the Act is also evident in the role of the Commission when it comes to the incorporation of a company. Where there is a deviation from the design or content of the prescribed form, the deviation will only invalidate the actions of the person if it affects the substance of the Notice of Incorporation negatively and materially (s 6(8)(b)(i)). Deviation will also invalidate the actions of the person if such deviation would reasonably mislead a person who is reading the Notice of Incorporation (s 6(8) (b) (ii)).

Activity 3.3

Vanitha and Sandra have just moved to a new town. There they meet a mutual friend, Wilma, from their boarding school days. The town has many orphans who are homeless. Vanitha, Sandra and Wilma have decided to form a nonprofit company that will provide food and shelter to the orphans. They have completed drafting the Memorandum of Incorporation for the company to be registered as Hayani (NPC). They wish to start operating before winter sets in. The directors are Vanitha, Sandra and Wilma.

A day before filing their documents with the Commission, Vanitha finds out that Sandra has been prohibited by a court of law from becoming a director. She discusses this with Wilma and together they decide to proceed with the process of incorporation because looking for someone to replace Sandra as a director will cause unnecessary delays. They agree that they will look for someone to replace Sandra after incorporation. They file a copy of the Memorandum of Incorporation and the Notice of Incorporation, together with the prescribed fee with the Commission.

How must the Commission deal with this notice of Incorporation?

Feedback

Although the Act allows for flexibility, there are circumstances in which the Commission is compelled to reject the Notice of Incorporation. Read section 13(4) (b) in conjunction with section 69(8) of the Act.

3.3 REGISTRATION OF A COMPANY

Prescribed study material

- Paragraph 2.9.4 in the textbook
- Section 14 of the Companies Act

Registration of a company is regulated by section 14 of the Act. Once the Notice of Incorporation has been filed, the Commission

- assigns a unique number to the corporation
- enters the prescribed information on the company in the Companies Register
- issues and delivers a registration certificate to the company, if all the other requirements have been complied with (note the discussion on p 31 in the textbook regarding the registration certificate)

The date stated on the registration certificate is the date on which the company acquires legal personality. If the promoters have stipulated a specific date on the Notice of Incorporation, the date on the registration certificate will be the later one of that date and the date on which the certificate is issued by the Commission.

Activity 3.4

Discuss the steps that must be taken by the Commission for a company to acquire legal personality.

Feedback

This is clearly stated in section 14. When discussing this, remember to state which date is regarded as the date on which the company acquired legal personality.

3.3.1 Memorandum of Incorporation

Prescribed study material

- Paragraph 2.9.5 in the textbook
- Section 15 of the Companies Act
- *Ben-Tovim v Ben-Tovim and others* 2001 (3) SA 1074 (C)

The Act is flexible and allows the incorporators of a company to include provisions not covered by the Act, in the Memorandum of Incorporation. Despite its flexibility, the Act specifically requires that provisions of the Memorandum of Incorporation have to be consistent with provisions of the Companies Act (s 15(1) *(a)*). Where there are inconsistencies, provisions in the Memorandum will be void, but only to the extent of the inconsistency (s 15(1) *(b)*).

Read the case of *Ben-Tovim v Ben-Tovim and Others* 2001 (3) SA 1074 (C) (although decided in terms of the 1973 Companies Act) which provides an example of a provision that would be regarded as being inconsistent with the Act.

Section 15(2)*(b)* provides that the Memorandum of Incorporation of a company may contain special conditions applicable to the company and requirements in addition to those stipulated in the Act, for the amendment of such conditions. Section 15(2)*(c)* also allows the Memorandum to prohibit the amendment of any particular provision in the Memorandum.

If the Memorandum of Incorporation of a company contains any of the provisions allowed by section15 (2) *(b)* and *(c)*, the name of the company must be followed by the expression "(RF)". This is an abbreviation for the words "ring fencing" and is intended to warn outsiders dealing with the company that there are special conditions contained in the Memorandum which they should check. The Notice of Incorporation filed by the company must also contain a prominent statement drawing attention to each such provision and where it is located in the Memorandum of Incorporation (s 13(3)).

Note that where the Act is silent on a particular issue, the incorporators of a company are allowed to include provisions pertaining to that issue in the Memorandum of Incorporation. The objective of flexibility with regard to incorporation is once again highlighted. Do you think this flexibility is a good thing? Give reasons for your answer.

Activity 3.5

Study paragraph 2.9.5. and draft a Memorandum of Incorporation in which you include ten issues that may be included in a Memorandum of Incorporation. Ensure that the provisions of the Memorandum of Incorporation give clarity on all the different issues.

Feedback

This activity is intended to familiarise you with issues that are usually included in the Memorandum of Incorporation. Did you check the provisions to ensure that they are consistent with the Act? When drafting a Memorandum of Incorporation it is important to ensure that the provisions are consistent with the Act.

3.3.2 Rules made by the board of directors

Prescribed study material

- Paragraph 2.9.6 in the textbook
- Section 15 of the Companies Act

In terms of section 15(3), should both the Act and the Memorandum of Incorporation be silent on certain matters that have to do with the governing of the company, the board of directors of a company is generally allowed to

- make rules
- amend any existing rules
- repeal any rules

Such rules must not be in conflict with the Memorandum of Incorporation of the company or with the Act. In terms of section 15(4)*(a)*, if there is a conflict between a rule made by the board of directors and the Act or the Memorandum of Incorporation, the rule will be void, but only to the extent of its inconsistency.

Before the rules of the board become effective, the following must occur:

Publication of a copy of the rules (s 15(3) (a))
Rules made by the board must be published in the manner stated in the Memorandum of Incorporation. If there is no manner stated, the rules must be published in the manner stated in the rules themselves.

Filing of a copy of the rules with the Commission (s 15(3)(b))
If filing is prescribed by the Memorandum of Incorporation or by the rules, the rules must be filed as required.

Twenty business days after publication of the rules or after the date stated in the rules (if any), the rules become effective. As soon as the rules become effective, they are binding on an interim basis, until put to the vote at the next general shareholders' meeting. For the rule to become permanent, ratification by an ordinary resolution is required at the general meeting. Note that if a rule is rejected by the majority of the shareholders, the board is not allowed to make a similar rule until a period of 12 months has lapsed. The board may only make a similar rule within 12 months if this is approved in advance by ordinary resolution at the shareholders' meeting.

Activity 3.6

Activity

You are a member of the board of directors of Regona (Pty) Ltd. At the last meeting of the board it became clear that the Memorandum of Incorporation was silent on certain issues relating to the governance of the company. After lengthy discussions, three rules concerning the governance of the company were made. They were filed with the Commission a month ago.

The next general shareholders' meeting has not yet taken place.

You decide to read the rules thoroughly and you realise that one of the rules is already addressed by the Act. You also realise that another rule is actually inconsistent with the company's Memorandum of Incorporation. You mention this to the other members of the board. You are then requested to find out whether or not these rules are valid. You are further requested to find out when they will become permanent and on whom they are binding.

Hint: See paragraph 2.9.6 in the textbook as well as sections 15(4) to 15(5) of the Act.

Feedback

- The board of directors has the power to make rules concerning the governance of the company, provided that they are not addressed in the Act or in the Memorandum of Incorporation.
- A rule made by the board which is inconsistent with the Memorandum of Incorporation or with the Act will be void, but only to the extent of its inconsistency.
- Although the rule becomes effective 20 business days after publication, ratification by an ordinary resolution at the next shareholders' general meeting is important.

3.4 THE LEGAL STATUS OF THE MEMORANDUM OF INCORPORATION AND THE RULES DEVELOPED BY THE BOARD OF DIRECTORS

Prescribed study material

- Paragraph 2.9.7 in the textbook
- Section 15 of the Companies Act

Note that the Memorandum of Incorporation and the Rules are binding between

- the company and each shareholder (s 15(6) *(a)*) or
- the shareholders of the company (s 15(6) *(b)*)
- the company and each director or prescribed officer of the company (s 15(6) *(c)* (i))
- the company and each member of the audit committee or member of a committee of the board

Activity 3.7

Exit (Pty) Ltd is a newly incorporated company. As one of the directors you have been tasked to find out the following:

- Who is bound by the Memorandum of Incorporation?
- Who is bound by the rules of the company?

Feedback

The legal status of the Memorandum of Incorporation and the rules of the company are explained in paragraph 2.9.7 in the textbook and in section 15(6) of the Act. It is imperative for you to know which parties are bound by both the Memorandum of Incorporation and the rules of the board of directors.

3.5 AMENDING THE MEMORANDUM OF INCORPORATION

Prescribed study material

- Paragraph 2.9.8 in the textbook
- Section 15 of the Companies Act

The Act allows for changes to be made to the Memorandum of Incorporation (unless the amendment of a provision is prohibited by the Memorandum itself in terms of section 15(2) *(c)* as discussed above in 3.3.1). Such changes may be in the form of

- a new Memorandum of Incorporation or
- amendments to the existing provision of the Memorandum of Incorporation

Note that if changes are in the form of a new Memorandum of Incorporation, the new one will replace the existing Memorandum of Incorporation.

Proposals for amendment may be made

- by the board of directors
- by shareholders who collectively exercise not less than 10% of the voting rights
- in terms of the procedure set out in the company's Memorandum of Incorporation
- by means of a court order an amendment in terms of a court order is given effect via a board resolution but there is no need for a shareholders' resolution

An amendment may result in a profit company not meeting the criteria for that category of profit companies. When this happens, the name and the ending expression must also be amended in such a way that it reflects the new category under which the profit company falls.

Activity 3.8

- Is it possible to make changes to the Memorandum of Incorporation?
- Must a meeting be convened for the purposes of changing the Memorandum of Incorporation?

Feedback

Section 16 relates to the amendment of the Memorandum of Incorporation. Changing the Memorandum of Incorporation is allowed and it may be in the form of a new Memorandum of Incorporation or in changes to existing provisions of the Memorandum of Incorporation. There is no need to convene a meeting.

Since it is sometimes difficult for some shareholders to attend meetings, the proposal to amend the Memorandum of Incorporation may be by way of a round robin among shareholders who are entitled to vote.

3.6 ALTERATION TO A MEMORANDUM OF INCORPORATION OR RULES TO CORRECT ERRORS

Prescribed study material

- Paragraph 2.9.9 in the textbook
- Section 17(1) of the Companies Act

The Act allows for changes or alterations to be made to the company's rules and to the Memorandum of Incorporation. These may be made with a view to correcting minor errors such as grammar, punctuation, spelling and references.

Note that it is the board of a company or an individual, to whom the board has given authority, that may make the changes.

For an alteration to be effected

- a notice of alteration must be published in accordance with the Memorandum of Incorporation and the rules
- a notice of alteration must be filed

Activity 3.9

Sue is Jason's wife. Jason is one of the directors of Roshuma Ltd. Sue accompanies her husband to Cape Town for a meeting of the board of directors. During the meeting she stays in the hotel room. She realises that Jason has left additional copies of the Memorandum of Incorporation and the rules of the board of directors in the room. She decides to read the documents. She picks up several grammatical errors in the Memorandum of Incorporation and decides to correct them.

The Memorandum explains how a Notice of Alteration should be published, but does not state who should perform this task. Sue informs her husband and he gives her permission to effect the alterations. She publishes a Notice of Alteration in accordance with the Memorandum of Incorporation and the rules. She then files it accordingly.

Will Sue's actions result in the alteration to the Memorandum of Incorporation?

Feedback

Although one of the directors has given Sue permission to alter the Memorandum of Incorporation, her actions will not be effective. The Act contains clear requirements in this regard. Read section 17(1) of the Act.

3.7 TRANSLATIONS OF A MEMORANDUM OF INCORPORATION

Prescribed study material

- Paragraph 2.9.10 in the textbook
- Section 17(3) and 17(4) of the Companies Act

A company that has filed a Memorandum of Incorporation has the right to file a translation thereof. The translation may be in any official language or more that is one of the official languages of the Republic of South Africa. It must be filed together with a sworn statement by the translator confirming that the translation is a true, accurate and complete translation of the Memorandum of Incorporation (s 17(4)).

Note that in the event of a conflict between the Memorandum of Incorporation and the translated version, the Memorandum of Incorporation prevails.

Activity 3.10

After Exit (Pty) Ltd was incorporated, the Memorandum of Incorporation was translated into Afrikaans and Tshivenda. The English, Tshivenda and Afrikaans copies were kept together. There is now confusion about the provision that deals with the frequency of meetings as the three versions state different things.

Which version of the Memorandum of Incorporation should prevail and why?

Feedback

In the event of a conflict between a provision in the Memorandum of Incorporation and a provision in the translated version, the provision in the original Memorandum of Incorporation prevails.

3.8 CONSOLIDATION OF A MEMORANDUM OF INCORPORATION

Prescribed study material

- Paragraph 2.9.11 in the textbook
- Section 17(5) and 17(6) of the Companies Act

As stated above, after filing the Memorandum of Incorporation, a company may make amendments or alterations to its Memorandum of Incorporation. Anytime thereafter, the company may file a consolidated revision of its Memorandum of Incorporation. It is also possible for the Commission to require the company to do so.

The consolidated revision of the Memorandum of Incorporation has to be filed together with a sworn statement made by a director of the company or by an attorney or notary confirming that it is a true, accurate, updated and complete representation of the Memorandum of Incorporation.

Activity 3.11

Punch (Pty) Ltd has made alterations to its Memorandum of Incorporation three times in the past year. The Commission is concerned about the number of documents that have to be handled each time one has to read Punch (Pty) Ltd's Memorandum of Incorporation. How can the Commission address this problem?

Feedback

The Commission may request the company to file a consolidated revision of its Memorandum of Incorporation. Remember that there is a sworn declaration that must accompany this.

3.9 AUTHENTICITY OF VERSIONS OF THE MEMORANDUM OF INCORPORATION

Prescribed study material

- Paragraph 2.9.12 in the textbook
- Section 18 of the Companies Act

In the event of a conflict between the Memorandum of Incorporation and its translated versions, the Memorandum of Incorporation, as altered or amended prevails. The same applies to a conflict between the Memorandum of Incorporation, as altered or amended, and its filed consolidated version. The consolidated version may prevail only if it has been ratified via a special resolution at a general shareholders' meeting of the company.

In the event of a conflict between the latest version of the Memorandum of Incorporation endorsed by the Commission and any other document purporting to be a Memorandum of Incorporation, the latest version as endorsed by the Commission will prevail.

Activity 3.12

Exit (Pty) Ltd has had several alterations and translations made to its Memorandum of Incorporation. Some of the alterations were made in respect of the same provisions. One of the directors approaches you because he is worried about the fact that the Memorandum contains too many documents. He is already confused and does not know which version should prevail in the event of a conflict, and why. Advise him.

Feedback

In terms of the Act, where there is a conflict between various versions of the Memorandum of Incorporation, the latest version that has been endorsed by the Commission prevails.

In your advice to the director, you may inform him about the possibility of consolidating the Memorandum of Incorporation

3.10 SHAREHOLDERS' AGREEMENTS

Prescribed study material

- Paragraph 2.9.13 in the textbook
- Section 15(7) of the Companies Act

The Act allows shareholders to enter into agreements with one another about any matter concerning the company. Such agreements must not be inconsistent with the Act and with the company's Memorandum of Incorporation. Where a provision of the agreement is inconsistent with the Act or with the Memorandum of Incorporation, it is void to the extent of its inconsistency.

Activity 3.13

Ryno has been appointed as a director of a private company. He becomes aware of an agreement between the company's shareholders. As he reads the agreement he realises that two of the ten provisions contained in the agreement are not consistent with the company's Memorandum of Incorporation. He is concerned about the validity of the agreement. Advise Ryno.

Feedback

Although the Act allows shareholders to enter into agreements on matters concerning the company, such agreements must be consistent with the Act and with the company's Memorandum of Incorporation. Provisions that are inconsistent with the Act or with the Memorandum of Incorporation are void to the extent of the invalidity.

3.11 PRE-INCORPORATION CONTRACTS

Prescribed study material

- Paragraph 2.10 in the textbook
- Section 21 of the Companies Act
- *McCullough v Fernwood Estate Ltd* 1920 AD 204
- *Nine Hundred Umngeni Road (Pty) Ltd v Bali* 1986 (1) SA 1 (A)
- *Botha v Carapax Shadeports (Pty) Ltd* 1992 (1) SA 202 (A)

The common law does not allow a person to act as an agent for a principal who does not exist. This means that under the common law no person can act as an agent for a company which has not as yet been incorporated because the company does not exist before incorporation. This may result in the company losing the chance to enter into beneficial contracts which present themselves prior to incorporation. To avoid this state of affairs, section 21 allows pre-incorporation contracts to be entered into on behalf of a company which has yet to be incorporated.

Section 1 of the Act describes a pre-incorporation contract as "an agreement entered into before the incorporation of a company by a person who purports to act in the name of, or on behalf of, the company, with the intention or understanding that the company will be incorporated, and will thereafter be bound by the agreement".

A person who enters into such a contract is held jointly and severally liable for liabilities emanating from the pre-incorporation contract if

- incorporation does not take place, or
- once the process of incorporation has been completed, the company does not ratify any part of the agreement.- Note, however, that joint and

several liabilities will not apply where, after incorporation, the contract is replaced by another similar contract.

Section 21 does not exclude the common law, which means that a promoter may also use the common-law alternatives. These are the contract for the benefit of a third party (*stipulatio alteri*), a trust or cession and delegation. The common-law constructions have a major advantage over a section 21 contract because in terms of the common law, the promoter is not automatically liable if the company is not incorporated or does not ratify the contract.

Activity 3.14

During the process of forming Doe Ltd, Jane was one of the people who entered into a contract with Dijo Ltd on behalf of Doe Ltd. It is now four months after incorporation and Jane is concerned about the possibility of being held jointly and severally liable for liabilities arising as a result of that contract. If you were Jane, what course of action would you take?

Hint: Note the time period.

Feedback

This has to do with the ratification or rejection of a pre-incorporation contract. The answer can be found in paragraph 2.10 in the textbook and in section 21(5) and (6) of the Act. If there is a failure to ratify or reject the pre-incorporation contract after a three-month period, the agreement will be deemed to have been ratified.

3.12 REGISTRATION OF COMPANY NAMES

Prescribed study material

- Paragraph 2.11 in the text book
- Section 11 of the Companies Act
- *Peregrine Group (Pty) Ltd v Peregrine Holdings Ltd* 2001 (3) SA 1268 (SCA)

When choosing a company name one must avoid names that

- are offensive to people of a particular race, ethnic group, gender or religion (s 11(2)*(c)*(iii))
- amount to passing off. Passing off occurs when a company makes use of a feature which is associated with another business. Common law prohibits passing off.

Activity 3.15

You are approached by Xander Xulu who lives in KwaZulu-Natal. He is in the process of registering a company name. The company's main business is the production of two products: tomato sauce and tomato paste. The company name Xander wishes to register is XX Two Products (Pty) Ltd. He fears that the name may not be accepted because the name XX2 (Pty) Ltd is used by a company in Limpopo that sells tomatoes.

According to him, he is using his initials so he ought to be allowed to register the name he has chosen. He is worried about the fact that the matter may end up in court.

He asks you to inform him about the factors the court will take into account if the name is registered, and XX2 (Pty) Ltd applies for an order that XX Two Products (Pty) Ltd change its name.

Feedback

The fact that one company conducts its business in KwaZulu-Natal and the other in Limpopo is irrelevant. *Peregrine Group (Pty) Ltd v Peregrine Holdings Ltd* deals with the factors that are considered by the courts. Also read paragraph 2.11 in the textbook.

3.12.1 Criteria for names of companies in terms of the Act

Prescribed study material

- Paragraph 2.11.1 in the textbook
- Section 11 of the Companies Act

The name of a company may not

- be the same as the name of another company, close corporation or cooperative
- resemble the name of another company, close corporation or cooperative to the extent that it may create confusion or create the impression that the two businesses are associated
- give the impression that the company is associated with the government, or with a particular person or government office, etcetera
- be the same as the name of a business which has already been registered in terms of the Business Names Act 27 of 1960
- be the same as a trademark of a business which has been filed for registration in terms of the Trade Marks Act 194 of 1993

The name of a company may

- be the registration number of the company, provided that it is a "profit" company. The number has to be followed by the words "(South Africa)".

Note that this is applicable to profit companies only. Nonprofit companies are not allowed to have registration numbers as their names.

- be in any language and it may consist of any letters, numbers or punctuation marks and brackets. It may also contain any of the specified symbols listed in paragraph 2.11.1 in the textbook. A combination of the above is allowed. In addition, the name of the company must end with the appropriate expression for that type of company. Remember to add the expression "(RF)" to the list contained in paragraph 2.11.1 in the textbook.

Activity 3.16

The name of a company must end with the words that are prescribed for that particular type of company. List the different types of companies that may be formed and their prescribed endings. Thereafter explain what will happen if the prescribed ending does not form part of the name on the Notice of Incorporation.

Feedback

Read paragraph 2.11.1 in the textbook.

3.12.2 Change of name

Prescribed study material

- Paragraph 2.11.2 in the textbook
- Section 11(3) of the Companies Act

Where a name that is to be registered is similar to another registered name, the Act allows the Commission to make use of the registration number of the company as an interim name.

The registration number will appear in

- the Companies Register, and on
- the Registration Certificate

The registration number must end with the relevant suffix, as stated in section 11(3). The company is afforded another opportunity to file a Notice of Incorporation containing an acceptable name. Upon receipt of the Notice of Incorporation with the amended name, the Commission has to enter the new name in the Companies Register. It must also issue an amended Registration Certificate reflecting the amended name.

Where, according to the Commission, there is a possibility that the name is similar to the name of another company or another business undertaking or trade mark, or that the name gives the impression that there is a connection between the company that is applying and another entity or state organ, the Commission may compel the applicant to inform parties that may be interested by serving them with a copy of the application and name reservation.

The Act also allows any person who has an interest in the name of a company to apply to the Companies Tribunal for it to determine whether or not the name is in accordance with the requirements of the Act.

Activity 3.17

You are approached by Xolani Xaba Jnr. The name of the company he wishes to register is XX2 (Pty) Ltd. You inform him that there is already a company with the same name. He decides to proceed and is ready to provide an alternative name if the first one is rejected.

How will the Commission deal with this?

What will happen if the alternative name gives the impression that the business is associated with another business?

Feedback

See paragraph 2.11.2 in the textbook.

Note the decision of the court in *Azisa (Pty) Ltd v Azisa Media CC and Another* 2002 (4) SA 377 (C).

3.12.3 Use of name and registration number

Prescribed study material

- Paragraph 2.11.3 in the textbook
- Section 32 of the Companies Act

Section 32 requires that a company provide its full name or registration number to any person on demand. It further prohibits the misstating of the name or registration number and the stating of the name in such a way that it may mislead or deceive a person.

Where the Commission issues a Registration Certificate with an interim name, the company is obliged to use its interim name. The interim name is used until the company name has been amended.

Activity 3.18

Explain how the name and registration number of a company should be used.

Feedback

Read paragraph 2.11.3 in the textbook and the case of *Epstein v Bell* 1997 (1) SA 483 (D).

3.12.4 Reservation of a name for later use

Prescribed study material

- Paragraph 2.11.4 in the textbook
- Section 12 of the Companies Act

In terms of section 12, a name may be reserved for use at a later stage, to be used for a newly incorporated company or to be used as a replacement for the existing name of a company.

A reservation is made by filing an application and paying the prescribed fee. Once this has been done, the Commission is obliged to reserve the name.

The Commission will not reserve a name if

- it is already the name of another registered company, close corporation or cooperative
- it is already a name given to an external company
- it is a name that has already been reserved in terms of the Act

There is a six-month reservation period. It is calculated from the date of application for reservation. Should the person who applies for reservation of a name wish to transfer the name to another person, this is possible. It must be done by filing a notice of transfer.

Activity 3.19

Lufuno has registered a company called Lufuno's Pots (Pty) Ltd. The company's main business is the manufacturing of three- legged pots. These are sold to individuals and to shops. The business is thriving and the market growing.

Lufuno's dream is either to expand the business or register another company in the near future, which will deal mainly with the renting out of tents, chairs, three-legged pots, tables, and so on, for functions such as funerals and parties. She has a name in mind, but is worried about the fact that someone else may register another company using the same name. She approaches you. Advise Lufuno accordingly.

Feedback

It is possible to reserve a name with a view to making use of it in the future. A name may be reserved for use as

- the name of a new company or
- a new name of an incorporated company

A name is reserved by filing an application and paying the prescribed fee. The Commission is bound by law to reserve all names that appear in the application for reservation. An applicant may reserve more than one name.

A name is reserved for six months. The six-month period is calculated from the date of the application for reservation. Also note the fact that the Act allows for the transfer of a reserved name to another party.

REFLECTION

The purpose of the Companies Act of 2008 was to simplify the procedure for incorporation of companies. There is one constitutive document, a Memorandum of Incorporation, instead of the two documents that were required under the Companies Act of 1973.

In terms of the Companies Act 1973, companies had to reserve their names in order to avoid the possibility that companies would be incorporated with names that could deceive the public or be undesirable. The Companies Act of 2008 makes name reservation optional. Do you think that the Companies Act of 2008 has fulfilled its aim of simplifying the formation of companies?

REVIEW

In this study unit you learnt the procedure for incorporation of companies. You should be able to advise a person wishing to form a company of the procedure to follow in order to form a company.

You were further introduced to the new statutory position where contracts are concluded prior to incorporation on behalf of the company, or pre-incorporation contracts. Keep in mind that the various common-law options remain available for conclusion of pre-incorporation contracts. The formal requirement and liability of the promoter (person who is concluding the pre-incorporation contract on the company's behalf) that is effected by the Companies Act 2008 may be stricter than some common-law options. For instance, would it not be better to conclude a contract for the benefit of a third party in terms of the common law to achieve the desired results?

You also learnt that companies are no longer obliged to reserve names prior to incorporation of the business. There are, however, still measures in place to protect a company's goodwill and avoid deception of the public arising from the registration of undesirable names.

Please ensure that you are able to answer the questions at the beginning of this study unit.

In the next study unit we shall discuss who has the authority to participate in the management of companies, and when contracts concluded by natural persons who represent the company would bind the company.

Study unit 4

CAPACITY AND REPRESENTATION OF A COMPANY

PRESCRIBED STUDY MATERIAL

- Study paragraphs 2.12 to 2.14 in the textbook.
- Study sections 19 and 20 of the Companies Act.
- *Royal British Bank v Turquand* (1856) 6 E & B 327, 119 ER 886 [101]
- *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480 [103]

4.1 INTRODUCTION

In study unit 3 we learnt how a company is incorporated and registered. To incorporate a company, a Notice of Incorporation accompanied by a copy of the Memorandum of Incorporation must be filed with the Commission and the prescribed fee must be paid. Upon acceptance of a Notice on Incorporation, the Commission will allocate a unique registration number to the company. If all the formalities are met, a registration certificate will be issued and delivered to the company. We also learnt that prior to a company's incorporation, it may enter into pre-incorporation contracts provided that it complies with certain requirements. In this study unit we will explain the legal capacity and representation of companies.

This study unit deals with the validity of company actions. Firstly, this entails the power or legal capacity of a company to perform a specific act, and secondly, the authority of the person representing a company to act on the company's behalf.

You will know that you understand this study unit if you are able to answer the following **key questions**:

- What is meant by capacity of a company?
- What is the *ultra vires* doctrine? What are the consequences if a company acts outside its capacity?
- In what circumstances does a person have the authority to represent a company and bind it to a contract?

- What is the purpose of the *Turquand* rule and how does it operate under the Companies Act of 2008?

This study unit will follow the structure indicated below.

Capacity of a company

- ***Ultra vires* doctrine**
- **Section 36 of the Companies Act of 1973**
- **Sections 19 and 20 of the Companies Act of 2008**

Doctrine of constructive notice

The *Turquand* rule

4. The doctrine of estoppel

4.2 CAPACITY OF A COMPANY AND THE *ULTRA VIRES* DOCTRINE

Prescribed study material

- Paragraphs 2.12 and 2.13 in the textbook
- Sections 19(1) and 20 of the Companies Act

The capacity of a company is the sphere of actions a company may legally perform. In terms of our common law, a contract is *ultra vires* the company when the conclusion of the transaction is beyond its legal capacity.

The *ultra vires* doctrine is based on the understanding that a company exists in law only for the purpose for which it was incorporated. According to the *ultra vires* doctrine, when an act on behalf of the company falls outside its main and ancillary objects, the company does not exist in law and consequently such an act is not binding on the company. Such an act is described as an *ultra vires* act.

In *Attorney-General v Mersey Railway Co* (1907) 1 Ch 81 (HL), the court explained that whether a particular contract falls within the capacity and powers of the company is a question of fact. If the main purpose of the company was to conduct the business of a hotel, it is clear that acts necessary to achieve this purpose, for example, the purchasing of furniture and the hiring of staff, are *intra vires*.

Under section 36 of the Companies Act of 1973, if members of a company find out about a proposed *ultra vires* contract before it is concluded, they may interdict the company from entering into the contract. However, if an *ultra vires* contract has already been concluded, the contract will be binding on the company. An action can then be brought against directors who have exceeded their powers by concluding a contract on behalf of the company which falls outside the capacity of the company, on the basis that the directors have breached their fiduciary duty not to exceed the scope of their authority.

Section 19(1) *(b)* of the Companies Act of 2008 now considerably widens the capacity of a company. It provides that a company has all the legal capacity and the powers of a natural person except to the extent that a juristic person is incapable of exercising any such power, or the company's Memorandum of Incorporation provides otherwise. A company's capacity is therefore no longer limited by its main or ancillary objects or business. Although the company's Memorandum of Incorporation may limit, restrict or qualify the purposes, powers or activities of the company (in other words, impose restrictions on the legal capacity of the company) in terms of section 19(1)*(b)*(ii), any such restrictions would not render any contract invalid that conflicts with these restrictions (s 20(1)*(a)*). Thus, the contract remains valid and binding upon the company and the other party to the contract. Section 20(6) of the Act provides that each shareholder has a claim for damages against any person who fraudulently or due to gross negligence causes the company to do anything inconsistent with the Act or a limitation, restriction or qualification on the powers of the company as stated in its Memorandum of Incorporation, unless ratified by special resolution in terms of section 20(2). This is in addition to the remedy provided in section 165 (see study unit 9).

However, if the company or directors have not as yet performed the planned action (say, concluded the contract) that is inconsistent with a limitation or qualification of the company's powers contained in the Memorandum of Incorporation, one or more shareholders, directors or prescribed officers of the company may obtain a court order restraining (ie preventing) the company or directors from doing so. A third party who did not have actual knowledge of this limitation or qualification and acted in good faith, will in such a case have a claim for any damages suffered as a result. In terms of section 20(4), shareholders, directors, prescribed officers and a trade union representing employees of the company may also institute proceedings to prevent the company from doing anything inconsistent with the Act. Note that it is only in the last-mentioned case that a trade union may prevent the company from acting.

Activity 4.1

Steelbelts Railway Carriages (Pty) Ltd's main business is the manufacturing and selling of railway carriages. Mr Buckley, one of the directors, is authorised by the board of directors to act on the company's behalf. Mr Buckley concludes a contract with Mr Matthews for the purchase of a holiday flat.

Is the company bound by the contract concluded by Mr Buckley?

Feedback

Section 19(1) of the Act provides that a company has all the legal capacity and the powers of a natural person except to the extent that a juristic person is incapable of exercising any such power. The company's Memorandum of Incorporation may impose restrictions on the company's legal capacity but there is no indication that the Memorandum contains any such restriction. The company is also not restricted by its main business. The contract is therefore valid and binding on the company and the other party to the contract.

4.3 REPRESENTATION

Representation relates to a person acting under the company's authority. If a company gives an agent authority to act on its behalf, the agent possesses actual authority and will bind the company in acts which fall within the scope of the mandate given to him or her. Authority can be given expressly (in writing or orally) or by implication. Whether authority has been conferred is a question of fact.

A company may also be bound to a contract on the basis of estoppel where the person purporting to conclude the contract on its behalf lacked actual authority, express or implied, but the other party to the contract had been misled by the company into believing that he or she did have authority. This is referred to as ostensible or apparent authority (see the discussion in 4.3.3 below).

4.3.1 The doctrine of constructive notice

Prescribed study material

- Paragraph 2.14 (specifically the first paragraph) in the textbook
- Section 19(5) and (6) of the Companies Act

The doctrine of constructive notice provides that third parties dealing with a company are deemed to be fully acquainted with the contents of the public documents of the company. Section 19(4) of the Act partly abolishes this doctrine. Thus, third parties contracting with the company will no longer be deemed to have had notice of the contents of the public documents of a company merely because they have been filed with the Commission or are accessible for inspection at the office of the company. However, section 19(5) of the Act provides for two exceptions: firstly, a person is deemed to have knowledge of any provision of a company's Memorandum of Incorporation in terms of section 15(2)*(b)* (relating to special conditions applicable to the company and additional requirements regarding their amendment). This is subject to the condition that the Notice of Incorporation contains a prominent statement drawing attention to such a provision as required by section 13(3). The second exception applies to a personal liability company. A person is also regarded as having received notice and knowledge of the effect of section 19(3) on a personal liability company. Section 19(3), in turn, provides that the directors and past directors of a personal liability company are jointly and severally liable, together with the company, for any debts and liabilities of the company contracted during their respective periods of office.

Activity 4.2

Steelbelts Railway Carriages (Pty) Ltd's Memorandum of Incorporation determines that only the board of directors or a person who has obtained authority from the board of directors will have authority to contract on the company's behalf. It further states that any transaction exceeding the amount of R100 000 must first be authorised in a general meeting by ordinary resolution.

Mr Buckley, a director, is authorised by the board of directors to conclude contracts on the company's behalf. Mr Buckley concludes a contract with Mr Matthews for the purchase of equipment to be used in the manufacture of railway carriages priced at R150 000. The company did not consent to the purchase in a general meeting. Mr Matthews is aware of this stipulation because he has previously done business with the company. However, he assumed that consent had been obtained from the general meeting since this had always been the case in previous transactions.

(1) Will the company be bound by the agreement concluded by Mr Buckley?
(2) Assume that Mr Matthews was a director of Steelbelts Railway Carriages (Pty) Ltd, who resigned as director shortly before conclusion of the contract. Would your answer differ from the one in (a)?

Feedback

Section 19(4) of the Act provides that third parties contracting with the company are not deemed to have had notice of the contents of the public documents of a company merely because they have been filed with the Commission or are accessible for inspection at the company's office. Mr Matthews is therefore not expected to know that the general meeting's consent was required for the validity of a contract of that size. It would seem from the set of facts that the exceptions in section 19(5) are not applicable.

4.3.2 The Turquand rule

Prescribed study material

- Paragraph 2.14 in the textbook
- Section 20(7) of the Companies Act
- *Royal British Bank v Turquand* (1856) 6 E & B 327, 119 ER 886

The *Turquand* rule was derived from *Royal British Bank v Turquand* (1856)

6 El. & Bl. 327; 119 ER 886). According to the common law *Turquand* rule, an outsider contracting with the company in good faith is entitled to assume that all internal requirements and procedures have been complied with. The company will be bound by the contact even if the internal requirements and procedures have not been complied with.

The following exceptions apply: if the outsider was aware of the fact that the requirements and procedures had not been complied with; or if the circumstances under which the contract was concluded were suspicious. The rule was formulated to keep an outsider's duty to inquire into the affairs of the company within reasonable bounds.

For the *Turquand* rule to come into effect, the person who acted must have possessed actual authority, which was subject to an internal formality. In *Tuckers Land and Development Corporation (Pty) Ltd v Perpellief* 1978 (2) SA 11 (T), the court found that third parties may not automatically assume that a branch manager or an ordinary director has authority to act on the company's behalf. The company may still escape liability on the grounds that the person had no authority.

Section 20(7) of the Companies Act of 2008 now codifies the *Turquand* rule in a modified form by providing that a person dealing with a company in good faith is entitled to assume that the company has complied with all of the procedural requirements in terms of the Act, the company's Memorandum of Incorporation and any rules of the company, unless the person knew or reasonably ought to have known of any failure by the company to comply with its formal and procedural requirements.

Activity 4.3

Steelbelts Railway Carriages (Pty) Ltd's Memorandum of Incorporation provides that only the board of directors, or any person authorised by the board, has the power to conclude contracts on the company's behalf. In addition, any transaction that exceeds R100 000 must first be authorised by the company in general meeting by way of ordinary resolution.

Mr Buckley, one of the directors, is authorised by the board of directors to act on the company's behalf. Mr Buckley concludes a contact with Mr Matthews for the purchase of equipment that will be used in the process of manufacturing railway carriages to the value of R150 000 without the authorisation of the company in general meeting.

Mr Matthews knows about this provision because he has dealt with the company before. However, he assumes that the approval of the general meeting has been obtained since it had always been obtained for previous transactions.

(1) Is the company bound by the contract concluded by Mr Buckley?
(2) Suppose Mr Matthews resigned from the company as a director shortly before the contract was signed. Would your answer differ from the one in (1)?

Feedback

(1) The company is bound by the contract concluded by Mr Buckley because of the operation of section 20(7) of the Act. It provides that a person dealing with a company in good faith is entitled to assume that the company has complied with all of the procedural requirements in terms of this Act, its Memorandum of Incorporation and any rules of the company unless the person knew or reasonably ought to have known of any failure by the company to comply with its formal and procedural requirements.

There is no indication from the facts that Mr Matthews knew or reasonably ought to have known that Mr Buckley failed to comply with the procedural requirement in terms of the Memorandum of Incorporation. There is also no indication that Mr Matthews was aware of the fact that Mr Buckley did not comply with procedural requirement and had acted in bad faith. Based on these facts, the company is bound by the contract.

If Mr Matthews recently resigned as a director of the company, the answer would differ from the one in (1). Mr Matthews would not only have known that prior authorisation by the general meeting is required for any transaction that exceeds R100 000, but he also knew, or reasonably ought to have known that no such approval was obtained. Based on this, the company is not bound by the contract.

4.3.3 The doctrine of estoppel

Prescribed study material

- *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480

Estoppel applies only when the agent did not have actual authority to bind the company. Take particular note of the fact that the misrepresentation (ie that the agent had the necessary authority when, in fact he or she did not) must have been made by the company as principal. Based on such misrepresentation, the company will be estopped from denying liability if the third party can prove that

(a) the company misrepresented, intentionally or negligently, that the agent concerned had the necessary authority to represent the company
(b) the misrepresentation was made by the company
(c) the third party was induced to deal with agent because of the misrepresentation
(d) the third party was prejudiced by the misrepresentation

REFLECTION

Despite the fact that companies enjoy separate legal personality, it is still necessary for individuals to act on their behalf. Only individuals with some type of authority may represent companies. This authority need not always be expressed authority. Are you able to explain under what circumstances someone who has no actual authority could conclude a contract that would bind a company?

REVIEW

You have now learnt that there are persons who may conclude binding contracts on behalf of companies. It is also clear that different types of authority should be considered.

The changes effected to the doctrine of constructive notice and the Turquand rule in the Companies Act 2008 were also highlighted.

Please ensure that you are able to answer the questions at the beginning of this study unit.

In the next study unit you will be introduced to the corporate finance structure and learn about shares, debentures and distribution.

Study unit 5

CORPORATE FINANCE: SHARES, DEBENTURES AND DISTRIBUTIONS

PRESCRIBED STUDY MATERIAL

- Study chapter 3 in the textbook.
- Study sections 35 to 48 of the Companies Act.
- *Lipschitz v UDC Bank Ltd* 1979 (1) SA 789 (A) [138]

5.1 INTRODUCTION

By now you should know that one of the main advantages of running one's business in the form of a company is that a company has separate legal personality from its shareholders. This means that a company is the owner of its own assets and responsible for its own obligations.

Another major advantage of the company as a business form is that it offers the opportunity to raise money from a wide range of investors. In this study unit we will explain the different ways in which a company can raise money. You will also learn how dividend payments work. In certain circumstances a company may buy back shares it previously issued.

You will learn when a company may buy back its shares. Lastly, we will consider under what circumstances a company may financially assist a person to buy shares in the company.

We realise that many students find these topics confusing and unfamiliar. It is therefore imperative that you study these notes in conjunction with the material in the textbook. Together we will master corporate finance!

You will know that you understand this study unit if you are able to answer the following **key questions:**

- What is a share?
- What classes of shares may a company issue in terms of the Act?
- What is a debenture? How does a debenture differ from a share? What transactions will be considered 'distributions' in terms of the Companies Act 71 of 2008?
- What are the requirements before a company may repurchase its shares?

- What is a dividend?
- What are the requirements before a company may give financial assistance to a person so that he or she may buy shares in the company?

The structure of this study unit is set out below.

Definition of a share

Classes of share

- **Preference shares**
- **Ordinary shares**
- **Deferred shares**

Issue of shares

- **Right of pre-emption**

Debentures

Distribuitons

Capital maintenance

Financial assistance for the purchase of shares

5.2 DEFINITION OF A SHARE

Prescribed study material

- Paragraphs 3.1 and 3.2 in the textbook
- Section 35 of the Companies Act

The Companies Act 71 of 2008 defines a "share" as "one of the units into which the proprietary interest in a profit company is divided." To understand this definition, we should start by asking: What is a shareholder? A shareholder is essentially one of the contributors of the fund that sets up a company. This fund is the share capital of the company. A "share" is the unit of the contribution made to the share capital. It is property in itself and can be traded.

In terms of the Companies Act of 1973, shares could be issued with a nominal value attached for instance, a company could issue 100 shares with a nominal value of R1 each. These shares were known as par value shares. In terms of the new Companies Act, in future, no shares will be issued with a nominal value attached. Only the number of shares, not their value, must be authorised in a company's Memorandum of Incorporation.

A company's Memorandum of Incorporation must set out the classes of shares and the number of each class that a company is authorised to issue. This is referred to as the company's "authorised share capital". A company may only issue shares authorised by the Memorandum of Incorporation.

However, a company's board may increase or decrease the authorised share capital. They may further reclassify any shares authorised but not issued. The board decides when to issue shares and how many shares must be issued. In other words, not all the authorised shares need to be issued.

If a company issues 100 shares and the price per share that a shareholder pays is R1, the company will have a share capital of R100. In other words, the company will have raised R100 to use in its business. After the initial issue, the share will be worth what the market is willing to pay for it.

The decision in *Standard Bank of SA Ltd v Ocean Commodities Inc* (see par 3.2 in the textbook) provides the classical definition of a share in the view of the courts. Besides the definition in the Companies Act, this definition is also extremely important. A share usually entitles its holder to vote at a shareholders' meeting, to share in dividends if declared by the board (see below) and to share in any assets of the company after it has been wound up.

Activity 5.1

Describe what you understand under the concept "share".

Feedback

Remember that you must mention both the cases discussed in paragraph 3.2 in the textbook and the definition in the Companies Act.

5.3 CLASSES OF SHARES

Prescribed study material

- Paragraph 3.3 in the textbook, excluding paragraphs 3.3.8 and 3.3.9
- Sections 36 and 37 of the Companies Act

Shares are divided into classes according to the specific rights a share confers on its holder. The rights that differ among the various classes can usually be divided into the following:

- the right to vote
- the right to information
- the right to share in the profits that have been declared as a dividend
- the right to share in the assets that are left in the winding-up of the company after its creditors have been paid.

The classes of shares most commonly found are preference, ordinary and deferred shares.

5.3.1 Preference shares

Preference shares provide their holders with a preference over other shareholders to dividends, and/or return on capital on winding-up. One needs to consult the company's Memorandum of Incorporation as well as the terms of issue of the preference shares, to find out in which respect they confer a preference on their holders. If the preference shareholders have the right to receive dividends first, this right is usually subject to a dividend being declared. In other words, if the company has not made any profit, or if the directors decide instead to use profits in the business than to declare them as dividends, the preference shareholders do not have a right to demand a dividend payment.

In return for the preferential rights to dividends, the right of preference shareholders to vote is usually curtailed in the Memorandum of Incorporation. However, even if the Memorandum of Incorporation provides that preference shareholders do not have the right to vote, the Companies Act provides that they have an irrevocable right to vote on any proposal to amend the preferences, rights, limitations and other terms associated with their shares.

There must always be at least one class of shareholders of the company that can vote at a meeting of shareholders and at least one class of shareholders that are entitled to the net assets of the company upon its liquidation. In other words, a company is not allowed to only issue preference shares that do not grant their holders the right to vote.

The following types of preference shares can be distinguished:

- *Cumulative preference shares*. If a dividend is not declared in a specific year, the shareholder's right to a dividend is carried over to the next year. When a dividend is declared the next year, the preference shareholder will have to be paid two years' dividends before the ordinary shareholders can receive their dividends.
- *Participating preference shares*. After receiving their preference dividends, preference shareholders may be given the right to also receive normal dividends along with the ordinary shareholders or just after the ordinary shareholders.
- *Preferential right to capital on winding-up*. Preference shareholders could be given the preferential right to receive repayment of the capital they contributed to the company on its winding-up. In addition, they can

be given the right to share in any surplus assets of the company upon its winding-up after receiving their capital contributions, but this is the exception rather than the rule.

- *Convertible preference shares*. The right to convert the preference shares to shares of another class after a certain date attaches to the preference shares.

Activity 5.2

Activity

Thato is a cumulative preference shareholder of United Ltd. He receives a notice of a meeting informing him that a resolution is to be proposed to change the rights of United Ltd's preference shareholders so that they will not have cumulative rights to dividends. The terms of issue of his shares read that the shares do not entitle their holders to vote at meetings of the company's shareholders Advise Thato on whether or not he will have the right to vote at the meeting at which the resolution will be proposed.

Feedback

Feedback

The Companies Act provides that any shareholder has the right to vote at meetings at which a resolution is to be proposed which will affect an amendment of his or her rights in terms of his shares. When you answer a question like this in an examination, remember to end with the answer to the question in this case, the fact that Thato will have the right to vote at the meeting.

5.3.2 Ordinary shares

Ordinary shareholders usually receive dividends after the preference shareholders have received theirs. Ordinary shareholders also usually have the right to receive any of the company's surplus assets after it has been wound up.

Ordinary shareholders normally have the right to vote at meetings of shareholders.

This right may be curtailed in terms of the Companies Act, so that one class of ordinary shareholders will not have the right to vote. However, there must always be at least one class of shareholders with the right to vote and if there is only one class of shareholders, they must all have the right to vote.

5.3.3 Deferred shares

Occasionally, shares are issued to the founders of a company that entitle them to dividends, only if the dividend amount exceeds a certain threshold and after the ordinary shareholders have been paid. In other words, deferred shareholders are last in line to receive dividends.

5.4 ISSUE OF SHARES

Prescribed study material

- Paragraph 3.4 in the textbook
- Section 38 of the Companies Act

The Companies Act regards the issuing of shares as a management decision. Unless specifically limited in the Memorandum of Incorporation, the board of directors will have the authority to take the decision to issue shares without the shareholders' approval. The board of directors also has the authority to increase the authorised shares of the company.

However, in the following circumstances, a resolution by the board of directors to issue shares must be approved by a special resolution of the shareholders:

- where the shares are issued to the directors, future directors or prescribed officers of the company. A "future director" or "future prescribed officer" does not include a person who becomes a director or officer more than six months after the shares were issued.
- where the shares are issued to a person related or interrelated to the company, a director or a prescribed officer of the company. A natural person is related to another natural person if she is married to or lives with that person as if they were married, or is that person's parent, sister, aunt or first cousin. A natural person is related to a company when she directly or indirectly controls the company by either having the majority of voting rights or by having the right to appoint the majority of directors of the company.
- A juristic person is related to another juristic person if it directly or indirectly controls the other by either having the majority of voting rights or by having the right to appoint the majority of directors of the company, or if it is a subsidiary of the company, or if it controls the business of the company.
- where the shares are issued to a nominee of a director or a prescribed officer of the company
- where the voting power of the shares to be issued will exceed 30 per cent of the voting power of the shares of that class held immediately before the issue

5.4.1 Right of pre-emption

As a general rule, shareholders of private companies have a right of pre-emption to new shares issued by the company. This means that when the company issues new shares, these must be offered to existing shareholders first, pro rata to their current shareholdings.

The reason why this provision was included in the Companies Act is to guard against the dilution of ownership in private companies.

Dilution of ownership can be explained as follows: Suppose that Fidelity

(Pty) Ltd has two shareholders who each hold 10 shares. At a meeting of shareholders they will have equal voting power. Suppose that Fidelity (Pty) Ltd decides to issue 20 more shares. If a third person acquires all 20 of these shares, that person will have half of the voting rights at a meeting of shareholders. The original shareholders will now only have a 25 per cent voting power in the meeting of shareholders. If they had exercised rights of pre-emption, each of them would have been entitled to half of the 20 shares, and they would consequently retain the same voting power in the company.

Activity 5.3

The directors of Rainbow (Pty) Ltd wish to issue shares to Fred. Fred is currently not a shareholder of Rainbow (Pty) Ltd, but has agreed to become the managing director of Rainbow (Pty) Ltd in a month's time. Fred has entered into a service agreement with Rainbow (Pty) Ltd and is required to hold qualification shares in the company before he can become a director. Advise the directors on whether or not they may take the decision to issue the shares to Fred without shareholder approval. Further consider whether the current shareholders' right of pre-emption would apply.

Feedback

Because Fred is a future director of the company, shareholder approval is required by way of a special resolution. The current shareholders' pre-emptive rights will probably not apply to this scenario, because the shares are not issued for cash but as part of an employee scheme.

5.5 DEBENTURES

Prescribed study material

- Paragraph 3.5 in the textbook
- Section 43 of the Companies Act

A debenture is an acknowledgment by a company that it owes the debenture holder a certain sum of money, as evidenced in the document. Debenture holders are creditors of the company by virtue of having extended loans to the company.

The duties of the company towards the debenture holders can be secured or unsecured. A trustee will usually be appointed to hold security on the debenture holders' behalf. If the company defaults on its commitments to the debenture holders, the trustee will be able to enforce the security on their behalf, without the need for every debenture holder to institute action individually.

The board of directors can decide whether to issue debentures without approval of the shareholders, unless otherwise indicated in the Memorandum of Incorporation.

5.6 DISTRIBUTIONS

Prescribed study material

- Paragraph 3.8 in the textbook
- Section 46 of the Companies Act

The concept of distributions was rather narrowly defined in the Companies Act of 1973. Payments made to shareholders in their capacity as shareholders were included in the concept, but a repurchase of shares by a company and redemption of shares were expressly excluded.

In the Companies Act of 2008, the last-mentioned acts are now also classified as distributions.

Section 46 of the Companies Act regulates distributions. You need to know that the payment of dividends to shareholders is a distribution in terms of the Act. Other acts that fall under the definition are the purchase by a company of its previously issued shares, the incurrence of a debt for the benefit of one or more of the shareholders of the company, or the forgiveness of a debt owed to the company by one or more of the company's shareholders.

A distribution may be made in the following circumstances:

- The board of directors must authorise the distribution.
- It must reasonably appear that the company will be able to satisfy the solvency and liquidity test immediately after the distribution has been made.

The solvency and liquidity tests are set out in section 4 of the Act:

- *Solvency test*. Considering all reasonably foreseeable financial circumstances of the company at that time, the assets of the company, fairly valued, equal or exceed the liabilities of the company as fairly valued.
- *Liquidity test*. Considering all reasonably foreseeable financial circumstances of the company at that time, it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of 12 months after the distribution. If the distribution was in the form of giving a loan to a shareholder or forgiving a loan made to a shareholder, the period runs from 12 months after the test was considered.

The distribution must be made within 120 days after the test was applied, otherwise the resolution by the board must be taken again and the test must be applied again.

As long as these requirements are met, dividends can be paid out of a company's share capital. However, dividends are usually paid from the profits of a company. The board of directors decides how much of the profits they wish to pay out to shareholders. They are free to decide that they are going to keep all profits for the expansion of the business of the company. In such circumstances, the shareholders are normally not entitled to dividends.

Activity 5.4

You are the company secretary of Tau Gold Ltd. At a meeting of the board of directors it is proposed that a dividend be paid out to shareholders. Advise the board on the requirements before a dividend can be validly paid to shareholders.

Feedback

You need to keep the requirements of section 46 in mind, as well as the solvency and liquidity tests.

5.7 CAPITAL MAINTENANCE

Prescribed study material

- Paragraph 3.7 in the textbook

You do not need to study the historical background on pages 53 to 55 in the textbook, but make an effort to read through it because it puts the new regulation of capital maintenance in perspective.

Companies were originally required to maintain their share capital. In other words, they were not allowed to return to shareholders some of the funds originally given in return for their shares, nor were companies allowed to issue shares at a discount, causing the company to gain less share capital in return for the shares than the nominal value of the shares reflected.

The maintenance of capital was gradually relaxed through amendments to the Companies Act of 1973. You do not need to know the details of these provisions, only the following:

- A company is allowed to repurchase its shares. This is considered a distribution, which means that the solvency and liquidity tests must be met. See above for the definition of these tests.
- After the company has purchased its shares, there must be shares left other than convertible or redeemable shares. Some shares must be held by shareholders other than the company's subsidiaries.
- If the company repurchased shares and it emerges that it did not meet the solvency or liquidity tests, the agreement between the shareholder and the company in terms of which the company would repurchase the shareholder's shares, remains enforceable.
  - The company must apply for a court order to suspend the repurchase of the shares. The company bears the burden of proof that it did not meet the financial requirements of the Act. The court may make any order it deems fit.
  - The court's order must ensure that the person from whom the shares are purchased will be paid at the earliest time that the company will still be able to fulfil its financial obligations as they fall due and payable.
- Alternatively, if the repurchase was in contravention of the solvency and liquidity tests, the company can apply for a court order to have the repurchase reversed:
  - The person from whom the shares were bought will then be required to return the consideration received.
  - The company will have to issue shares to that person in return.

Directors who approved a repurchase of shares in contravention of the requirements relating to distributions are liable in the same manner as set out on page 57 in the textbook.

Activity 5.5

Mega-Manufacturers Ltd took a decision to repurchase shares. The board of directors considered the solvency and liquidity tests and was satisfied at the time that these requirements were met.

However, it subsequently emerged that a patent belonging to the company was grossly overvalued in its financial statements. Mega-Manufacturers Ltd has now applied to have the transaction reversed. Advise Asanda, one of the shareholders whose shares were repurchased, on her legal position.

Feedback

If the application is successful, Asanda will have to refund the money she received. However, the company will return the shares it repurchased.

5.8 FINANCIAL ASSISTANCE FOR THE PURCHASE OF SHARES

Prescribed study material

- Paragraph 3.10 in the textbook
- Section 44 of the Companies Act
- *Lipschitz v UDC Bank Ltd*1979 (1) SA 789 (A) [138]

In terms of the Companies Act of 1973, a company was prohibited from providing financial assistance to a person to enable him or her to acquire shares or other securities in the company, except for a number of very specific exceptions.

In terms of section 44 of the Companies Act of 2008, a company may assist a person in acquiring shares and other securities in the company, provided that such assistance is not prohibited by the Memorandum of Incorporation and that certain requirements are met.

The decision to assist a person to acquire shares in the company rests with the board of directors, but only where the assistance is in terms of an employee share scheme or where a special resolution by the shareholders authorised such assistance to a specific person or persons who fall in a specific class or category. In the latter case, the person to whom the assistance will be given must fall in that class and the resolution must have been taken within the two years preceding the board's decision to assist.

Section 44 further requires that the board must be satisfied that the solvency and liquidity requirements are met (see above) and that the assistance is given under terms that are fair and reasonable to the company.

The Memorandum of Incorporation may place further restrictions on the provision of financial assistance and the board must ensure that these requirements are also met.

The *Lipschitz* decision dealt with the prohibition of financial assistance in terms of the old Act. However, the decision is still important for the application of section 44, because it provides guidelines on when the provisions of the section will be applicable to a particular scenario.

In *Lipschitz,*it was held that the transaction had to be assessed in two phases:

- First, it had to be ascertained whether there was financial assistance. In *Gradwell (Pty) Ltd v Rostra Printers Ltd* 1959 (4) SA 419 (A), the "impoverishment test" was formulated to assist in determining whether financial assistance was provided.

In terms of the impoverishment test, one considers whether a transaction will have the effect of leaving the company poorer. If so, financial assistance was provided. In *Lipschitz,* the court held that this is not the only measure of financial assistance, but that exposing the company to risk would also qualify as financial assistance for purposes of the Act.

For example, if the person obtained a loan to purchase shares in the company and the company stood surety for that loan, it would count as financial assistance. If the company buys an asset from the person to enable that person to purchase shares in the company, it will depend on the facts whether there was financial assistance. Factors that have emerged from case law to assist in this regard are whether the company needs the asset in its normal business and whether it paid a fair price for it.

- Second, it must be determined whether that assistance was for the purpose of acquiring shares in the company. Suppose Company A is a major creditor of Company B. Company A acquires most of the shares in Company B. After the acquisition, Company A causes Company B to grant security over its movable assets to secure the loans. This will be financial assistance in terms of the first test, but it is not in connection with the purchase of shares. The assistance is to secure a loan.

  When a transaction passes these two phases, it will have to comply with section 44 in order to be valid. If it was not financial assistance, or if the assistance was not in connection with the purchase of shares, section 44 is not relevant to the transaction.

Activity 5.6

Activity

David wishes to purchase shares in Free-4-All (Pty) Ltd. He does not have money available, but offers to sell some computer equipment left over from a previously unsuccessful business to the company. He will then use this money to purchase shares in Free-4-All (Pty) Ltd. Advise the board of directors of Free-4-All (Pty) Ltd whether the company must comply with the requirements of section 44 of the Companies Act 71 of 2008 before they may sell the shares to David.

Feedback

Feedback

You will have to consider the approach of the court in the *Lipschitz* decision in your answer. Remember that we are not asking what the requirements of section 44 are. You must determine whether section 44 is applicable here.

After discussing the process as formulated in *Lipschitz*, you must draw a conclusion. For instance, you may say that if Free-4-All (Pty) Ltd needs the equipment, this will not be financial assistance and the company will not need to comply with section 44.

REFLECTION

The importance of capital maintenance to ensure that company creditors are not prejudiced by some of the transactions companies may enter into is clear. Can you remember under what circumstances the solvency and liquidity criteria must be adhered to before the company is allowed to act?

REVIEW

In this study unit we dealt with the nature of shares and debentures in companies. Both shares and debentures are issued by companies to raise capital. However, they confer very different rights on their holders. You should be able to identify the differences between shareholders and debenture holders.

We explained under what circumstances a company would be allowed to acquire its own previously issued shares and provide financial assistance for the purchase of its shares.

Please ensure that you are able to answer the questions at the beginning of this study unit.

In the next study unit we shall look at shareholders as an important organ of the company. You will also learn how decisions are made in company meetings.

Study unit 6

SHAREHOLDERS AND COMPANY MEETINGS

PRESCRIBED STUDY MATERIAL

- Study paragraphs 4.1 to 4.15 in the textbook.
- Study sections 58 to 65 of the Companies Act.

Prescribed cases for this study unit

You have to read the cases below in the casebook.You only need to study the other cases referred to in the prescribed paragraphs in the textbook in so far as they are discussed in the textbook.

- *Gohlke and Schneider v Westies Minerals (Pty) Ltd* 1970 (2) SA 685 (A) [61]
- *In re Duomatic Ltd* [1969] 1 ALL ER 161 (Ch) [71]
- *Pender v Lushington* (1877) 6 ChD 70 [70]
- *Sammel & Others v President Brand Gold Mining Co Ltd* 1969 (3) SA 629 (A) [114]

6.1 INTRODUCTION

In study unit 5 we learnt that a profit company has two types of share capital, namely authorised and issued share capital. A company may divide its shares into different classes of shares.

In this study unit we will explain the different types of meetings and the voting rights of shareholders.

You will know that you understand this study unit if you are able to answer the following **key questions:**

- What kinds of meetings can a company hold?
- Why and how are the meetings convened?
- What is representation by proxy?
- What decisions require a special resolution?
- How do shareholders exercise their voting rights?

The structure of the study unit is set out below.

- **Notice of meetings**
- **Representation by proxy**
- **Demand to convene a shareholders' meeting**
- **Shareholders acting other than at a meeting**
- **Annual general meeting**
- **Convening a meeting in special circumstances**
- **Quorum**
- **Conduct of meetings**
- **Majority rule**
- **Exercise of voting rights**
- **Shareholder resolutions**
- **Decisions that require a special resolution**
- **Postponement and adjournment of meetings**

6.2 NOTICE OF MEETINGS

Prescribed study material

- Paragraphs 4.1 to 4.3 in the textbook
- Section 62 of the Companies Act

The Companies Act of 2008, unlike the Companies Act of 1973, where a shareholder was also referred to as a member of the company, uses only the term "shareholder" in respect of a profit company. The term "member" of a company is reserved for nonprofit companies that do not have shareholders. Hence there is now a definite difference in meaning between a member and a shareholder.

A "shareholder" is defined in section 57(1) of the Act as a person who is entitled to exercise any voting rights in relation to a company, irrespective of the form, title or nature of the securities to which those voting rights are attached.

A company may provide for a shareholders' meeting to be conducted by electronic communication. Where a company allows for participation in a meeting by electronic communication, a notice convening the meeting must inform the shareholders or their proxies of the availability of the option to participate electronically. The shareholders bear the costs of participation.

Activity 6.1

Activity

The board of directors of Zithulele (Pty) Ltd convened a meeting to be held on 26 February 2010. Mr Ngcobo, a shareholder of Zithulele (Pty) Ltd, was given a notice dated 19 February 2010, to attend the meeting in the boardroom of Zithulele (Pty) Ltd at 10:00. The agenda for the meeting was to discuss Zithulele's business.

Advise Mr Ngcobo whether he was given proper notice.

Feedback

Section 62 provides that a notice must be in writing; must include the date, time and place of the meeting; must explain the general purpose of the meeting; must contain a statement that a shareholder is entitled to appoint a proxy to attend, participate in and vote at the meeting in the place of a shareholder; must indicate the participants will be required to provide proof of identity at the meeting; must be accompanied by a copy of any proposed resolution that will be considered at the meeting; and notice of 10 days must be given before the date of the meeting.

Mr Ngcobo was not given proper notice: the notice he received did not explain the purpose of the meeting, but merely stated that the business of Zithulele (Pty) Ltd would be discussed; did not inform Mr Ngcobo whether he was entitled to appoint a proxy; did not inform him whether he would be required to provide proof of identity; was not accompanied by a copy of a proposed resolution; and did not give 10 days' notice.

6.3 REPRESENTATION BY PROXY

Prescribed study material

- Paragraph 4.4 in the textbook
- Section 58 of the Companies Act

6.3.1 Appointment of a proxy

The appointment should meet the following requirements:

- It must be in writing and signed by the shareholder.
- It must be valid for one year.
- It may be for a specific period of time. It may be for two or more persons concurrently exercising voting rights for different shares
- A proxy may delegate to another person authority to act on behalf of the shareholder.
- A copy of the proxy appointment form must be delivered to the company before the shareholders' meeting.
- A shareholder is not compelled to make an irrevocable proxy appointment.
- A shareholder may alter proxy by cancelling it in writing, appointing another proxy and delivering a copy of the revocation to the proxy and the company.

Activity 6.2

The Memorandum of Incorporation of Zithulele (Pty) Ltd provides that should share-holders wish to exercise the right to appoint a proxy, they may only appoint one proxy from the list provided by the company.

Advise Mr Ngcobo who is a shareholder of the company and wishes to appoint as his proxy, a person who is not a shareholder.

Feedback

A shareholder may appoint more than one proxy. Shareholders could be invited by the company on the proxy appointment form to appoint a proxy from a list provided by the company. However, a shareholder is not obliged to choose one or more persons from the list. The appointment form should contain sufficient space for the shareholder to indicate whether the proxy will vote in favour of or against the resolution. Mr Ngcobo may appoint two or more proxies concurrently who will exercise voting rights attached to different shares held by him.

6.4 DEMAND TO CONVENE A SHAREHOLDERS' MEETING

Prescribed study material

- Paragraph 4.5 in the textbook
- Section 61 of the Companies Act

A shareholders' meeting may be called by the board or any person authorised by the Memorandum of Incorporation (s 61). A meeting must be convened if required by the Act or the Memorandum of Incorporation, or demanded by shareholders holding at least 10% of the voting rights that may be exercised at that meeting.

6.5 SHAREHOLDERS ACTING OTHER THAN AT A MEETING

Prescribed study material

- Paragraph 4.6 in the textbook
- Section 60 of the Companies Act
- *Gohlke and Schneider v Westies Minerals (Pty) Ltd* 1970 (2) SA 685 (A)

The Companies Act of 1973 provides that a particular annual general meeting need not be held if all the members who are entitled to attend such a meeting consent in writing. In such a case, any resolution that would have been dealt with at this meeting will also be deemed to be valid if it is in writing and signed by all the members entitled to vote at that meeting. Otherwise, resolutions have to be taken at properly constituted members' meetings. However, in English and South African case law, the common law rule of unanimous assent was accepted. In terms of this rule, certain decisions may be valid without a meeting being held, if all the members are fully aware of the facts and they all assented thereto, although it need not be in writing.

In *Gohlke and Schneider v Westies Minerals (Pty) Ltd* 1970 (2) SA 685 (A), the court held that members may validly appoint a director to the board without any formal meeting being held because there was evidence of their unanimous consent. The court in *In re Duomatic Ltd* [1969] 1 ALL ER 161 (Ch) held that the unanimous approval of directors' remuneration by the two directors holding all the voting shares in a company could be regarded as a resolution of a general meeting approving the payment.

The situation has now been changed by the Companies Act of 2008. Although the general principle still remains that shareholders exercise their rights through resolutions at meetings, a resolution may be submitted to shareholders and, if adopted in writing by the required majority, will have the same effect as if it had been adopted at a meeting without actually holding a general meeting of shareholders (s 60). This means that the unanimous assent of all shareholders will no longer be necessary. However, any business of a company that must, in terms of the Act or the company's Memorandum of Incorporation, be conducted at an annual general meeting may not be conducted by means of this procedure.

Activity 6.3

The shareholders of Zithulele (Pty) Ltd wish to elect Mr Khuzwayo as a director to replace a director who has died. They wish to know whether it is necessary to call a general meeting of shareholders for this purpose. Advise the shareholders of the procedure they should follow to replace a director.

Feedback

The shareholders of Zithulele (Pty) Ltd may elect a director without having a formal meeting, by written polling of all shareholders entitled to vote on his or her election. The company must deliver a statement within ten business days after adopting the resolution, describing the results of the vote, consent process or election to every shareholder entitled to vote on the resolution.

6.6 ANNUAL GENERAL MEETING

Prescribed study material

- Paragraph 4.7 in the textbook
- Section 61(7)-(10) of the Companies Act

In terms of the Companies Act of 1973, every company was compelled to convene an annual general meeting at the times prescribed by the Act unless all the members who were entitled to attend the meeting agreed in writing that the meeting need not be held. In terms of the Companies Act of 2008, only public companies have a statutory obligation to convene annual general meetings.

Section 61(8) stipulates that at least the following matters must be transacted at the Annual General Meeting:

- the election of directors to the extent required by the Act or the company's Memorandum of Incorporation
- the appointment of an auditor for the following financial year
- the appointment of an audit committee
- the presentation of the directors' report
- the presentation of audited financial statements for the immediately preceding financial year
- the presentation of an audit committee report
- any matter raised by shareholders

Activity 6.4

Zithulele Ltd has not yet held an annual general meeting. Explain whether the company is obliged to hold an annual general meeting, and if so, when such a meeting would have to be held. Also advise the company about what matters must be discussed at this meeting.

Feedback

See section 61(8) of the Companies Act 2008. Keep in mind that Zithulele is a public company. Also consider what difference it would have made in terms of the Companies Act 1973 if Zithulele had been a private company. For a list of the matters to be discussed at general meetings, see the discussion under 6.6 above.

6.7 CONVENING A MEETING IN SPECIAL CIRCUMSTANCES

Prescribed study material

- Paragraph 4.8 in the textbook
- Section 61(11)-(12) of the Companies Act

The textbook does not make it clear that two different situations are discussed under this heading. The first one, regulated by section 61(11), has to do with the situation in which the company is unable to convene a meeting because it has no directors or all its directors are incapacitated. The second situation is regulated by section 61(12), which applies to the situation in which a company, for reasons other than those covered by section 61(11), fails to convene its annual general meeting or a meeting required by its Memorandum of Incorporation or shareholders.

6.8 QUORUM

Prescribed study material

- Paragraph 4.9 in the textbook
- Section 64 of the Companies Act

Note that a quorum is required for the meeting to begin, as well as for the consideration of each specific matter.

Activity 6.5

The annual general meeting of Zithulele Ltd is attended by Mr Ngcobo who holds 5% of the voting rights, Mr Dladla who holds 5% and Mr Kwikkie who holds 20% of the voting rights in the company.

Are the requirements of the Companies Act of 2008 met in relation to a quorum which would allow the meeting to start?

Feedback

Section 64 provides that a meeting may not begin until sufficient persons holding at least 25% of all the voting rights are present. Furthermore, if a company has more than two shareholders, as this company clearly has, at least three shareholders must be present. Since three shareholders are present and hold 30% of the voting rights, a quorum is present and the meeting may commence.

6.9 CONDUCT OF MEETINGS

Prescribed study material

- Paragraph 4.10 in the textbook
- Section 63 of the Companies Act

Note the difference in the number of votes that may be exercised, depending on whether voting takes place by a show of hands or a poll. The textbook states that a person who abstains or fails to exercise his or her voting rights on a resolution will be deemed to have voted against the resolution.

This statement is not based on any provision of the Act, and must also not be taken to mean that an abstention vote will be taken into consideration when determining whether a resolution has been adopted.

The requirements for both a special and an ordinary resolution clearly state that the required percentage of votes **exercised** on the resolution must be in favour of the resolution to have it validly adopted. Only the votes of shareholders who actually exercise their votes are thus taken into consideration.

Activity 6.6

Activity

The shareholders of Zithulele Ltd will be exercising their voting rights at the meeting through a poll. Mr Ngcobo holds 8% of the voting rights in the company, Mr Dladla 10%, Mrs Dooka 12% and Mr Kwikkie holds 20%. Mr Kwikkie decides not to vote. Advise the shareholders of the effect this would have on the valid adoption of an ordinary resolution.

Feedback

Feedback

Since the shareholders of Zithulele Ltd are voting by way of a poll, a shareholder or his or her proxy will exercise all the voting rights attached to the shares. The required percentage of votes that may be exercised on a resolution is present (at least 25%). Only the votes exercised on a resolution are taken into consideration. Since only 30% of the voting rights will be exercised, more than half of them, that is, more than 15% of the total voting rights, will have to be exercised in favour of the resolution to have it validly adopted.

6.10 MAJORITY RULE

Prescribed study material

- Paragraph 4.11 in the textbook

This rule is not contained in the Act itself, but is a common law rule. The protection of minority shareholders against oppression by the majority as a result of majority rule is discussed in paragraph 9.3 in study unit 9.

6.11 EXERCISE OF VOTING RIGHTS

Prescribed study material

- Paragraph 4.12 in the textbook
- Section 57(2)–(6) of the Companies Act

Three possible situations are discussed under this heading. Briefly summarised, they are as follows:

(1) A profit company (other than a state-owned enterprise) with only one shareholder:

- The shareholder may exercise all the voting rights.
- Rules of setting a record date, etcetera, do not apply.

(2) A profit company (other than a state-owned enterprise) with only one director:

- The director may exercise any power or perform any function of the board at any time except when the Memorandum of Incorporation provides otherwise.

(3) A company (other than a state-owned enterprise) where every shareholder is also a director:

- Shareholders may decide on any matter to be referred by the board at any time, without notice or compliance with any internal formalities except when the Memorandum provides otherwise; subject to certain specified conditions.

Activity 6.7

Every shareholder of Zithulele (Pty) Ltd is also a director of the company. Advise them on whether they have to convene a formal meeting of shareholders to consider matters that have to be referred to shareholders.

Feedback

Where every shareholder is also a director of a company, they may decide on any matter to be referred by the board at any time, without notice or compliance with any internal formalities except when the Memorandum of Incorporation provides otherwise. All the directors must be present at the board meeting when the matter is referred to them in their capacity as shareholders. A quorum must be present at the meeting and the resolution passed must be accepted for it to be either an ordinary or special resolution. All the shareholders of Zithulele (Pty) Ltd may decide on any matter to be referred by the board at any time, without notice or compliance with any internal formalities except when the Memorandum of Incorporation provides otherwise.

6.12 SHAREHOLDER RESOLUTIONS

Prescribed study material

- Paragraph 4.13 in the textbook

- Section 65(7)-(11) of the Companies Act

The Companies Act of 2008 (in s 65(7) and (9)), like the Companies Act of 1973, also provides for two types of resolutions that may be taken in a shareholders' meeting, namely an ordinary resolution, requiring more than 50% of the votes exercised, and a special resolution, requiring at least 75% of the voting rights exercised.

The primary difference is that the Companies Act of 2008 allows a company to stipulate a higher percentage for approval of all or some ordinary resolutions in its Memorandum of Incorporation (except one for the removal of a director), or a lower percentage for a special resolution, on condition that there must always be a difference of at least 10% between the percentages required for an ordinary and a special resolution.

Activity 6.8

Activity

Distinguish between ordinary and special resolutions.

Feedback

Feedback

Ordinary resolution

- It requires more than 50% of the voting rights exercised.
- The Memorandum of Incorporation may provide for a higher percentage.
- The Companies Act provides that there should be a margin of at least ten percentage points between the requirements for the adoption of a special resolution and an ordinary resolution.

Special resolution

- It requires at least 75% of the voting rights exercised.
- The Memorandum of Incorporation may provide for a lower percentage.
- There must be a margin of at least ten percentage points between the requirements for a special resolution and an ordinary resolution.

6.13 DECISIONS THAT REQUIRE A SPECIAL RESOLUTION

Prescribed study material

- Paragraph 4.14 in the textbook

A special resolution is compulsory for certain resolutions stipulated in the Act but may also be required by the Memorandum of Incorporation.

6.14 POSTPONEMENT AND ADJOURNMENT OF MEETINGS

Prescribed study material

- Paragraph 4.15 in the textbook
- Section 64(4)–(13) of the Companies Act

Activity 6.9

At the shareholders' meeting of Zithulele (Pty) Ltd, the chairperson, Mr Phakathi, wishes to adjourn the meeting because there are not enough shareholders to form a quorum.

Advise the shareholders whether the meeting may be validly adjourned.

Feedback

A meeting may be adjourned for a week if within an hour of the scheduled starting time the quorum is not formed. Mr Phakathi may extend the one-hour limit, where the quorum is not formed at the scheduled starting time on the grounds that exceptional circumstances exist.

A notice of adjournment will only be given if the location of the adjourned meeting is different. Shareholders of Zithulele (Pty) Ltd may agree on different periods in the Memorandum of Incorporation and alter the one-hour rule and the one-week adjournment. A meeting may be adjourned for a fixed time and place or until further notice. Where a meeting is adjourned, it may not be adjourned for more than 120 business days.

REVIEW

In this study unit you learnt about the important role shareholders fulfil in decision making in companies. Shareholders enjoy voting rights attached to the respective class of shares they hold.

You also learnt about the procedure used to call a meeting where a decision, that is, either an ordinary or special resolution, is to be passed. Make sure that you are aware of the different notice periods and the quorum requirements in order to pass a valid resolution. You should also know how to postpone or adjourn a meeting.

Please ensure that you are able to answer the questions at the beginning of this study unit.In the next study unit you will learn about directors and board committees.

Study unit 7

DIRECTORS AND BOARD COMMITTEES

PRESCRIBED STUDY MATERIAL

- Study chapter 6 in the textbook.
- Study sections 1, 66, 68, 69, 71, 72, 75, 76, 78 and 162 of the Companies Act.

Prescribed cases for this study unit

These are the cases you have to read in the casebook. You only need to study the other cases referred to in the prescribed paragraphs in the textbook in so far as they are discussed in the textbook.

- *Robinson v Randfontein Estate Gold Mining Co Ltd* 1921AD 168 [75]
- *Regal Hastings Ltd v Gulliver* 1All ER 378 (HL) [76]
- *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd* 1981 (2) SA 173(T) [80]
- *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC* 1988 (2) SA 54 (T) [81]
- *Fisheries Development Corporation of SA v Jorgenson* 1980 (4) SA 156 (W) [87]

7.1 INTRODUCTION

In study unit 6 you were introduced to one of the organs of a company, namely the general meeting of shareholders. The shareholders of a company exercise their rights and the functions entrusted to them in the Companies Act 71 of 2008 or the Memorandum of Incorporation by adopting resolutions at a meeting of shareholders. In this study unit we will introduce the other main organ of the company, namely the board of directors (the directors).We will also introduce you to one of the office-bearers of a company, namely the manager of a company.

You will know that you understand this study unit if you are able to answer the following **key questions**:

- What are the legal positions of a company director and the board of directors?
- What are the different types of directors?

- What is the difference between directors and managers?
- Who are ineligible or disqualified from becoming directors?
- How are directors appointed and removed?
- How are the meetings of the board of directors conducted?
- What are the rights and duties of directors?

This study unit will follow the structure indicted below.

Meaning of the word "director" and the different types of directors

Directors and managers

Number of directors and consent

Directors: the Act and a company's Memorandum of Incorporation

Ineligible and disqualified persons

- **Exemptions by a court**
- **Exemptions of certain private companies**

Application to declare a person delinquent or under probation

- **Application to the court to suspend or set aside a delinquency order**

First directors of a company

Vacancies on the board

Filling of vacancies

Removal of directors

Board of committees

Board of meetings

Duties of directors

- **Standard of directors' conduct**
- **Directors must not abuse their position or information (s 76(2)) and must act in a certain way when there is a personal financial interest (s 75)**
- **Acting in good faith and with a certain degree of care, skill and diligence**
- **Liability of directors and prescribed officers**
- **Indemnification and director's insurance**

7.2 MEANING OF THE WORD "DIRECTOR" AND THE DIFFERENT TYPES OF DIRECTORS

Prescribed study material

- Paragraph 6.1 in the textbook
- Sections 1, 66(4)*(a)*(i–iii), 66(4)*(b)* and 68 of the Companies Act

A director is a member of the board of a company and includes any person occupying the position of a director or alternate director. A person becomes a director only

- when he or she has given his or her written consent to serve as a director
- after having been appointed or elected or holding office in accordance with the provisions of section 66 of the Companies Act

Different **types of directors** have been recognised by both the *King Code* and the Companies Act. The textbook refers to the *King II Report* of 2002 (in footnote 3) but there is also now a third *King Report on Corporate Governance* (*King III*) which became effective in September 2009 but does not differ substantially from its predecessor.

However, remember that the King Codes are not law. They do not have the force of law and are therefore not enforceable, except for provisions that have been included in an Act or have been made compulsory in another way, say, by being included in the listing requirements of the JSE Ltd for companies wishing to list on the stock exchange. They are guidelines to indicate the principles that a company should adhere to for purposes of good governance.

The **King Code** differentiates between the following three types of directors:

- executive directors
- non-executive directors
- independent directors

You should, however, note that the court in *Howard v Herrigel* 1991 (2) SA 660 (A) held that it is unhelpful or even misleading to classify company directors as "executive" or "nonexecutive" **for the purposes of determining their duties** to the company or when any specific or affirmative action is required of them. Once a person accepts an appointment as a director, he or she is obliged to display the utmost good faith towards the company irrespective of whether such a person is an "executive" or "nonexecutive" director.

The **Companies Act** recognises the following types of directors:

- an *ex officio* director
- a Memorandum of Incorporation-appointed director
- an alternate director
- an elected director
- a temporary director who is appointed in order to fill a vacancy

Activity 7.1

Study paragraph 6.1 in the textbook and then do the following activity:

> Sam is appointed as a director in ABC Ltd subsidiary FAB Ltd. Sam has a separate employment contract with the company and is engaged in its day-to day operations.

Linda was elected as a director by the shareholders. However, she does not participate in the management of ABC Ltd or any of its subsidiaries. She does not have a separate contract of employment with ABC Ltd.

In the company's annual report it is states that ABC Ltd's Head of Department will by virtue of holding this office be a director. Jack is appointed as the Chief Executive Officer, but was never appointed as a director by the shareholders at any meeting.

Calvin was appointed by the directors of ABC Ltd to stand in for Sandra, an executive director of the company, while she is on maternity leave.

Distinguish between the different types of directors as recognised in the Companies Act. Indicate which types of directors Sam, Linda, Jack and Calvin would be classified as.

Feedback

See paragraph 6.1 in the textbook and ensure that you understand the differences between the different types of directors. You should know the characteristics of each type of director.

7.3 DIRECTORS AND MANAGERS

Prescribed study material

- Paragraph 6.2 in the textbook
- *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168

There are many differences between being a "director" and a "manager". A **manager** is an employee of a company whereas a **director does not have to be an employee**. Managers and directors also differ in their roles with regard to, *inter alia*, leadership, decision making and their respective duties and responsibilities. The boards of directors, for example, are responsible for the leadership and direction of a company, while the managers have to implement the strategy on the directors' behalf. Directors are also responsible for organisational decision making, while mangers are concerned with the implementation of such decisions and policies. For a detailed discussion on the difference between directors and managers see the table on pages 80 to 82 in the textbook.

Activity 7.2

Study paragraph 6.2 in the textbook and then answer the following question:

> John is appointed as the new manager of Rand Air (Pty) Ltd. His wife, who is very aware of status, tells all her friends that John is a director. Explain whether or not these terms can correctly be used interchangeably.

Hint: You may use the table on pages 80 to 82 in the textbook to answer the question.

Feedback

You should now know the difference between a manager and a director.

You should also note that apart from the duties discussed in the table on pages 80 to 83 in the textbook you will be introduced to director's duties in particular, in paragraph 6.14 in the textbook. This will include certain fiduciary duties. Note that an employee or manager of a company has duties similar to those of the fiduciary duties of a director towards a company. See *Phillips v Fieldstone Africa (Pty) Ltd and Another* (2004) 1 All SA 150 (SCA), *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD and *Daewoo Heavy Industries (Pty)Ltd v Banks and Others* (2004) 2 All SA 530 (C) in this regard (par 6.2 in the textbook).

7.4 NUMBER OF DIRECTORS AND CONSENT

Prescribed study material

- Paragraph 6.3 in the textbook
- Section 66(11) of the Companies Act

The different types of companies should each have a specified minimum number of directors in terms of the Companies Act.

A person becomes a director of a company when he or she

- has been appointed or elected as a director in terms of the Companies Act or Memorandum of Incorporation, or
- holds an office, title, designation or similar status entitling that him or her to be an *ex officio* director of the company.

See further *S v Vandenberg and Others* 1979 (1) SA 208 (D) as discussed in paragraph 6.3 in the textbook.

A person will only become a director once he or she has delivered a written consent accepting such a position.

Activity 7.3

Study paragraph 6.3 in the textbook and do the following:

Fill in the following table, dealing with the number of directors required for certain types of companies:

Type of company	Number of directors
Private company	
Personal liability company	
Public company	
Nonprofit company	

Feedback

Remember that (inspite of the requirement that certain types of companies must have a minimum number of directors) where a company does not have the prescribed minimum number of directors, this does not negate or limit the authority of the board. This will also not invalidate any act performed by the board or the company.

7.5 DIRECTORS: THE ACT AND A COMPANY'S MEMORANDUM OF INCORPORATION

Prescribed study material

- Paragraph 6.4 in the textbook
- Sections 66(2)*(a)* and *(b)*, 66(4)*(a)*(ii-iii), 66(10) and 66(11) of the Companies Act

Certain provisions of the Act, including some in respect of directors, may be changed by the provisions of a company's Memorandum of Incorporation, while others may not. For a summary of the key issues regarding directors in the Companies Act and a company's Memorandum of Incorporation, see the table on pages 85 and 86 in the textbook.

Activity 7.4

Study paragraph 6.4 in the textbook and answer the following question:

(1) The Memorandum of Incorporation of Locke Ltd states that

(a) a minimum number of six directors must be appointed
(b) the shareholders of the company will be allowed to elect at least 30% of any alternate directors

(c) the directors will be entitled to a fixed remuneration, as determined from time to time
(d) a director may only serve a term of five years

Explain whether each of the above-mentioned provisions of the Memorandum of Incorporation of Locke Ltd is permissible in terms of the Companies Act. Substantiate your answer.

Feedback

In terms of its Memorandum of Incorporation, a public company may specify a higher number than the minimum number of directors required in terms of the Act. Locke Ltd may therefore require that a minimum of six directors be appointed. Section 66(4) of the Act provides that the Memorandum of Incorporation of a profit company must provide that the shareholders will be entitled to elect at least 50% of any alternate directors. The provision stating that the shareholders will only be allowed to elect at least 30% of the alternate directors is therefore invalid. A company's Memorandum of Incorporation may provide for the payment of remuneration to its directors and the term of office. Clauses 3 and 4 of the Memorandum of Incorporation will thus be valid.

7.6 INELIGIBLE AND DISQUALIFIED PERSONS

Prescribed study material

- Paragraph 6.5 in the textbook
- Sections 69(7)*(a–c)*, 69(8)*(a)* and *(b)*(i–iv), 69(11) and 69 (12) of the Companies Act

Certain people are **ineligible** to be appointed as a director of a company, while certain people are **disqualified**.

Note: If a person is ineligible to be appointed as a director, he or she is absolutely prohibited from becoming a director, without any exceptions.

If a person is **disqualified** from being appointed as a director this means that, with the exception of a person who has been prohibited from being a director by a court of law, a person may still be appointed as a director of a company with the permission of the court.

The other disqualifications (as stated in the table on pp 87 and 88 in the textbook) are thus **not absolute because** the court has discretion on application to allow such disqualified persons to be appointed as directors.

7.7 DIRECTOR DISQUALIFICATIONS: EXEMPTIONS

Prescribed study material

- Paragraph 6.6 in the textbook
- Sections 69(11) and 69(12) of the Companies Act

Section 69(11) gives a court a discretion to exempt certain disqualified persons, while section 69(12) affords the shareholders of certain private companies the opportunity to avoid this disqualification.

7.7.1 Exemptions by a court

Prescribed study material

- Paragraph 6.6.1 in the textbook
- Section 69(12) of the Companies Act

A court may exempt certain disqualified persons from the disqualification.

Activity 7.5

Study paragraph 6.6.1 in the textbook and then answer the following questions:

(1) Who may be exempt from disqualification by a court of law?
(2) What will have to be proved where an applicant was removed from an office of trust for misconduct relating to dishonesty? In your answer, refer to *Ex Parte Schreuder* 1964 (3) SA 84 (O) and *Ex Parte Tayob* 1990 (3) SA 715 (T).

Feedback

After you have studied the paragraph you should be able to state who may apply to a court of law to be exempt from disqualification. You will see that where the applicant was removed from an office of trust for misconduct relating to dishonesty, he or she will have to prove that he or she has been rehabilitated from his or her wrongful ways and can be trusted with the responsibilities of a director. In order for the court to determine whether the applicant is honest and trustworthy, certain factors will be considered such as the nature of the offence and the circumstances under which it was committed.

7.7.2 Exemptions for certain private companies

Prescribed study material

- Paragraph 6.6.2 in the textbook
- Section 69(12) of the Companies Act

You already know that certain persons may be disqualified from being appointed as directors of a company (see par 7.6 above). However, section 69(12) specifically provides that under certain conditions, a disqualified person may act as a director of a **private company**.

Activity 7.6

Study the case of *Ex Parte Barron* 1977 (3) SA 1099 (C) on page 90 in the textbook and answer the following questions.

- What were the factors that affected the discretion of the court?
- Why was the court more lenient towards the private company?
- Do you support the court's approach?

Feedback

The court correctly held in the *Ex Parte Barron* case that it could be more lenient in a case where a private company is affected than where a public company is affected.

This is because a director of a public company deals with funds in which a vast number of people are involved. Such a director should obviously be under more scrutiny than a director of a private company.

7.8 APPLICATION TO DECLARE A PERSON DELINQUENT OR UNDER PROBATION

Prescribed study material

- Paragraph 6.7 in the textbook
- Section 162 of the Companies Act

The power given to a court to declare a director either delinquent or under probation was introduced into South African company law for the first time by the Companies Act of 2008. Depending on the grounds on which a person has been declared to be a delinquent, he or she will subsequently be either unconditionally disqualified from being a director for the rest of his or her life, or disqualified for a period of at least seven years and subject to any conditions the court considers appropriate. An order of probation, however, may not exceed a period of five years and may be made subject to any conditions the court considers appropriate, such as a designated remedial programme. See the table on pages 91 to 94 in the textbook for a summary of who may apply to court, the grounds for application, the order sought and the effect of the order. Also note that three additional grounds to apply for an order of delinquency are available to the Commission or Takeover Regulations Panel (see p 94 in the textbook in this regard).

Activity 7.7

Study page 94 in the textbook and answer the following question:

> Garry is a director of Centro Pharmaceuticals (Pty) Ltd. Centro has found a new cure for pneumonia. Gary gives the formula to the senior scientist of Acerbic Pharmaceuticals (Pty) Ltd against payment of a fee. Centro Pharmaceuticals (Pty) Ltd is furious about this. Explain whether Centro Pharmaceuticals (Pty) Ltd would be able to lodge an application to have Garry declared delinquent. If so, also explain what the effect of such an order would be.

Feedback

In order to answer the question you need to know the following:

- who is allowed to make an application
- the grounds for an application
- the relevant order sought
- the effect of an order

Your answer should reflect the following:

- A company (Centro Pharmaceuticals (Pty) Ltd) can apply to a court of law for an order to have a director declared delinquent.
- Garry grossly abused his position as director and acted in a manner that amounted to a breach of trust.
- A declaration of delinquency may be made.
- This declaration may be subject to any conditions the court considers appropriate and will be for at least seven years from the date of the order.

7.8.1 Application to the court to suspend or set aside a delinquency order

Note that this application may be made only in those cases where the declaration was not made unconditional and for the lifetime of the person declared delinquent. Also note that the applicant first has to apply for a suspension of the order and then, after a further two years, may apply for it to be set aside.

Activity 7.8

Read paragraph 6.7.1 in the textbook and answer the following question:

> It is the year 2014. Steven was a director of Hamilton (Pty) Ltd, but in 2011 the court declared him delinquent because he used information obtained as a director for his personal advantage.

He feels that he has now rehabilitated himself and has met all the conditions of his court order. He would like to serve as director of Hamilton (Pty) Ltd once again. Explain whether Steven would be able to apply to a court to suspend the order of delinquency.

Feedback

Steven will be able to apply for the suspension of the order of delinquency because three years have elapsed since the order of delinquency was made and the order was not based on one of the two grounds which would have resulted in an unconditional declaration subsisting for his lifetime. He will, however, have to satisfy the court that he has rehabilitated himself and has met all the conditions of his court order.

7.9 FIRST DIRECTORS OF A COMPANY

Prescribed study material

- Paragraph 6.8 in the textbook
- Section 67 of the Companies Act

You already know that different types of companies must have a minimum number of directors required for that specific type of company (see par 6.4 in the textbook). At the incorporation of a new company, every incorporator is deemed to be a director of such company until sufficient directors have been appointed to meet the required minimum number of directors.

Activity 7.9

Read paragraph 6.8 in the textbook and answer the following question:

> What must be done by the board of a company if, after its incorporation, the number of directors of that company is lower than the minimum number of directors required for that company?

Feedback

The board of the company will have to call a meeting within 40 business days after the date of incorporation for the purpose of electing sufficient directors to fill all the vacancies.

7.10 VACANCIES ON THE BOARD

Prescribed study material

- Paragraph 6.9 in the textbook
- Section 70 of the Companies Act

A vacancy will arise on the board of a company if, say, a director resigns, dies or is unable to perform his or her duties as director. For a comprehensive list of the circumstances under which a vacancy on the board arises, see paragraph 6.9 in the textbook.

Activity 7.10

Read paragraph 6.9 in the textbook and answer the following questions:

(1) List the circumstances in which a vacancy on the board of a company can arise.
(2) When will a resignation by a director become effective?

Feedback

See paragraph 6.9 in the textbook and *Rosebank Television & Appliance Co (Pty) Ltd v Orbit Sales Corporation (Pty) Ltd* 1969(1) SA 300 (T) as discussed on page 96 in the textbook. In the *Rosebank Television & Appliance Co (Pty) Ltd v Orbit Sales Corporation (Pty) Ltd* case, the court confirmed that a resignation becomes effective once it has been communicated to a company, irrespective of whether it was only subsequently accepted.

7.11 FILLING OF VACANCIES

Prescribed study material

- Paragraph 6.10 in the textbook
- Section 70 of the Companies Act

If a vacancy arises in the board, other than as a result of an *ex officio* director ceasing to hold that office, it must be filled by a new appointment or by a new election as prescribed by the Act.

Activity 7.11

Read paragraph 6.10 in the textbook and answer the following questions:

(1) If, as a result of a vacancy, there are no remaining directors of a company, who may convene a meeting to elect directors?
(2) Must a company file a notice after a person ceases to be a director?

Feedback

See paragraph 6.10 in the textbook.

7.12 REMOVAL OF DIRECTORS

Prescribed study material

- Paragraph 6.11 in the textbook

A director can be removed by the shareholders and, in some circumstances, by the board of directors.

Activity 7.12

Read paragraphs 6.11.1 to 6.11.3 in the textbook and complete the following table:

Fill in the following table, which relates to the removal of a director:

Name the kind of resolution needed by a shareholders' meeting to remove a director.	
State the number of days' notice that must be given.	
Can a director be removed in terms of the 2008 Companies Act by a shareholder's meeting, despite an agreement between any shareholder and a director? What was the position before the 2008 Companies Act? *Hint:* See the *Amoils v Fuel Transport case* on page97 in the textbook.	
List the grounds upon which a director may be removed by the board of directors.	
Will the director still have a claim for damages in terms of a separate employment contract with the company? Hint: See the *De Villiers v Jacobsdal Saltworks* case on page 98 in the textbook.	

Feedback

You will notice on page 98 in the textbook that a director who has been removed from office may apply to a court to review the board's determination. This application must be brought within 20 business days from the date of a decision taken by the board. The court has discretion whether to confirm the determination of the board.

7.13 BOARD COMMITTEES

Prescribed study material

- Paragraph 6.12 in the textbook
- Section 72 of the Companies Act

The board of directors may, except to the extent that a Memorandum of Incorporation provides otherwise, appoint committees and may delegate any of the authority of the board to such a committee. Note, however, that a director will still remain liable for the proper performance of his or her duties despite the delegation of a duty to a committee.

In terms of the Companies Act 71 of 2008, the Minister of Trade and Industry may prescribe that a company or a certain category of company must have a social and ethics committee. In terms of section 94(2), every public or state-owned company must appoint an audit committee of at least three members (see study unit 8). The *King Code* (previously discussed in par 7.1) also proposed that board committees should be established to assist the directors by giving detailed attention to important areas. Examples of such committees include an audit committee and a remuneration committee.

Activity 7.13

Read paragraph 6.12.1 and the table on page 100 in the textbook and answer the following questions:

(1) List the different type of committees that should be established by a public listed company in terms of the *King Code*.
(2) What are the respective duties of the remuneration committee, audit committee and nomination committee?

Feedback

After answering the questions above you will know that in terms of the *King Code* a public listed company should at least have both an audit and remuneration committee. The establishment of a nomination committee is also recommended. You will also know that the respective committees make certain recommendations and assist the board of directors in the specific area of expertise.

7.14 BOARD MEETINGS

Prescribed study material

- Paragraph 6.13 in the textbook
- Section 73 of the Companies Act

Board meetings may be called by the directors authorised to do so. The necessary notice must be given to all directors before any meeting is held. A majority of the directors of the board must be present at a meeting before a vote may be called. Every director has one vote per meeting, while the chairperson has a deciding vote in the event of a tie.

At a meeting, minutes must be kept of all decisions and any resolution taken by the board.

Activity 7.14

Read paragraphs 6.13.1 to 6.13.6 in the textbook and fill in the following table, which deals with board meetings:

Read the each statement and indicate whether it is true or false. Substantiate your answer.	True/false: Reason:
Joe is the Chairman of Van der Linde (Pty) Ltd. He wishes to suspend the services of Jane, one of the directors. He believes that there is no need for a meeting or a resolution to be taken as he has a casting vote. Is this true? Hint: see the *Van Tonder v Pienaar and Others* case on page 101 in the textbook.	
Board meetings may not be conducted by way of telephone conferencing.	
A director who is present at a board meeting but did not receive notice thereof may waive his or her right to have been notified before the meeting.	
The minutes of a board meeting are evidence of the proceedings of such a meeting.	
A decision of the board of directors may not be made other than at a meeting of the board of directors.	
Hint: See paragraph 6.13.6 in the textbook and the *Van Tonder v Pienaar and Others* case on page 101 in the textbook.	

Feedback

You will notice that the meetings of the board of directors follow much the same procedure as the general meetings of members.

7.15 DUTIES OF DIRECTORS

Prescribed study material

- Paragraph 6.14 in the textbook
- Sections 75 to 78 of the Companies Act

There are four sources from which the duties of directors arise, namely their contracts with the company (if any), the company's constitution (Memorandum of Incorporation), the Companies Act and the common law. The rights and duties created by contract are determined by reference to the specific contract. Those created by the company's constitution were discussed in study unit 3, while the duties imposed by the Companies Act 71 of 2008 as well as by the common law will be discussed in this study unit.

Apart from a few specific duties and limitations placed on directors by the Companies Act of 1973, such as the duty to disclose to the board any interest in contracts of the company, most of the duties of directors were determined by the common law. At common law, directors are subject to fiduciary duties to exercise their powers *bona fide* (in good faith) and for the benefit of the company, and to the duty to exercise their powers with care and skill.

The Companies Act 71 of 2008 now introduces a partially codified regime of directors' duties, which includes duties similar to the common-law fiduciary duties and the duty to perform their functions with reasonable care and skill.

However, the common law is not excluded by the statutory provisions, and will continue to apply except insofar as it is specifically amended by the Act or is in conflict with a provision of the Act.

Note that for the purposes of these codified duties, "director" includes an alternate director and a member of a committee of the board who is not a director.

For the first time, the Act now also places an explicit duty on the board of directors to manage the company (s 66(1)).

Briefly summarised, the newly codified duties of directors in the Companies Act of 2008 are as follows:

(1) To disclose to the board any personal financial interest in matters of the company (s 75)
(2) Not to use the position of director or information obtained as director to gain an advantage for himself or herself or another person, or to knowingly cause harm to the company or a subsidiary (s 76(2) *(a)*
(3) To disclose to the board of directors any material information that comes to a director's attention (s 76(2)*(b)*)
(4) To act in good faith and for a proper purpose (s 76 (3) *(a)*)
(5) To act in the best interests of the company (s 76 (3) *(b)*)
(6) To act with a reasonable degree of care, skill and diligence (s 76 (3) *(c)*)

Activity 7.15

Study paragraph 6.14 in the textbook and consider the following statement:

> The Companies Act of 2008 has partly codified directors' duties. The case law referring to a director's common-law duties is therefore no longer of any interest to the courts when interpreting the codified duties of directors under the Companies Act of 2008. Do you agree with this? Substantiate your answer.

Feedback

The provisions in the Companies Act of 2008 are subject to and not in substitution of any of the duties of directors under the common law. When interpreting the provisions of the Companies Act, the courts may still have regard to the common law, including past case law. The prescribed case law is therefore still of great value and should be taken into account when studying the Act. It should also be kept in mind that the provisions in the Companies Act relating to directors' duties, are a partial codification (adopting the general principles while allowing some room for the development of the common law) of the company law.

7.15.1 Standards of directors' conduct

Prescribed study material

- Paragraph 6.14.1 in the textbook
- Sections 75 and 76 of the Companies Act

7.15.2 Directors must not abuse their position or information (s 76(2)) and must act in a certain way when there is a personal financial interest (s 75)

Prescribed study material

- Paragraph 6.14.2 in the textbook
- Sections 75 and 76(2) of the Companies Act
- *Regal Hastings Ltd v Gulliver* [1942]1 All ER 378(HL)
- *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd* 1981 (2) SA 173(T)
- *Robinson v Randfontein Estate Gold Mining Co Ltd* 1921 AD168
- *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC* 1988 (2) SA 54 (T)

The first three duties listed above are discussed in the textbook under this heading.

Firstly, section 75 of the Companies Act of 2008 prescribes how a director should act when his or her personal financial interests conflict with those of the company. Two different situations are regulated in this provision. If a director is the only director but not the only shareholder of the company, he or she must disclose any personal interest in an agreement or other matter of the company to the shareholders and obtain their prior approval by an ordinary resolution before he or she enters into this agreement or deals with the matter. In all other cases, disclosure must be made to the board of directors of any personal financial interest of the director in a matter to be considered at a board meeting and he or she may not be present or participate in the discussion. A director may also make an advance general disclosure of his or her personal financial interests to the shareholders or board, as the case may be.

Secondly, in terms of section 76 (2) *(a)* of the Companies Act of 2008, a director may not abuse his or her position as director, or information obtained while acting as a director, to gain an advantage for himself or herself or for another person other than the company or a wholly-owned subsidiary of the company, or to knowingly cause harm to the company or a subsidiary of the company.

he third duty that is discussed under this heading is the duty of a director to disclose any information that comes to his or her attention, subject to the exceptions mentioned in the textbook.

In the case of *Regal Hastings Ltd v Gulliver* [1942]1 All ER 378(HL) [case 76], the court held that directors should avoid placing themselves in a position where their duty to the company conflicts with their own interests. This was also the stance of the court in the case of *Robinson v Randfontein Estate Gold Mining Co Ltd* 1921 AD168 [case 75] where the court held the following: “Where one man stands to another in a position of confidence involving a duty to protect the interest of that other, he is not allowed to make a secret profit at the other’s expense or place himself in a position where his personal interest conflict with his duty”.

Also note the case of *CyberScene Ltd and Other v i-Kiosk Internet and Information (Pty) Ltd* 2000 (3) SA 806 (C) discussed in the textbook (p 107). However, there are limits to the duties that a director owes to his or her company. The court held in *Ghersi and Others v Timber Developments (Pty) Ltd and Others* 2007(4) SA 536(SCA) that the facts of each case are important in determining whether or not a person has acted in breach of the fiduciary duty owed to his or her company.

Activity 7.16

Study paragraph 6.14.2 of the textbook as well as the following cases:

- *Robinson v Randfontein Estate Gold Mining Co Ltd* 1921 AD 168 [case 75]
- *Regal Hastings Ltd v Gulliver* All ER 378(HL) [case 76]
- *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd* 1981 (2) SA 173(T) [case 80]
- *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC* 1988 (2) SA 54 (T)
- *CyberScene Ltd and Other v i-Kiosk Internet and Information (Pty) Ltd* (pp 104 and 107 in the textbook)
- *Ghersi and Others v Tiber Development (Pty) Ltd and others* (p 105 in the textbook) and answer the following question:

Mrs Slot is one of the directors of Middlestone (Pty) Ltd. The company manufactures and sells oak products. Mrs Slot prefers working for herself and intends resigning as a director of the company to start a similar business. She is unsure whether she may use the company's client list compiled over a number of years, to inform potential clients of her new business.

Advise Mrs Slot on whether she is allowed to make use of the company's client list. Substantiate your answer.

Feedback

You should have included the following points in your answer:

First explain that a director should not abuse his or her position as director or misuse any information obtained as director. He or she must prevent a conflict arising between his or her own interests and those of the company.

This means that a director may not for personal gain make use of any information he or she has acquired in his or her capacity as a director. You should then deal with the prescribed case law. You should also note that a director may be in breach of the duties owed by him or her to the company despite termination of his or her office. In *Sibex*, the directors resigned from their office to form a close corporation which competed directly with the special business of the company. The court found that the knowledge they had gained whilst employed by the company could not be used to the advantage of a rival before or after they had left the employ of the company (see also the reference to "practical issue" on p 104 in the textbook).

7.15.3 Acting in good faith and with a certain degree of care, skill and diligence

Prescribed study material

- Paragraph 6.14.3 in the textbook
- *Fisheries Development Corporation of SA v Jorgenson* 1980 (4) SA 156 (W)

The discussion in the textbook focuses on the duty to act with care, skill and diligence, but the duties to act in good faith and for a proper purpose, and in the best interests of the company, are equally important. Whereas the duty to act in the best interests of the company speaks for itself, the duty to act for a proper purpose perhaps merits further explanation.

This is one of the fiduciary duties recognised in terms of our common law as well, and requires that directors should use their powers for the real or true purpose for which these powers were given. One example of a breach of this duty that has often occurred in practice, is where boards issued shares to dilute the voting rights of other shareholders or obtain more votes for themselves to ensure their continued control over the company, instead of using this power for its real purpose, namely to obtain more capital for the company.

Regarding the duty to act with care and skill, the court in *Philotex (Pty) Ltd v Snyman and Others; Braitex (Pty) Ltd and Others v Snyman and Others* 1998(2) SA 138(SCA) held that although the test is an objective one, it contains subjective elements in that the general knowledge, skill and experience of the particular director in question are taken into account. A director who is a chartered accountant will therefore need to be more skilful when it comes to the company's financial affairs than a director who is, say, an electrician by trade.

The Companies Act introduced what is called the business judgment rule (s 76(4)). This provision states that a director will be regarded as having acted in the best interests of the company and with the required degree of care, skill and diligence if he or she

- took reasonable steps to become informed about the matter;
- had no material personal financial interest in the subject matter of the decision or knew of anybody else having a financial interest in the matter, or disclosed his interests; and
- made or supported a decision in the belief that it was in the best interests of the company;

A director is also entitled to rely on information provided by certain persons specified in the Act (see p 109 in the textbook).

Activity 7.17

Study paragraph 6.14.3 in the textbook and the case of *Fisheries Development Corporation of SA v Jorgenson* [case 87] and then do the following:

Summarise the three broad propositions as set out in the *Fisheries Development* decision about the duty to act with care and skill.

Feedback

You will note that the duty to act with a certain degree of care, skill and diligence is less burdensome than the fiduciary duties of directors.

7.15.4 Liability of directors and prescribed officers

Prescribed study material

- Paragraph 6.14.4 in the textbook
- Section 77 of the Companies Act

Directors may be held liable for certain losses or damage sustained by the company due to their actions. These actions may include acting without the necessary authority, fraudulently or in contravention of the provisions of the Companies Act or the company's Memorandum of Incorporation (see pp 110-112 in the textbook for a comprehensive list of all the actions as a result of which a director may incur liability). The first item in this list refers to the liability of a director for breaching the newly codified common-law duties described above. The remaining influence of the common law is clear when looking at this liability because the Act states that for a breach of the first five duties in the list (in 7.15.1 above), a director will be held liable in accordance with the common-law principles relating to breach of a fiduciary duty, while for a breach of the duty of care, skill and diligence, liability will be on the basis of the common-law principles of delict.

A director will be jointly and severally liable with any other person who is or may be held liable for the same act. The court may, however, relieve a director from liability, other than for wilful misconduct or wilful breach of trust, provided it appears to the court that the director acted honestly and reasonably.

Activity 7.18

Study paragraph 6.14.4 of the textbook and answer the following question:

List the circumstances under which a director may incur personal liability to the company.

Feedback

You will note that quite a lot is expected of a director. However, directors who act honestly and reasonably will not be held liable for losses or damage suffered by the company.

7.15.5 Indemnification and director's insurance

Prescribed study material

- Paragraph 6.14.5 in the textbook
- Section 78 of the Companies Act

A company may not indemnify a director in respect of liability arising out of certain circumstances such as a breach of his or her fiduciary duties. For a comprehensive list of the circumstances in which a company may not indemnify a director, see page 113 in the textbook. Indemnity insurance may also not be taken out for such circumstances.

A company is, however, entitled to take out indemnity insurance to protect a director against any liability or expenses for which the company is **permitted to indemnify** a director. The company may also take out insurance to insure itself against expenses that the company is permitted to advance to a director to defend litigation.

Activity 7.19

Study paragraph 6.14.5 in the textbook and answer the following question:

> Clause 12 of the Memorandum of Incorporation of De Beers Construction Ltd provides that "the company undertakes to indemnify and absolve from liability all directors in all transactions concluded by them on behalf of the company, provided that the directors have not been grossly negligent when conducting such transactions"
>
> Explain whether clause 12 of the Memorandum of Incorporation of De Beers Construction Ltd is a valid clause in terms of the Companies Act.

Feedback

The Companies Act makes it impossible to exempt directors from personal liability for negligence, default, breach of duty or breach of trust. The Memorandum of Incorporation may not conflict with any statutory rule. Thus the board of directors of De Beers Construction Ltd should be advised that the provisions purporting to exempt directors from liability in all instances except where gross negligence was present, are void.

REFLECTION

You have seen that the ownership of a company is vested in the general meeting of members (study unit 6) and that the control of the company is vested in the board of directors. Do you think it is a sound principle to separate ownership and control or should the members of the company also manage it? It is here that the principle of the separate legal personality of the company comes into play again. It is the company that owns its assets and is responsible for its liabilities, not the shareholders. The shareholders only hold a right to share in those assets, should the company be wound up.

REVIEW

In this study unit we discussed the composition and functioning of another organ of the company, namely the board of directors. We also looked at the duties of directors and the persons ineligible or disqualified from becoming directors.

Please ensure that you can answer the questions at the beginning of the study unit.

In the next study unit we will learn about the role of auditors and the company secretary.

Study unit 8

AUDITORS AND THE COMPANY SECRETARY

PRESCRIBED STUDY MATERIAL

- Study chapter 7, but only paragraphs 7.10 to 7.15 and chapter 8 in the textbook.
- Study sections1, 24, 28, 29, 30, 69(8) and 84 to 94 of the Companies Act.

Prescribed cases for this study unit

These are the cases you have to read in the casebook. You only need to study the other cases referred to in the prescribed paragraphs of the textbook in so far as discussed in the textbook.

- Thoroughbred Breeders' Association v Price Waterhouse 2001 (4) SA 551 SCA [149]
- International Shipping Co (Pty) Ltd v Bentley 1990 (1) SA 680 (A) [153]

8.1 INTRODUCTION

For a comprehensive understanding of company law you should be aware that the compulsory disclosure of financial information concerning the company plays a vital role in protecting the interests of shareholders, investors and creditors. In order to undertake certain projects, companies usually depend on capital investments made by members of the public. For example, members of the public may purchase shares or debentures in the company or advance loans. Investors and financiers are usually unwilling to invest or lend money unless there is proper financial reporting and disclosure of how the company's funds are applied.

The availability of reliable financial information on the company's affairs is conducive to a healthy economic climate. The whole aim of a company's financial statements is to inform the existing shareholders, as well as prospective investors in the company, of its financial standing. The financial statements reflect the company's general financial state. They disclose whether its assets exceed its liabilities, whether it has sufficient liquid funds and the extent of its working capital (liquid assets as well as credit facilities).

The annual financial statements which must be placed before the annual general meeting consist of the following:

- a balance sheet
- an income statement
- a statement of cash flow information
- a directors' report
- an auditor's report

The law regulating the disclosure of financial information and the auditing profession is incorporated in the Companies Act 71 of 2008 and the Auditing Profession Act 26 of 2005. The Companies Act 71 of 2008 contains a number of sections which regulate a company's financial disclosures and maintenance of accounting records.

The Companies Act imposes certain minimum financial disclosure requirements on all companies and more stringent disclosure requirements on public companies and certain private companies. Section 24(3) of the Companies Act stipulates a number of records that the company must maintain, including copies of all accounting records for the current and previous seven financial years. (see par 7.4 in the textbook). In terms of section 28, a company is required to keep accurate and complete accounting records, in one of the official languages, as necessary to enable the company to satisfy its obligations under the Companies Act and any other law with respect to the preparation of financial statements (see the definition of "financial statements" in s 1 of the Companies Act). The accounting records must be kept in the prescribed manner and form and must be kept at or be accessible from the company's registered office.

The type of accounting records which a company must maintain depends on factors such as the type of company, its purpose and the nature and extent of its activities. Section 29 of the Companies Act states that a company's financial statements must satisfy the financial reporting standards, present fairly the state of affairs and business of the company and explain the transactions and financial position of the company's business. The financial statements must also show the company's assets, liabilities and equity, as well as its income and expenses and any other prescribed information.

Section 30 of the Companies Act requires all public or state-owned enterprises to prepare annual financial statements within six months after the end of its financial year. The annual financial statements must include an auditor's report (s 30(5)).

In terms of section 44 of the Auditing Profession Act 26 of 2005, it is an auditor's duty to examine a company's financial statements and accounting records and to express an opinion on the truth and fairness, in all material respects, of the statements and the accountant's adherence to financial reporting standards. Section 1 of the Auditing Profession Act 26 of 2005 states that an "audit" means the examination of, "in accordance with prescribed or applicable accounting standards, (a) financial statements with the objective of expressing an opinion as to their fairness or compliance with an identified financial reporting framework and any applicable statutory requirements; or (b) financial and other information, prepared in accordance with suitable criteria, with the objective of expressing an opinion on the financial and other information''. By attesting that the financial statements fairly present a company's financial condition and past performance , an auditor fulfils a vital role in reinforcing the reliability of financial information.

This study unit will follow the structure indicated below.

Appointment of an auditor

Resignation and vacancies

Rotation of auditors

Rights and restricted functions of auditors

The Auditing Profession Act 26 of 2005

Audit committees

The company secretary

- **Mandatory appointment of company secretary**
- **Disqualification as company secretary**
- **Duties of a company secretary**
- **Resignation or removal of a company secretary**

Registration of company secretaries and auditors

In this study unit you will learn about auditors, their appointment and removal from office, their rights and functions, audit committees and auditor rotation. You will further learn about the company secretary, his or her appointment and removal from office and his or her functions and duties.

You will know that you understand this study unit when you are able to answer the following **key questions:**

- Who qualifies to be the auditor of a company?
- How is an auditor appointed?
- What happens if the auditor resigns or a vacancy arises in the office of auditor?
- What are the rights of an auditor?
- What are the duties of an auditor?
- What is auditor rotation?
- What is the purpose of the audit committee?
- Under what circumstances may an auditor be removed from office?
- What is a company secretary?
- What type of company must appoint a company secretary?

- Who is disqualified from appointment as a company secretary?
- What are the functions and duties of a company secretary?
- How can a company secretary be removed?

8.2 APPOINTMENT OF AN AUDITOR

Prescribed study material:

- Paragraphs 8.1 and 7.10 to 7.15 in the textbook
- Sections 90 and 91 of the Companies Act

The *Thoroughbred Breeders* case discussed on page 140 in the textbook would probably be decided differently today. The Supreme Court of Appeal held that, although the negligence of the Breeders' Association had also contributed to their loss, their claim against the auditors was based on contract, and the Apportionment of Damages Act only applied to claims based on delict.

However, in terms of section 58(2) of the Auditing Profession Act, which was enacted after the *Thoroughbred Breeders' Association* case, contributory negligence now applies to claims based on either delict or contract. This section provides that in respect of damages suffered by any person as a result of an act or omission of a registered auditor, the reference in the Apportionment of Damages Act 1956 to "damage" must also be construed as a reference to damage caused by a breach, by the registered auditor, of a term of a contract concluded with the registered auditor.

Activity 8.1

Study sections 90 and 91 of the Companies Act and paragraph 8.1 in the textbook and then answer the following questions:

(1) What types of companies must appoint an auditor?
(2) How is an auditor appointed?
(3) Who is disqualified from being an auditor of a company?

Feedback

A public company or state-owned company is required to appoint an auditor every year at the annual general meeting (see ss 34, 84 and 85 of the Companies Act). Other companies such as private companies, personal liability companies and nonprofit companies are not required under the Companies Act to appoint an auditor, but may do so voluntarily (see s 34 of the Companies Act). Section 85 of the Companies Act requires that every company that appoints an auditor must file a notice of the appointment with the Registrar within ten business days after the appointment. The notice must reflect the name of the auditor and the date of appointment.

Section 85(4) requires that the incorporators of a company file a notice of the appointment of the company's first auditor as part of the company's Notice of Incorporation. The auditor may be an individual person or a firm and is appointed by a company by way of a contract.

In companies with an audit committee (see 8.8 below), the audit committee is required in terms of section 94(7) of the Companies Act, to nominate for appointment a registered auditor who is independent of the company and determine the auditor's fees and terms of engagement.

Only a registered auditor may be appointed as auditor of a company. In terms of section 37 of the Auditing Profession Act, only persons who have complied with the prescribed education, training and competency requirements; have made arrangements regarding his or her continued professional development where that individual is not a member of an accredited professional body; is a "fit and proper person" to act as an auditor; and is resident within South Africa, may be registered as an auditor. The Auditing Profession Act states further in section 37(3) that any person who has been removed from an office of trust due to misconduct, has been convicted of theft, fraud or forgery or other act of dishonesty or corruption or has been declared by a court to be of unsound mind and unable to manage his or her own affairs, may not be registered as an auditor.

To ensure a required level of skill and that the auditor is independent of the company he or she is auditing, section 90(2) of the Companies Act disqualifies certain persons from being appointed as the auditor of a company. Such persons include a director or prescribed officer of the company; an employee or consultant of the company who was or has been engaged for more than one year in the maintenance of any of the company's financial records or the preparation of any of its financial statements; a director, officer or employee of a person appointed as company secretary; a person who, alone or with a partner or employees, habitually or regularly performs the duties of accountant or bookkeeper, or performs related secretarial work, for the company; a person who, at any time during the five financial years immediately preceding the date of appointment, was a person contemplated above or is a person related to a person contemplated above.

8.3 RESIGNATION AND VACANCIES

Prescribed study material

- Paragraph 8.2 in the textbook
- Sections 91 of the Companies Act

Section 91 of the Companies Act deals with the resignation of auditors and with vacancies.

Activity 8.2

Daniel is the auditor of Moonblue Ltd. Owing to ill health, he resigns as auditor during his period of office. Describe the procedure Moonblue Ltd should follow to appoint a new auditor.

Feedback

An auditor may resign at any time during his or her period of office. The resignation is effective when the notice of resignation is filed. The board of Moonblue Ltd must appoint a new auditor to replace Daniel within 40 business days after the filing of his resignation. Since Moonblue Ltd is a public company, it is required to have an audit committee. Prior to making an appointment, the board must propose to the audit committee of Moonblue Ltd, within 15 business days after the vacancy occurs, the name of at least one registered auditor to be considered to replace Daniel as auditor. The board of Moonblue Ltd may appoint the person proposed if, within five business days of making the proposal, the audit committee does not give notice in writing to the board rejecting the proposed auditor.

8.4 ROTATION OF AUDITORS

Prescribed study material

- Paragraph 8.3 in the textbook
- Section 92 of the Companies Act

Section 92 of the Companies Act makes provision for the rotation of auditors. In terms of this section, the same individual may not serve as the auditor or designated auditor of a company for more than five consecutive financial years. This rotation requirement applies to individual auditors only and not to firms or private companies.

Activity 8.3

Suppose that Given is appointed as the auditor of Moonblue Ltd to replace Daniel. Having served as auditor of Moonblue Ltd for three consecutive years, Given decides to take a six-month holiday in Europe and resigns from his position as auditor. On his return from Europe, Given reapplies for the position as auditor of Moonblue Ltd. Can he be reappointed?

Feedback

The Companies Act provides that if an individual has served as an auditor of a company for two or more consecutive financial years and then ceases to be the auditor, that individual may not be reappointed as auditor of that company until after the expiry of at least two further financial years. Given would therefore not be able to be reappointed as auditor of Moonblue Ltd after a six-month period.

8.5 RIGHTS AND RESTRICTED FUNCTIONS OF AUDITORS

Prescribed study material

- Paragraph 8.4 in the textbook
- Section 93 of the Companies Act

Section 93 of the Companies Act provides that at all times, the company auditor has a right to access the company's accounting records as well as all books and documents The auditor may attend any general meeting held by the company.

Section 44(6) of the Auditing Profession Act provides that a registered auditor may not conduct the audit of any financial statements of an entity, whether as an individually registered auditor or as a member of a firm, if the registered auditor has or had a conflict of interest in respect of that entity, as prescribed by the Independent Regulatory Board for Auditors (IRBA).The IRBA is required to define in the code of professional conduct (see s21(2)(a) of the Auditing Profession Act) which nonaudit services an auditor is prohibited from rendering to the company it is auditing.

Activity 8.4

Suppose Hamid is appointed as the auditor of Moonblue Ltd after Given's resignation. For the purpose of preparing the audit report, Hamid requests certain company documents from Barney, the financial director of Moonblue Ltd. Barney refuses to furnish Hamid with the documents. Advise Hamid of his legal rights, as auditor, under the Companies Act.

Feedback

Section 93 of the Companies Act provides that at all times, the company auditor has a right to access all the company's accounting records and books and documents. An auditor may require from the directors or officers such information and explanations as are necessary for the performance of his or her duties.

The auditor is further entitled to apply to court for an order to enforce the above rights and the court may make any order that is just and reasonable to prevent frustration of the auditor's duties by the company, directors, prescribed officers or employees (s 93(2)). The court may further make a costs order against any director or prescribed officer whom the court has found to have wilfully and knowingly frustrated or attempted to frustrate the performance of the auditor's functions (s 93(2)(b)).

Hamid is therefore entitled to have access to the documents requested from Barney, and may apply to court if necessary for an order that the documents be furnished to him. The court may make a costs order against Barney in his personal capacity.

8.6 THE AUDITING PROFESSION ACT 26 OF 2005

Prescribed study material

- Only READ paragraph 8.5 in the textbook

You will not be examined on the contents of this paragraph, but you should READ it carefully.

The Auditing Profession Act 26 of 2005 came into effect on 1 April 2006. While its predecessor, the Public Accountants' and Auditors' Act 80 of 1991 was concerned with the regulation of both accountants and auditors, the Auditing Profession Act 26 of 2005, which repeals the Act of 1991, focuses solely on the regulation of the auditing profession.

The Auditing Profession Act aims to "introduce a more comprehensive and modern framework for regulating the auditing profession [than the Act of 1991], to improve the integrity of South Africa's financial sector and financial reporting by ensuring that there is effective oversight with regard to the auditing profession as a whole". Section 3 of the Auditing Profession Act establishes an Independent Regulatory Board for Auditors ("IRBA") for the purpose of regulating the auditing profession. The integrity of the IRBA is safeguarded by disqualifying certain persons from membership.

Such persons include unrehabilitated insolvents; persons who have been convicted of an offence and sentenced to imprisonment without the option of a fine; persons who have been convicted of fraud; persons who have been found guilty of improper misconduct under the Act; or persons who have been removed from an office of trust as a result of improper misconduct (s 13(1)). Section 4 of the Auditing Profession Act sets out five general functions which the IRBA is required to perform, as well as four further general functions which it may perform.

Part 3 of Chapter II of the Auditing Profession Act deals with the powers of the IRBA which include a number of general powers (set out in s 9) and powers relating to the making of rules (s 10). In terms of section 20(2) of the Act, the IRBA is required to establish six permanent committees, namely a committee for auditor ethics; a committee for auditor standards; a committee for education, training and professional development; an inspection committee; an investigating committee; and a disciplinary committee. The committee for auditor ethics must assist the IRBA in developing rules of conduct and in providing auditors with advice on ethics and conduct (s 21). The committee for auditing standards is required in particular to assist the IRBA with developing and prescribing auditing pronouncements and ensuring that the auditing pronouncements are consistent with accepted international pronouncements (s 22). The investigating committee is required to investigate and make a recommendation regarding alleged improper conduct by registered auditors (s 48). The disciplinary committee is required to hear charges of alleged misconduct against registered auditors (s 50).

8.7 AUDIT COMMITTEES

Prescribed study material

- Paragraph 8.6 in the textbook
- Section 94 of the Companies Act

Activity 8.5

Activity

Study section 94 of the Companies Act and then answer the following questions:

- Which companies are required under the Companies Act to appoint an audit committee?
- What are the functions of an audit committee?

Feedback

Feedback

Section 94 of the Companies Act requires that at each annual general meeting, a public company, a state-owned enterprise and any other company which has voluntarily decided to have an audit committee, must appoint an audit committee for every financial year. The audit committee must have at least three members and consist only of nonexecutive directors of the company who have not been involved in the company's day-to-day management in the preceding three financial years. For the year the audit committee is appointed, it must perform the functions listed in paragraph 8.6 in the textbook.

8.8 THE COMPANY SECRETARY

Prescribed study material

- Paragraphs 8.7 and 7.13 in the textbook
- Sections 86 to 89 of the Companies Act

8.8.1 Mandatory appointment of company secretary

The company secretary is the principal administrative officer of his or her company. Every public company or state-owned enterprise must appoint a company secretary who is knowledgeable or experienced in the relevant laws (s 86 of the Companies Act.) A private company, personal liability company or a nonprofit company may voluntarily appoint a company secretary.

The first company secretary of a public company or state-owned enterprise may be appointed by

- the incorporators of the company; or
- within 40 business days after the incorporation of the company, by either the directors of the company or an ordinary resolution of the company's shareholders (s 86(3))

Within 60 business days after a vacancy arises in the office of company secretary, the board must fill the vacancy by appointing a person whom the directors consider to have the requisite knowledge and experience (s 86(4)).

Every company secretary must be a permanent resident of the Republic, and must remain so while serving in that capacity (s 86).

8.8.2 Disqualification as company secretary

A person who is disqualified in terms of section 69(8) to serve as a director of a company, may not be appointed as a company secretary (see study unit 7 in which these disqualifications are discussed.) In a nutshell, a person is therefore disqualified from being appointed as a company secretary if such a person –

- has been prohibited to be a director or has been declared to be delinquent by a court order;
- is an unrehabilitated insolvent;
- is prohibited in terms of any public regulation to be a director of the company;
- has been removed from an office of trust, on the grounds of misconduct involving dishonesty; or
- has been convicted, in the Republic or elsewhere, and imprisoned without the option of a fine, or fined more than the prescribed amount, for theft, fraud, forgery, perjury, or an offence (i) involving fraud, misrepresentation or dishonesty; (ii) in connection with the promotion, formation or management of a company; or (iii) under the Companies Act or some other Acts listed in the section, and also listed in the textbook on page 146.

Section 87 provides that a juristic person or partnership may be appointed to hold the office of company secretary, provided that every employee of that juristic person, or partner and employee of that partnership, as the case may be, satisfies the requirements contemplated in section 84(5); and at least one employee of that juristic person, or one partner or employee of that partnership, as the case may be, satisfies the requirements contemplated in section 86.

8.8.3 Duties of a company secretary

The last item in the list of a company secretary's duties stated in the textbook, is a reference to the duty on every company to file an annual return (not to be confused with a company's annual **financial** statements) containing certain prescribed information (s 33). Section 33(3) provides that every company must designate a director, employee or other person as the company's compliance officer in this annual return. In the case of a company with a company secretary, he or she will thus automatically be the compliance officer.

Section 88 provides that a company secretary is accountable to the company's board. The company secretary's duties include, but are not restricted to the following:

- providing the directors of the company collectively and individually with guidance as to their duties, responsibilities and powers;
- making the directors aware of any law relevant to or affecting the company;
- reporting to the company's board any failure on the part of the company or a director to comply with this Act;
- ensuring that minutes of all shareholders meetings, board meetings and the meetings of any committees of the directors, or of the company's audit committee, are properly recorded in accordance with this Act;
- certifying in the company's annual financial statements whether the company has filed required returns and notices in terms of this Act, and whether all such returns and notices appear to be true, correct and up to date;
- ensuring that a copy of the company's annual financial statements is sent, in accordance with this Act, to every person who is entitled to it; and
- carrying out the functions of a person designated in terms of section 33(3) (ie the person responsible for filing the company's annual return).

8.8.4 Resignation or removal of a company secretary

In terms of section 89(1), a company secretary may resign from office by giving the company one month's written notice, or, with the approval of the board, less than one month's written notice. If the company secretary is removed from office by the company's board, the secretary may require the company to include a statement in its annual financial statements relating to that financial year setting out the secretary's contention as to the circumstances that resulted in the removal.

Activity 8.6

Mike is one of the directors of Oak Ridge Ltd. The company wishes to appoint a company secretary. The position has been vacant since the incorporation of Oak Ridge Ltd. He wants to know whether Oak Ridge Ltd is obliged to appoint a company secretary, what the duties of the company secretary are and who would be responsible for appointing this company officer. Advise Mike.

Feedback

You should advise Mike that, under section 86 of the Companies Act, a public company is obliged to appoint a company secretary. Since it is apparent that Oak Ridge Ltd is a public company, a secretary must be appointed. The duties of a company secretary as set out in section 88 must be explained, and you should also explain that this is not a comprehensive list of duties.

The secretary is usually the chief administrative officer of the company, but is not involved in the management of the company. His or her specific duties will vary in scope and nature according to the size of the company, the nature of its activities and the function that the directors assign to the secretary. The secretary should be appointed by the directors of an existing company. The first secretary (ie of a new company) should be appointed as provided in section 86.

8.9 REGISTRATION OF COMPANY SECRETARIES AND AUDITORS

Prescribed study material

- Paragraphs 8.8 and 7.14 in the textbook
- Sections 85 of the Companies Act

In addition to the record of company secretaries and auditors that a company must keep (explained in the textbook), section 85 of the Companies Act also requires every company that appoints a company secretary or auditor to file a notice of the appointment, or the termination of service of such an appointment, with the Registrar within ten business days after the appointment or termination, as the case may be. Section 85(4) allows the incorporators of a company to file a notice of the appointment of the company's first company secretary as part of the company's Notice of Incorporation.

REVIEW

In this study unit you were introduced to the duties of the auditor in validating the financial statements of the company. We saw that he or she must exercise due professional care in the examination of the company's statements and reports. We also saw how auditors can be appointed to and removed from office and how they should resign. Lastly, we looked at the mandatory appointment of a company secretary, his or her duties and his or her resignation or removal.

Please ensure that you can answer the questions at the beginning of this study unit.

In the next study unit we will examine the procedures to be followed in the referral of complaints in companies.

Study unit 9

REMEDIES, ENFORCEMENT AGENCIES AND ALTERNATIVE DISPUTE RESOLUTION (ADR)

PRESCRIBED STUDY MATERIAL

- Study chapter 11 in the textbook.
- Study sections 161, 163, 164 and 165 of the Companies Act.

Prescribed case for this study unit

You need to read this case in the casebook. You only need to study the other cases referred to in the prescribed paragraphs in the textbook in so far as they are discussed in the textbook.

- *Donaldson Investments (Pty) Ltd v Anglo-Transvaal Collieries Ltd* 1979 (3) SA 713 (W) [166]

9.1 INTRODUCTION

Prescribed study material

- Paragraph 11.1 in the textbook

In study unit 8 we discussed auditors and the company secretary. We dealt with the appointment, resignation and rotation of auditors, as well as their rights and restricted functions. We referred to the Auditing Profession Act of 2005 and audit committees. We now know that a public company or state-owned enterprise must appoint a company secretary. We also dealt with the registration of secretaries and auditors. In this study unit we will explain the different remedies against directors who have abused their position, as well as other statutory remedies for shareholders.

We will also discuss the potential liability of different persons for the abuse of the separate juristic personality of a company. Lastly, we will deal with enforcement agencies and alternative dispute resolution (ADR).

You will know that you understand this study unit when you are able to answer the following **key questions:**

- What remedies are available against directors who have abused their position?
- Who may bring an application to declare a director delinquent or under probation?
- What are the consequences for a director against whom a successful application was made in terms of section 161?
- When is a court obliged to make an order declaring a person to be a delinquent director in terms of section 162?
- When may a court place a director under probation?
- Discuss the derivative action in terms of section 165.
- What remedies are available to shareholders to protect their own rights?
- Discuss the remedy for relief from oppressive or prejudicial conduct in terms of section 163.
- Discuss a dissenting shareholder's appraisal rights in terms of section 164.
- Discuss the application to protect rights of securities holders in terms of section 161.
- Explain the possible imposition of personal liability in instances where there has been abuse of a company's separate juristic personality.
- What body is normally responsible for the enforcement of the Companies Act?
- Name four alternatives that the Act envisages for addressing complaints relating to alleged contraventions of the Act.
- What are the functions of the Companies and Intellectual Property Commission?
- Who may file a complaint with the Companies and Intellectual Property Commission?
- How may the Companies and Intellectual Property Commission respond to a complaint?
- Discuss the procedure that an investigation of a complaint by the Companies and Intellectual Property Commission will follow.
- What are the functions of the Companies Tribunal?
- What is ADR and to what alternatives does it refer?
- What is the main difference between conciliation and mediation, on the one hand, and arbitration, on the other?

This study unit will follow the structure indicated below.

Remedies against directors who have abused their position

- **Application to declare a director delinquent or under probation**
- **Derivative action in terms of section 165**

Remedies available to shareholders to protect their own rights

- **Relief from oppressive or prejudicial conduct in terms of section 163**
- **Dissenting shareholders' appraisal rights in terms of section 164**
- **Application to protect rights of securities holders in terms of section 161**

Personal liability for abuse of the separate juristic personality of a company

Enforcement agencies and ADR

9.2 REMEDIES AGAINST DIRECTORS WHO HAVE ABUSED THEIR POSITION

Part B of Chapter 7 of the Act contains a number of specific remedies. We will discuss most of these in this study unit.

The specific remedies fall into three broad categories. The first category concerns remedies against directors who have abused their position.

Two remedies can be classified under this category, namely an application to declare a director delinquent or under probation and the derivative action in terms of section 165.

9.2.1 Application to declare a director delinquent or under probation

Prescribed study material

- Paragraph 11.2 in the textbook
- Section 162 of the Companies Act
- This topic is also discussed in detail in study unit 7, paragraph 7.6.

A court may declare a director to be a delinquent director or place a director under probation;

Such an order has serious consequences for a director;

A court is obliged to make an order declaring a person to be a delinquent director if one of the statutory grounds is established;

A court may place a director under probation on the grounds in section 162(4).

9.2.2 Derivative action in terms of section 165

Prescribed study material

- Paragraph 11.3 in the textbook
- Section 165 of the Companies Act
- See *TWK Agriculture Ltd v NCT Forestry Co-operative Ltd and Others*2006 (6) SA 20 (N) (par 11.3 in the textbook) regarding the nature of the derivative action.
- Since the common-law derivative action was unsatisfactory for a number of reasons, section 266 of the 1973 Act introduced a statutory derivative action as an alternative to the common-law remedy.

- In *Thurgood v Dirk Kruger Traders (Pty) Ltd* 1990 (2) SA 44 (E) [par 11.3 in the textbook], the applicant brought a successful application in terms of section 266 of the 1973 Act for the appointment of a *curator ad litem.*
- Section 165 of the 2008 Act retains the statutory derivative action in terms of section 266 of the 1973 Act, but with important changes.
- Section 165 abolishes the common-law right of a person other than the company to bring legal proceedings on behalf of the company.
- Specific steps must be taken to institute an action in terms of section 165.
- Instead of a *curator ad litem* appointed by the court, the new procedure provides for the appointment of an independent and impartial person or committee by the company to investigate the demand and report back to the board.

9.3 REMEDIES AVAILABLE TO SHAREHOLDERS TO PROTECT THEIR OWN RIGHTS

The second category concerns statutory remedies for shareholders.

Three remedies can be classified under this category, namely relief from oppressive or prejudicial conduct in terms of section 163, dissenting shareholders' appraisal rights in terms of section 164 and an application in terms of section 161 to protect the rights of the holders of securities.

9.3.1 Relief from oppressive or prejudicial conduct in terms of section 163

Prescribed study material

- Paragraph 11.4 in the textbook
- Section 163 of the Companies Act
- Section 252 of the 1973 Act provided a statutory remedy to minority shareholders who were the victims of oppressive conduct by the majority.
- This remedy was in addition to the personal action that minority shareholders could bring against the company under the common law.
- Section 163 of the 2008 Act essentially retains the remedy provided for in section 252 of the 1973 Act, but with a number of important refinements.
- In *Donaldson Investments (Pty) Ltd v Anglo-Transvaal Collieries Ltd* 1979 (3) SA 713 (W) [case 166], preference shareholders were unsuccessful in their action under section 252 where they were deprived of certain rights but granted additional privileges, because an order in terms of section 252 would have resulted in the shareholders receiving a price for their shares that was far in excess of their actual market value. *Robson v Wax Works (Pty) Ltd*2001 (3) SA 1117 (C) (par 11.4 in the textbook) is an example of a situation in which section 252 would have brought appropriate relief.

9.3.2 Dissenting shareholders' appraisal rights in terms of section 164

Prescribed study material

- Paragraph 11.5 in the textbook
- Section 164 of the Companies Act
- Although section 163 of the 2008 Act retains the remedy provided for in section 252 of the 1973 Act (as explained above), and although relief under section 252 could include the purchase by the company of a dissenting shareholder's shares, the current Act provides for an independent remedy for dissenting shareholders, referred to as dissenting shareholders' appraisal rights.
- An appraisal right is the right of a shareholder to require his or her company to buy his or her shares at their fair value if his or her company takes any of the listed triggering actions.
- A specific procedure must be followed by the shareholder once his or her company has taken a triggering action.

9.3.3 Application to protect the rights of securities holders in terms of section 161

Prescribed study material

- Paragraph 11.6 in the textbook
- Section 161 of the Companies Act
- The holder of issued securities may apply to court for a declaratory order regarding his or her rights.
- Alternatively, the holder of the securities can apply for an appropriate order to protect his or her rights or to rectify any harm done to him or her by the company as a result of an act or omission in contravention of the Act, the Memorandum of Incorporation, rules or applicable debt instrument, or harm done by any of the company's directors, but only to the extent that they may be held liable under section 77.

9.4 PERSONAL LIABILITY FOR ABUSE OF THE SEPARATE JURISTIC PERSONALITY OF A COMPANY

Prescribed study material

- Paragraph 11.7 in the textbook
- Section 163(4) of the Companies Act
- This topic is also dealt with in study unit 1, paragraph 1.4.

The third category refers to the liability for abuse of the separate juristic personality of a company.

Effectively, this remedy refers to the lifting of the corporate veil and the consequent imposition of personal liability if the separate juristic personality of a company has been abused. The court may declare that the company is to be deemed not to be a juristic person in certain respects.

Activity 9.1

Concil Ltd passed a special resolution which would effectively change the control in the company. Sarah is a minority shareholder who has voted against the decision because this would prejudice her rights as a shareholder of Concil Ltd. Advise Sarah whether the remedy contained in section 163 for relief from oppressive or prejudicial conduct, or the remedy afforded by section 164 which entails dissenting shareholders' appraisal rights, would be available to her.

Feedback

Refer back to paragraphs 11.4 and 11.5 in the textbook and make sure you understand the difference between relief from oppressive or prejudicial conduct in terms of section 163 and dissenting shareholders' appraisal rights in terms of section 164.

9.5 ENFORCEMENT AGENCIES AND ADR

Prescribed study material

- Paragraph 11.8 in the textbook

The 2008 Act, unlike the 1973 Act which extensively provided for criminal sanctions, generally uses a system of administrative enforcement.

The body normally responsible for the enforcement of the Act is the Companies and Intellectual Property Commission (the Commission), except with regard to matters within the jurisdiction of the Takeover Regulation Panel. The Commission takes the place of the Registrar of Companies under the 1973 Act. Among other things, the Commission must monitor proper compliance with the Act, investigate complaints concerning contraventions of the Act, promote the use of ADR by companies for resolving internal disputes, keep a Companies Register, advise the Minister on changes to the law, and so forth.

The Commission plays a central role in the enforcement of the Act. Any person may file a complaint with the Commission and the Commission may also initiate complaints on its own motion or at the request of another regulatory authority. The commission may respond to complaints in different ways.

The Act also establishes a new entity, namely the Companies Tribunal. Its two main functions are to serve as a forum for voluntary ADR in any matter arising under the Act and to carry out reviews of administrative decisions made by the Commission.

As an alternative to applying to court or filing a complaint with the

Commission, an applicant or complainant may refer a matter to the Companies Tribunal or to an accredited entity for resolution by mediation, conciliation or arbitration. There are certain differences between these three methods of ADR. Use of ADR is voluntary and all parties must agree to the use of the process.

Activity 9.2

Billy alleges that Timex (Pty) Ltd has contravened certain provisions of the Companies Act. Billy's complaint can basically be addressed in four different ways. List Billy's options.

Feedback

Refer back to paragraph 11.8 in the textbook. The different ways in which a complaint can be addressed must not be confused with the alternatives to court proceedings, namely mediation or conciliation and arbitration. ADR is merely one of the ways in which a complaint can be addressed

REFLECTION

You have now been introduced to different ways in which complaints can be dealt with. Which forum would you advise your client to consult?

REVIEW

In this study unit we discussed the various remedies available to companies and shareholders. You should be able to advise a client on the grounds for instituting the various actions and what the onus of proof is.

There are alternative forums (not only courts) available for referral of complaints. Would you be able to advise an aggrieved shareholder of the procedure to follow in case of prejudicial conduct of the company against his or her rights?

Please ensure that you are able to answer the questions at the beginning of this study unit.

In the next study unit you will be introduced to a new form of business, namely partnerships.

Study unit 10

PARTNERSHIPS

PRESCRIBED STUDY MATERIAL

- Study chapter 12 in the textbook.

Prescribed cases for this study unit

Read these cases in the caseook. You only need to study the other cases referred to in the prescribed paragraphs in the textbook in so far as they are discussed in the textbook.

- *Pezzuto v Dreyer and Others* 1992 (3) SA 379 (A) [8]
- *Bester v Van Niekerk* 1960 (2) SA 779 (A) [6]
- *Goodrickes v Hall and Another*1978 (4) SA 208 (N) [29]
- *Lee en 'n Ander v Maraisdrif (Edms) Bpk* 1976 (2) SA 536 (A) [32]

10.1 INTRODUCTION

A partnership may be descried as a contractual relationship between 2 or more – but usually not more than 20 – persons (called partners) who operate a lawful business with the object of making a profit. Partners may be natural or juristic persons. The essential characteristics of a partnership are that each partner has to contribute something to the partnership, the partnership must be carried on for the joint benefit of the partners and each partner should have the expectation of sharing in the profit. Due to the fragility in terms of the continuation of partnerships and the risks associated with this particular business form, a relationship of utmost good faith is required between partners.

A partnership does not have a legal personality. The partners in their personal capacity, rather than the partnership as such jointly enter into all transactions or contracts. The assets contributed to or accumulated by the partnership belong to all the partners jointly as c-owners. The partners are also jointly liable for all the partnership debts.

Although a partnership is not a juristic person., the law nevertheless regards a partnership as an entity for certain limited purposes.

The continued existence of a partnership depends on the continued involvement of the partners. It is also largely dependant on the legal capacity of the partners.

During the existence of the partners are jointly liable for all claims against the partnership, regardless of who was responsible for bringing about the claim. A creditor must either sue all the partners jointly or sue in the name of the partnership. If the partnership assets are insufficient to meet he claim of the creditor, the partners are liable for the debt of their personal estates. The personal possessions of the partners are therefore not protected against any claim. Once a partnership has been dissolved the partners are jointly severally liable for partnership debts. The means that a creditor can recover the full debt from one partner only, leaving it it to the partner who settle the claim to claim the necessary proportionate contributions from his co-partners.

The partners have jooint control and authority over the buisness. However the partners casn adjust the congtrol and authority aspect in their partnershp agreement, by for excluding one or more partners from representing or participating in the management of the partnership. This would however not necessarily exclude liability in terms of transactions concluede by such an excluded partner. The principle of mutual mandagte provides for liability of the partners for contrracts concluded by anypartner in the name of the partnership if such transaction falls within the scope of the parnership business. Therefor the partners will during the existence of the partnership; be held jointly liable in tersm of an y transction concluded by a partner is such contract is not outside the scope of the buisness. A parnter who is excluded from partidipating in management and concludes a contract within the scope of the partnersip wil however be in beach of his fiduciary duty to his co-partners.

The joint management of the partnership can lead to problems if the partners have different opinions or work ethics. A partnership may even be terminated as a result of personal circumstances of its partners or their incompatibility in running the business.

You will know that you understand this study unit if you are able to answer the following **key questions:**

- How do universal partnerhips differ from other types of partnerships?
- What is the difference between an anonymous partnership and a partnership *en commandite*?
- List the essential (or *essentialia*) of a partnership.
- List the natural consequences (or *naturalia*) of a partnership.
- What are the two exceptions to the general rule that a partnership does not exist independently of the partners?
- Explain the duties of a partner towards the partnership.
- Under which circumstances can a partner bind the partnership in a contract with a third party?
- List the different ways in which a partnership may be dissolved or terminated.

10.2 TYPES OF PARTNERSHIP

Prescribed study material

- **Paragraph 12.2 of the textbook**

Apart from ordinary partnerships, which form the subject of the discussion in this study unit, there are also universal, particular and extraordinary partnerships.

10.2.1 Universal and particular partnerships

Universal partnerships differ from other types of partnerships in their ambit – they are not restricted to a particular transaction or a specific business.

Two types of universal partnerships can be distinguished, namely the *societas universorum bonorum* and the *societas universorum quae ex quastu veniunt.*

The *societas universorum bonorum* is a partnership of all property that generally will take place within the context of marriage.

The *societas universorum quae ex quastu veniunt* is a partnership of all profit which occurs within the context of commercial undertakings.

Particular partnerships

A partnership can be established in respect of a specific project, for example the construction of a block of flats.

In *Bester v Van Niekerk* 1960 (2) SA 779 (A) it was held that if persons who are not partners in other business share that profits and loss of one particular transaction, they become partners as to that transaction but not as to anything else.

This study unit will follow the structure indicated below.

Definition of a partnership

Types of partnership

- **Universal and particular partnerships**
- **Ordinary and extraordinary partnerships**

The essential of a partnership

- **Contribution by partners**
- **The business should be conducted for the joint benefit of the parties**
- **The business should be conducted with the objective of making a profit**

- **The contract should be a legitimate contract**
- **Other legal formalities**

Legal nature of a partnership

- **Insolvency**
- **Litigation**

Relationship between partners

The relationship between partners and third parties

Dissolution of partnerships

10.3 DEFINITION OF A PARTNERSHIP

Prescribed study material

- Paragraph 12.1 in the textbook

In *Pezzutto v Dreyer and Others* 1992 (3) SA 379 (A), a partnership was defined as a legal relationship created by way of a contract between two or more persons, in terms of which each of the partners agrees to make some contribution to the partnership business which is conducted for the joint benefit of the parties, the object of which is to make a profit.

You will know that you understand this study unit if you are able to answer the following **key questions:**

- How do universal partnerships differ from other types of partnerships?
- What is the difference between an anonymous partnership and a partnership *en commandite*?
- List the essentials (or *essentialia*) of a partnership.
- List the natural consequences (or *naturalia*) of a partnership.
- What are the two exceptions to the general rule that a partnership does not exist independently of the partners?
- Explain the duties of a partner towards the partnership.
- Under what circumstances can a partner bind the partnership in a contract with a third party?
- List the different ways in which a partnership may be dissolved or terminated.

10.4 TYPES OF PARTNERSHIP

Prescribed study material

- Paragraph 12.2 in the textbook
- Apart from ordinary partnerships, which form the subject of the discussion in this study unit, there are also universal, particular and extraordinary partnerships.

10.4.1 Universal and particular partnerships

Universal partnerships differ from other types of partnerships in their ambit they are not restricted to a particular transaction or a specific business.

Two types of universal partnerships can be distinguished, namely the *societas universorum bonorum* and the *societas universorum quae ex quastu veniunt*.

The *societas universorum bonorum*is a partnership of all property that generally occurs in the context of marriage.

The *societas universorum quae ex quastu veniunt* is a partnership of all profit that occurs in the context of commercial undertakings.

A particular partnership can be established in respect of a specific project, say, the construction of a block of flats.

In *Bester v Van Niekerk* 1960 (2) SA 779 (A) it was held that if persons who are not partners in other business share the profits and loss of one particular transaction, they become partners as to that transaction but not as to anything else.

10.4.2 Ordinary and extraordinary partnerships

Extraordinary partnerships differ from other types of partnerships in that the liability of certain of the partners to third parties may be limited.

Three types of extraordinary partnerships can be distinguished, namely the anonymous partnership (also called the silent partnership), the partnership*en commandite* and special partnerships which were registered under the now repealed Special Partnerships Limited Liabilities Act of the Cape Province and Natal.

In an anonymous or silent partnership, the business is conducted by one of the partners in his or her ownname. While an anonymous or silent partner remains undisclosed to the public, he or she is not liable to third parties for the debts of the partnership. However, he or she remains liable to his or her partner/s for his or her proportional share of the partnership losses. In other words, he or she shares the full risk of the enterprise.

In a partnership *en commandite* the business of the partnership is also conducted in the name of one or more of the partners, but every partner whose name is not disclosed is only liable to the other parties to the extent of the fixed amount of the agreed capital contribution made by him or her. Therefore if the partnership incurs losses, the liability of the partner *en commandite* will not exceed the fixed amount.

Special partnerships which were registered under the now repealed Special Partnerships Limited Liabilities Act of the Cape Province and Natal, referred to partnerships where the limited liability of a special partner would be lost if his or her name was employed in the name of the firm or if he or she personally entered into a transaction on the partnership's behalf.

10.5 THE ESSENTIALS OF A PARTNERSHIP

Prescribed study material

- Paragraph 12.3 in the textbook

The essentials (or *essentialia*) are those elements that must form part of an agreement in order for such agreement to constitute a partnership agreement. These essentials were set out in *Joubert v Tarry and Co* 1915 TPD 277 (par 12.3 in the textbook).

10.5.1 Contribution by partners

Each partner must contribute something or give a binding undertaking to make some kind of contribution to the partnership that has commercial value, such as money, property, skill, knowledge, expertise, contacts or experience. Remember that a partner's contribution must be exposed to the risks of the partnership business. If a partner makes a contribution on condition that it will be returned to him or her even if the enterprise fails, that contribution will not meet with this requirement of the *essentialia*.

However, bear in mind that partners can agree that a partner will retain full ownership of the goods he or she contributes to the partnership, in which case only the use of the goods is made available to the partnership. Since the use still has an economic value, the contribution would remain valid despite his or her retention of ownership.

10.5.2 The business should be conducted for the joint benefit of the parties

It is one of the *essentialia* of a partnership that each partner must be entitled to share in the net profit of the partnership, but partners need not receive equal shares in the profit. An agreement that a partner will only share in the profit if the net profit exceeds a stipulated profit margin is also valid. Although such a partner will not share in the profit if the profit margin is not exceeded, he or she at least has a right to share in it when the business of the partnership improves. One partner cannot be entitled to all the benefits while another has to bear all the losses. However, it is possible to exclude a partner from sharing in a net loss. This is discussed in paragraph 10.5 in this study unit.

10.5.3 The business should be conducted with the objective of making a profit

According to the court in *Ally v Dinath* 1984 (2) SA 451 (T) (par 12.3.3 in the textbook), the profit motive does not refer to purely pecuniary profit, but also to the achievement of another material gain such as a joint exercise for the purpose of saving costs.

However, sports clubs and welfare or charitable institutions cannot be considered to be partnerships.

10.5.4 The contract should be a legitimate contract

A partnership is established by means of a valid agreement and the contracting parties must have the intention of establishing a partnership.

In *Harrington v Fester and Others*1980 (4) SA 424 (C) (par 12.3.4 in the textbook), there was no written partnership agreement and the applicant claimed the existence of a partnership, but certain correspondence indicated that the applicant had treated the respondent as an employee, which is totally inconsistent with the existence of a partnership.

10.5.5 Other legal formalities

A partnership must comply with the law and cannot conduct business that is prohibited by law or public policy. The statement in paragraph 12.3.5 in the textbook that a partnership may generally not consist of more than 20 persons will no longer remain valid once the Companies Act of 2008 comes into effect. This is because section 30 of the Companies Act of 1973 which contained this prohibition, has not been repeated in the 2008 Companies Act. There will therefore be no limit on the number of partners in any partnership. At least two partners are required for a partnership to come into existence. There are no formal requirements for the actual partnership agreement, and the agreement may therefore be concluded in writing or orally or be implied by conduct, unless the partners agree on certain formalities.

Keep in mind that a partnership is nothing more than a specific type of contract. A valid contract must be lawful, parties must have contractual capacity, they must reach an agreement and the agreed performance must be possible.

Activity 10.1

Activity

Pule, Riaan and Cindy decide to form a partnership. They wish to buy and sell second-hand motor vehicles.

It is agreed that Pule will contribute R100 000 for the purchase of the first two vehicles, Riaan will service and clean the vehicles and Cindy will be the salesperson. It is further agreed that the net profit derived from the sale of vehicles will be divided equally between Pule and Cindy, while Riaan will be paid a stipulated salary every month. Explain whether a valid partnership will come into existence.

Feedback

Refer back to paragraph 12.3 in the textbook. You should ask yourself whether all the essential elements are present. Here, because Riaan is excluded, the agreement is not for the benefit of all the partners. It is therefore not a valid partnership agreement.

10.6 LEGAL NATURE OF A PARTNERSHIP

Prescribed study material

- Paragraph 12.4 in the textbook

A partnership does not exist independently from the partners. Section 8(3) of the Act repeats the provision that is presently found in section 31 of the Companies Act of 1973, namely that no association formed for the purpose of acquisition of gain by the association or its members will be a legal person unless it is registered as a company under this Act or formed pursuant to another law. The rights and obligations of the partnership are those of the partners and the assets belong to the partners. When one of the partners dies or retires, the partnership dissolves.

In *Sacks v Commissioner for Inland Revenue* 1946 AD 31 (par 12.4 in the textbook), the court held that unless a partnership agreement provided otherwise, receipts of income of a partnership were so received by the partners in common and only when the time arose at the end of an accounting period, would a partner become entitled to claim a separate determinable share of the partnership profits. However, this position has been altered by section 24H of the Income Tax Act 58 of 1962 which ensures that each partner is regarded as conducting the business of the partnership.

There are two exceptions to the general rule that a partnership does not exist independently of the partners. The first refers to insolvency and the second to litigation.

10.6.1 Insolvency

Section 13(1) of the Insolvency Act 24 of 1936 provides that sequestration of a partnership estate is to be treated as distinct from the estates of the individual members.

If the estate of an insolvent partnership is sequestrated, the partnership estate (which comprises the contributions of partners and further assets acquired by the partnership), the estates of the partners must be sequestrated simultaneously.

The debts of the partnership are first paid from the partnership estate before the private estates of the partners will be looked at to pay the partnership debt.

In *Michalow NO v Premier Milling Co Ltd* 1960 (2) SA 59 (W) (par 12.4.1.1 in the textbook), the court held that the Insolvency Act departed from the common law by retaining the partnership estate as a separate estate from the estates of the partners.

10.6.2 Litigation

The rights and obligations of the partnership are the rights and duties of the partners jointly. Hence an individual partner cannot be sued for a partnership debt during the subsistence of the partnership and an individual partner cannot generally enforce a partnership claim. In principle, all the partners must sue and be sued jointly in their own names during the subsistence of the partnership. However, in terms of Rule 14 of the Uniform Rules of the High Court, a partnership may be sued and may sue in its business name. A similar provision is to be found in Rule 54 of the Magistrates' Courts Act 32 of 1944. When judgment is levied against a partnership, the partnership assets must first be exhausted before execution can be levied on the separate property of the partners.

Activity 10.2

Rina, Elize and Lepaku form a partnership. Rina then becomes insolvent and her estate is sequestrated. Explain the effects of Rina's insolvency on the partnership.

Feedback

Refer back to paragraph 12.4 in the textbook. Make sure that you understand the legal nature of a partnership when answering this question. You should explain that the partnership estate and the partners' personal estates will be sequestrated, but that Rina's creditors will first be paid from her personal estate before the partnership estate will be looked at. A further consequence is that the partnership will dissolve, since the insolvency of one of the partners is a ground for the dissolution of a partnership. The dissolution of a partnership is explained later in this study unit.

10.7 RELATIONSHIP BETWEEN PARTNERS

Prescribed study material

- Paragraph 12.5 in the textbook

There are certain natural consequences (or *naturalia*) which ensue from a partnership agreement. In contrast to the *essentialia* of a partnership, as discussed earlier, partners are free to alter the *naturalia* of a partnership. If these consequences are not altered by the partners, the *naturalia* are the legal rules which will apply to the partnership.

The most important *naturalia* are the following:

- It is one of the *essentialia*of a partnership that each partner must be entitled to share in the net profits of the partnership, but the partners need not receive equal shares in the profits (see par 10.3 in this study unit).

  In the absence of an agreement on how profits are to be shared, profits are shared between the partners in proportion to the value of their respective contributions to the firm, but if the value of the contributions cannot be ascertained, the partners share the profits equally this is a *naturalia*of a partnership agreement.

- The losses of the partnership are shared in the same proportion that the profit would have been divided. Although it is permissible for partners to exclude one or more partners from sharing in the losses should the partnership make no profit and sustain a net loss, there must remain at least one ordinary partner who will carry the losses of the partnership;
- Each partner has the power to represent the partnership in transactions which fall within the usual scope of the business of the partnership. This is further discussed in paragraph 10.6.
- A partner is not entitled to compensation for his or her contribution to the partnership. Partners are, however, entitled to come to a different arrangement.
- The assets of the partnership belong to the partners jointly. This was discussed in paragraph 10.4.

A close mutual fiduciary relationship exists between partners. In *Purdon v Muller* 1961 (2) SA 211 (A) [case 7, case 19 and par 12.5 in the textbook], the court held that under our common law, a partnership is considered to be a contract of the utmost good faith.

The requirements of the fiduciary relationship are not strictly defined, but the following three broad categories of duties may be distinguished:

(1) A partner must comply with his or her duties in terms of the partnership agreement.
(2) A partner must further the interests of the partnership unselfishly and avoid a conflict between his or her personal interests and the interests of the partnership.

(3) A partner must disclose to his or her co-partners all information which affects the partnership.

The rights of partners between themselves include the following:

- a right to share in the profits of the partnership
- a right to participate in the management of the business
- the right to compensation
- the right to inspect the partnership books
- the right to distribution of assets on dissolution

The duties to the partnership include the following:

- the duty to make a contribution to the partnership
- a duty to share in the losses
- a duty of care and skill
- a duty of full disclosure or a duty to account

As indicated above, one of a partner's duties to the partnership is a duty of care and skill. To ascertain the reasonableness of an act by a partner, regard is given to the degree of care which the partner displays in the management of his or her own affairs. No basic level of expertise or any qualifications are required. Partners choose each other and have only themselves to blame if they take into the partnership an incompetent partner without restricting his or her management powers. However, if a partner undertakes to contribute any particular skill or expertise to the partnership, he or she will be liable for loss caused by any failure to display such skill or expertise. For example, if a partner undertakes to render professional services to the partnership, he or she will be liable for any losses to the partnership if his or her services fail to comply with applicable professional standards.

Separate duties that flow from the principle of utmost good faith include the following:

- a duty to accept and fulfil the obligations of the partnership agreement see *Purdon v Muller* 1961 (2) SA 211 (A) (par 12.5 in the textbook)
- a fiduciary duty to fellow partners and a duty not to compete with the partnership see *Mattson v Yiannakis* 1976 (4) SA 154 (W) (par 12.5 in the textbook)
- a duty to guard against a conflict of interest see *De Jager v Olifants Tin 'B' Syndicate* 1912 AD 505 [par 12.5 in the textbook]
- a duty to disclose to all co-partners all information in his or her possession which affects the partnership
- There are two specific actions with which a partner can enforce his or her rights as a partner against any of his or her co-partners, namely the *actio pro socio* and the *actio communi dividundo*:
  - The *actio pro socio* is a general multipurpose partnership action with which partners can enforce their mutual rights. It can be used, for example, to enforce compliance with the partnership agreement, to

request an interdict against a partner, to obtain the return of a partnership asset, and so on.

– The *actio communi dividundo* is an action with which co-owners effect physical division of tangible things which they hold in joint ownership. After dissolution of the partnership, a partner can bring this action to obtain physical division of jointly owned partnership assets.

Activity 10.3

Piet, Dorothy and Moseki practise in partnership as accountants. During his spare time, Piet does accounting work for AFC Enterprises Ltd without Dorothy and Moseki's knowledge. They find out about Piet's extra job and now want your advice on whether or not this is acceptable practice for a partner.

Feedback

Refer back to paragraph 12.5 in the textbook. Partners may not allow their personal interests to conflict with those of the partnership in any transaction falling within the scope of the partnership business.

Accordingly, no partner may acquire and retain for himself or herself any benefit or advantage which is within the scope of the partnership business and which it is therefore the partner's duty to acquire for the partnership rather than personally. All such benefits must be shared with and accounted for to his or her partners.

Where a partner purports to obtain a benefit for himselfor herself in conflict with this duty, such benefit is legally regarded as having been acquired for the partnership and the partner is obliged to transfer the benefit to the partnership. You should have discussed the *De Jager* case in this regard.

The only way in which a partner may lawfully retain a benefit is by fully disclosing the relevant facts in connection with the acquisition of the benefit to his or her co-partners, and by obtaining their approval.

10.8 THE RELATIONSHIP BETWEEN PARTNERS AND THIRD PARTIES

Prescribed study material

- Paragraph 12.6 in the textbook

Each partner is liable jointly and severally for partnership debts. However, during the existence of the partnership, creditors of the partnership cannot sue partners individually for partnership debts.

When a partner contracts with a third party on behalf of the partnership, he or she binds all his or her partners, provided that he or she acts within the scope of his or her authority. His or her authority to bind his or her partners may be based on actual or ostensible authority. Furthermore, actual authority may be express or implied.

Each partner has implied authority to perform all acts that are necessary for or are incidental to the proper conduct of the business of the partnership. This is sometimes referred to as the principle of mutual mandate. If a *bona fide* third party wishes to hold the partnership liable in terms of a contract concluded by a partner, it is sufficient for him or her to prove that the contract fell within the scope of the business of the partnership.

If it can be shown that a transaction fell outside the scope of the partnership business, then the contracting partner has exceeded his or her implied authority.

Remember that if a partner has been granted express authority to contract on behalf of the partnership, the partnership will be bound even if the transaction falls outside the scope of the partnership business. A partner's implied authority to bind his or her partners can be limited or excluded by agreement between the partners. However, a third party who is *bona fide* and unaware of a limitation on a partner's authority will be able to hold the partnership to a contract concluded within the scope of the partnership business see *Goodrickes v Hall and Another* 1978 (4) SA 208 (N) [case 29].

Activity 10.4

Riander, Daleen and Sipho are partners in a construction business. Riander's authority to contract on behalf of the partnership is excluded by express agreement between the partners. Riander buys material that can be used in the construction of buildings from Johan. Johan is unaware of the agreement that excludes Riander's authority to contract on behalf of the partnership. Would the partnership be bound to this contract? Explain.

Feedback

Refer back to paragraph 12.6.2 in the textbook and make sure you understand a partner's authority to bind his or her partnership.

10.9 DISSOLUTION OF PARTNERSHIPS

Prescribed study material

- Paragraph 12.7 in the textbook

The different ways in which a partnership may be dissolved or terminated include the following:

- effluxion of term
- end of undertaking (completion of partnership business)
- mutual agreement
- change in membership (which can occur because of the death or retirement of a partner or the admission of a new partner)
- the death of a partner
- insolvency and sequestration of partnership estate or the estate of any partner
- *bona fide* notice of dissolution by any partner
- if the partners become alien enemies on or after the outbreak of war
- an order of court

Regarding an order of court for the dissolution of a partnership, the following should be noted: an order may be given upon application of one or more of the partners for good cause. What constitutes good cause is a factual question which will need to be determined in each individual case. The textbook refers to a few examples or illustrations of what courts have held to be good cause.

It should be added that a court will also grant an order in the case of a breach of the fiduciary relationship between the partners. It should be noted that the situations under which a court will grant an order are not situations or grounds for automatic dissolution of a partnership, for instance, effluxion of term, completion of partnership business, change in membership and the other grounds for dissolution mentioned above. If the court is approached for an order for the dissolution of a partnership, it has discretion to make the order, and the partnership will only dissolve upon the granting of such order.

As indicated above, a partnership dissolves when the partnership estate or the estate of any of the partners is sequestrated or, should the partner be a company or a close corporation, when its estate is liquidated. The sequestration of the partnership estate leads to the simultaneous but separate sequestration of the personal estates of the partners (discussed in par 10.4 in this study unit), with the exclusion of the estates of extraordinary partners (discussed in par 10.2.2 in this study unit) and estates that cannot be sequestrated under the Insolvency Act, because it is a company or a close corporation, for instance.

A partner can also avoid sequestration of his or her estate by furnishing an undertaking that he or she will pay the partnership debts and by giving security for such payment. In principle, private creditors cannot claim against the partnership estate and partnership creditors cannot claim against the different estates of the partners. If a residue remains in one of the private estates after all the creditors of that partner have been paid, the balance will be available to the trustee of the partnership estate in so far as it may be required to pay partnership debts. Should a surplus remain in the partnership estate, it will be divided, and each partner's proportional share will be made available to the trustee of his or her personal estate.

The consequences of termination of a partnership include the following:

- A proper rendering of an account must be completed before amounts owed to the individual partners can be claimed.
- Upon termination, any creditor of the partnership can sue the partners as individuals, jointly and severally, for partnership debt see *Lee en 'n Ander v Maraisdrif (Edms) Bpk*1976 (2) SA 536 (A) [case 32]. The creditors of the partnership can therefore hold any of the partners liable for the total amount of their claims after dissolution of the partnership, but a partner who pays the total amount of a claim can recover from his or her former co-partners that portion of the payment that exceeded his or her proportional share.
- After termination, no partner has implied authority to bind the partnership.
- After termination, each partner may demand an account from his or her partners.

REFLECTION

Partnerships are probably the easiest form of enterprise to establish in South Africa. All that is required to form a partnership is the conclusion of a valid partnership agreement. However, there are many risks in this type of enterprise. Can you think of a few risks that could cause a financial loss for the partners?

REVIEW

The partnership is one of the oldest organised business forms. In South Africa, there is no Partnership Act. This type of enterprise is therefore mainly regulated by the common law. Partnerships are formed by means of a contract. The partnership does not enjoy any separate legal personality. The existence of a partnership is dependent upon its partners.

You should now know how partnerships are formed. In addition, you should be able to explain the relationships between partners and third parties and between the partners themselves, both during the existence of the partnership and after its dissolution.

Please ensure that you are able to answer the questions at the beginning of this study unit.

In the next study unit, we deal with a different type of enterprise aimed specifically at small businesses, namely close corporations. In contrast to partnerships, close corporations enjoy the benefits of separate legal personality.

Study unit 11

CLOSE CORPORATIONS

PRESCRIBED STUDY MATERIAL

- Study chapter 13 in the textbook.
- Study sections 23, 34(1), 36, 38 to 40, 42 to 44, 49 to 52, 54 to 56, 58(2) and 62 to 65 of the Close Corporations Act.

Prescribed cases for this study unit

Read these cases in the casebook. You only need to study the other cases referred to in the prescribed paragraphs of the textbook in so far as they are discussed in the textbook.

- *Haygro Catering CC v Van der Merwe and Others* 1996 (4) SA 1063 (C) [176]
- *Gatenby v Gatenby* 1996 (3) SA 118 (E) [169]
- *De Franca v Exhaust Pro CC (De Franca Intervening)* 1997 (3) SA 878 (SE) [170]

11.1 INTRODUCTION

The Close Corporations Act 69 of 1984 introduced a new and cheaper option for the incorporation of small enterprises. The Act combines some of the partnership attributes with the corporate attributes of legal personality and limited liability. It provides a simple, inexpensive and flexible form of incorporation for the enterprise consisting of a single entrepreneur or small number of participants.

The aim was to deregulate the system of incorporation of enterprises and to create an enabling business environment for the South African small business sector.

A close corporation, like a company, acquires legal personality upon incorporation. A legal person is regarded as an entity that can acquire rights and duties separate from its members. Close corporations also enjoy perpetual succession, which means that, unlike partnerships, close corporations remain in existence even if the members should change.

Clearly, with all the benefits attached to incorporation, in addition to the fact that running the business is unstifled by onerous regulation, entrepreneurs and owners of micro- and small businesses were presented with a most viable option appropriate to their business.

Although it cannot be said that the future of close corporations is under threat, with the inception of the New Companies Act 2008, this business form will no longer be an option for businesses. Although existing close corporations will continue to exist alongside companies, no further registrations in terms of the Close Corporations Act will be permitted.

You will know that you understand this study unit if you are able to answer the following **key questions:**

- In what circumstances would the separate legal personality of a close corporation be disregarded?
- What are the restrictions on membership of a close corporation? May a company become a member? Could a testamentary or *inter vivos* trust be a member of a close corporation?
- What is the registration document for formation of a close corporation called? What information should be included in the registration document?
- When would it be necessary to lodge an amended founding statement?
- What are the requirements to be adhered to if a member wishes to dispose of his or her member's interest?
- What are the requirements to be adhered to if a close corporation wishes to acquire the interests of one of its members? What happens if the requirements are not adhered to?
- What do the solvency and liquidity criteria entail? When would these criteria apply to close corporations?
- What would happen to a member's interest should his or her estate be sequestrated or he or she die?
- Is an association agreement compulsory? What provisions are unalterable by an association agreement?
- In whatcircumstances may a close corporation make a loan or provide security to one of its members?
- What does the fiduciary duty of members to a close corporation entail?
- What measure of care and skill is expected from the members of a close corporation?
- Who may conclude binding contracts on behalf of a close corporation? When will a close corporation not be bound by a contract that was concluded on its behalf?
- What is the future of close corporations?
- This study unit will follow the structure indicated below.

The structure of the study unit is set out below.

The nature of a close corporation

The number and nature of members

Formation of a close corporation and members' interest

Acquisition and disposal of a member's interest

- **Characteristics of a member's interest**
- **Acquisition of a member's interest**
- **Disposal of a member's interest**
- **Death of a member**
- **Insolvency of a member**
- **Attachment and sale in execution**

Duties members owe to the close corporation

- **Fiduciary duty**
- **Duty of care and skill**
- **Remedies in case of breach**

Cessation of membership by order of court

Acquisition of member's interest b the corporation

Internal relations and association agreements

Power of members to contract on behalf of the close corporation'

Payments by corporation to members

Prohibition on loans to an security on behalf of members

Accounting officer, records and financial statements

Circumstances in which members and others can be liable for a corporation's debts

11.2 THE NATURE OF A CLOSE CORPORATION

Prescribed study material

- Paragraph 13.1 in the textbook

Important terms

Legal personality: Also known as juristic personality. To be acknowledged in law as a person/ bearer of its own rights, with liability for its own debts.

Founding statement (Form CK 1): Constitutive/ registration document for close corporations.

Perpetual succession: Indicating independence from the members of the close corporation. The close corporation will continue to exist even if the members should change.

You learnt in study unit 1 that companies acquire legal personality upon incorporation. Likewise, in the case of close corporations, separate legal personality is acquired upon registration of the founding statement.

Close corporations also enjoy perpetual succession, which means that the entity exists separately from its members and changes in membership will not influence its future existence.

Sometimes the court may be called upon to "pierce the corporate veil" or disregard the separate legal personality of the close corporation.

Activity 11.1

(1) Compare a close corporation with a company. Compile a table in which you list the following:

- the number of members
- the registration documents
- when legal personality is acquired
- … the applicable legislation

(2) Read the section in the textbook and answer the following questions:

If a close corporation is indebted, will the members generally be personally liable to its creditors? Explain.

(3) It is the year 2015. Danny decides that he wishes to register a close corporation, because it is simpler and cheaper than incorporating a company. Advise Danny on whether or not this would be possible.

Hint: Refer to the transitional provisions in the Act.

Feedback

You have now been introduced to close corporations as a business form. Close corporations are a simpler, cheaper option specifically aimed at entrepreneurs and small businesses. A close corporation enjoys separate legal personality and will therefore generally be liable for its own debts. However, there are instances in which the courts will disregard the juristic personality of a close corporation.

Existing close corporations will continue to exist, but after the promulgation of the new Companies Act, new close corporations can no longer be formed. Danny will not be able to form a new close corporation. He needs to make use of one of the business forms allowed by the new Companies Act.

11.3 THE NUMBER AND NATURE OF MEMBERS

Prescribed study material

- Paragraph 13.2 in the textbook

Important terms

Testamentary trust: A trust established in a will which will come into operation after the death of the testator.

Trust inter vivos a trust established by someone during the person's life.

Since close corporations were intended mainly for small businesses, the number of members is limited to ten. Because only natural persons are permitted to be members of a close corporation, juristic persons are excluded from membership. A company or another close corporation may not be a member of a close corporation.

A minor, insolvent or person under legal disability may become or remain a member of a close corporation with the necessary assistance from a guardian, trustee or the court. A trustee, in his or her capacity as trustee of a testamentary or *inter vivos* trust, may become a member of a close corporation. However, the restriction in membership to the maximum of ten members still applies.

Should the membership in a close corporation change, an amended founding statement must be lodged for registration.

Activity 11.2

Compile a table in which you indicate which of the following people (1) can become a member of a close corporation, and (2) who may not. Also note whether or not any further requirements need to be adhered to for such a person to become a member:

- a minor
- a close corporation
- an unrehabilitated insolvent
- a beneficiary of a trust
- a woman married in community of property
- a company
- the trustee of a testamentary trust in terms of which the sole beneficiary is a close corporation
- a person under legal disability

Feedback

Most natural persons may become members of a close corporation. Even though certain natural persons may not have the legal capacity to participate in the management of a close corporation, even minors, insolvent persons and other persons with legal disabilities may, with assistance, become members of a close corporation. However, no juristic person (ie another close corporation or a company) may be a member. Trustees in their capacities as trustees of trusts *mortis causa* or *inter vivos*, or as administrator of persons under legal disability, may become members of a close corporation unless a juristic person would be a beneficiary of such a trust or the beneficiaries would result in the close corporation's membership exceeding the restricted number.

Should a person who is disqualified from membership become a member, he or she bears the risk of being held personally liable for all the close corporation's debts.

11.4 FORMATION OF A CLOSE CORPORATION AND MEMBERS' INTERESTS

Prescribed study material

- Paragraph 13.3 in the textbook

Important terms

Founding statement (Form CK 1): The only constitutive document required for registration of a close corporation.

Amended founding statement (Form CK 2): The document which must be lodged should particulars of members or the business change after registration of the founding statement.

Member's contribution: A contribution must be made by each member. It can consist of money, a thing or services contributing to the business of the close corporation.

Before a close corporation can be registered, a name has to be reserved. After name reservation, the founding statement must be lodged in triplicate at the registration offices (CIPRO), accompanied by a letter of the accounting officer accepting his or her appointment as such and payment of the prescribed fee.

The founding statement indicates the following particulars of the business:

(1) the full name/translations any abbreviation of the business name
(2) the principal business
(3) the number of members
(4) the date of the end of the financial bookyear
(5) the aggregate members' contribution
(6) the postal address
(7) the address of the registered office
(8) the name and postal address of the accounting officer
(9) particulars of the founding members (names, copies of IDs and addresses).
(10) member's interest of each member expressed as a percentage.

After registration, the Registrar certifies the Certificate of Incorporation. Should any of the particulars in the founding statement change after its registration, an amended founding statement must be lodged.

Each founding member is required to sign the founding statement or provide written authorisation (a power of attorney) for it to be signed on his or her behalf. A guardian or parent is required to sign on behalf of a minor. Where a trustee or curator signs on behalf of a member, such a person must indicate the capacity in which he or she signs the document.

The purpose of registration of close corporations is mainly for the purpose of name reservation. The founding statement is not a public document. The doctrine of constructive notice is therefore not applicable to close corporations.

NOTE: The following transitional provisions apply:

After the coming into effect of the Companies Act of 2008, it will no longer be possible to register new close corporations in terms of the Close Corporations Act or to convert existing companies into close corporations.

Activity 11.3

Janine, Sebo and Johannes decide to start a business together. They plan to initiate a mobile car-cleaning service. Sebo has a Toyota Fortuner which can be used for the business. Janine is willing to contribute R5 000 towards equipment.

Johannes has been unemployed for the last two years and is unable to make a monetary contribution at this time, but is willing to deliver general services to Janine and Sebo as his contribution.

They approach you for advice on the following:

(1) What are the differences between partnerships and close corporations?
(2) How would they go about registering a close corporation? Would it be necessary to conclude an association agreement?
(3) Should they decide to register a close corporation, would the proposed contributions suffice?
(4) Janine has applied for a position in Australia. She will know within five months whether or not her application is successful. Would the close corporation be able to continue with only Sebo and Johannes, should Janine leave?
(5) Janine and Sebo are concerned that Johannes has many unpaid creditors and that his estate may be sequestrated in the near future. What would the effect of Johannes's insolvency be on the close corporation?
(6) What should the total members' interest in a close corporation be?
(7) What would happen if a member's interest in a close corporation is terminated by death?

Feedback

You should be able to answer all these questions by studying paragraph 13.3 in the textbook.

A close corporation is distinct from a partnership in various ways. Close corporations are registered by one to ten natural persons, whereas partnerships are formed by an agreement between two or more persons (up to an unlimited number once the Companies Act 2008 comes into effect). Upon registration, a close corporation acquires separate legal personality.

Unlike in partnerships, where no legal personality exists, the existence of a close corporation will not be terminated by changes in membership, insolvency or the personal circumstances of its members. A close corporation also holds its asset separate from its members and is therefore not severely affected should the estate of a member be sequestrated.

To become a member of a close corporation, the prospective member has to make a contribution in the form of money or assets or anything with an economic value, or acquire an existing member's interest.

Because a member's interest is part of a member's estate, it can be sold or bequeathed in a will. If a member dies, the remaining members must consent to the transfer of the member's interest to the legatee, otherwise the member's interest must be sold subject to a pre-emption in favour of the corporation and other members.

11.5 ACQUISITION AND DISPOSAL OF A MEMBER'S INTEREST

Prescribed study material

- Paragraph 13.4 in the textbook

In the preceding paragraphs you learnt that a close corporation may be formed by one to ten natural persons, by simply reserving a name and lodging a founding statement for registration.

The founding statement must contain information about the founding members and also indicate the extent of each one's interest in the business. This is known as a member's interest.

11.5.1 Characteristics of a member's interest

A member's interest is expressed as a percentage (out of a total of 100%) in the founding statement.

- A member's interest may not be jointly held.
- The aggregate members' interests must at all times be 100%. A member's interest in a close corporation is similar to a share in a company.
- A member's interest is an incorporeal moveable thing.
- A member's interest is a personal right to share in the profits of the close corporation after its creditors have been paid.

11.5.2 Acquisition of a member's interest

A member's interest can be acquired by

- becoming a member upon registration of the founding statement
- acquiring a member's interest from existing members
- making a contribution to the close corporation

11.5.3 Disposal of a member's interest

Since a close corporation is intended for small businesses with few members in a close relationship with one another, changes in membership may have an extremely negative effect on the operations of the business. Hence the members largely control the disposal of a member's interest..

Note the following requirements for disposal of a member's interest:

- The process must be made in accordance with the association agreement.

  or

- All the members must consent.

Because a member's interest is part of his or her estate and has an economic value, it is essential to establish the manner in which it will be dealt with should the member die, become insolvent or if judgment is taken against a member by his or her creditors.

11.5.4 Death of a member

A member may bequeath his or her member's interest to his or her heir/legatee in a will. Transfer of the member's interest to the heir/legatee may, however, only occur with the consent of the other members.

Should the members not permit such transfer, the executor of the estate may

- sell the member's interest to the close corporation
- sell the member's interest to other members
- sell the member's interest to a third party subject to the other members' pre-emptive right to purchase the member's interest

The money value will thereafter be paid over to the heir/legatee.

11.5.5 Insolvency of a member

Section 34(1) of the Close Corporations Act 69 of 1984 prescribes a mandatory procedure for the disposal of an insolvent member's interest. The purpose is to balance the rights of the other members with the rights of creditors of the insolvent member's estate.

If a member becomes insolvent, the trustee may realise the member's interest and

- sell the member's interest to the close corporation
- sell the member's interest to the other members
- sell the member's interest to a third party, subject to the other members' pre-emptive right to purchase the member's interest

The money value will thereafter be paid over to the creditors.

11.5.6 Attachment and sale in execution

Section 34A of the Close Corporations Act applies in instances where a member's interest is attached after judgment is taken against a member.

The member's interest may then be sold to the close corporation, other members or an outsider subject to the right of pre-emption in favour of the close corporation and other members.

11.6 DUTIES MEMBERS OWE TO THE CLOSE CORPORATION

Prescribed study material

- Paragraph 13.5 in the textbook
- Sections 50 and 51 of the Close Corporations Act

Members owe the following two duties to the close corporation:

(1) a fiduciary duty (duty of good faith) in terms of section 42 of the Close Corporations Act 69 of 1984
(2) a duty of care and skill

11.6.1 Fiduciary duty

A member's fiduciary duties towards the close corporation are similar to the fiduciary duties a director owes to a company. However, it is not only the common-law principles regarding good faith that apply, but also provisions of the Close Corporations Act.

The Close Corporations Act (s 42) provides that a member should

- act honestly and in good faith
- avoid a conflict of interest between his or her own interests and those of the close corporation
- exercise powers in the interest of the corporation
- disclose any interest in a transaction to the other members of a close corporation as soon as possible
- not gain any financial gain by virtue of being members of the close corporation

Note the following with regard to **contracts concluded between a member and a close corporation**

As indicated above, a member of a close corporation is in a fiduciary relationship to the close corporation and the other members of the close corporation.

Should a member have a material interest in a contract of the close corporation, it must be disclosed to the other members and all material facts regarding the interest must be divulged as soon as possible.

Should a member fail to disclose his or her interest, the contract would be voidable at the option of the close corporation. Application can, however, be made to the court to declare the contract as binding upon the parties despite failure to disclose.

In the event that the fiduciary duties are breached, a member may be held personally liable for any loss suffered by the corporation or debts incurred as a result of such a transaction (s 42(3)). The member would in such an event have to repay any profit made by him or her.

Note the following regarding **personal liability for debts**:

A member may incur personal liability for the debts of the close corporation should a contract be concluded in conflict with his or her fiduciary duty to the close corporation.

However, personal liability can be avoided by disclosing all material facts regarding the member's interest in a transaction to the other members of the close corporation and acquiring prior written approval from all the other members.

11.6.2 Duty of care and skill

A member will be liable only if the close corporation suffers a loss as a result of the breach of this duty (s 43(1)).

The member's conduct is measured against the conduct which could reasonably have been expected from a person with the same skill and knowledge as the member (to establish negligence).

In case of a breach, another member may institute action against the close corporation or its members in his or her personal capacity.

Activity 11.4

Activity

(1) Anna, Bertus, Chris and Duncan are members of a close corporation. In terms of the founding statement, the primary business is the buying and selling of immovable property. Bertus buys a farm from Xander in competition with the close corporation and sells the farm at a profit. Xander is not prepared to do business with the close corporation. Chris and Duncan are unhappy with the state of affairs. Advise Chris and Duncan.

(2) What is the nature of the fiduciary duties of members of a close corporation?

Note the following in relation to answering an application-type question:

Remember to always refer to the important decisions and the sections of the Close Corporations Act 69 of 1984 when answering a question. Be mindful of the structure of your answer, and

- identify the problem that the question deals with
- refer to relevant sections of the Close Corporations Act 69 of 1984
- refer to case law where applicable and remember that the decision is the important part. you do not need to write down the reference, only the name of the case)
- apply the law (2 and 3 above) to the facts
- draw a conclusion reread the question to ensure that your conclusion provides a final answer to it

Feedback

(1) **Identify the problem:** from the set of facts you are able to see that there is a conflict of interest.

Refer to the relevant section of the Close Corporation Act, in this instance, section 42(3)*(b)* of the Close Corporations Act applies.

Refer to case law: *Geany v Portion 117 Kalkheuwel Properties CC and Others* and *Moosa NO v Mavjee Bhawan (Pty) Ltd and Another.*

Apply the law: the effect that the breach of the fiduciary duty will have on the contract.

In this instance, the contract would be voidable at the option of the close corporation.

However, if the member disclosed his interest and made all material facts known to the other members, the contract could be valid.

The member has also acquired a financial gain in competition with the close corporation. You can now **conclude** that this may be a breach of the member's fiduciary duty. In this set of facts, no such disclosure had taken place. The close corporation can thus reclaim the benefit the member acquired.

(2) Refer to the quotes from the relevant case law as discussed in the textbook (*Geany v Portion 117 Kalkheuwel Properties CC and others* and *Moosa NO v Mavjee Bhawan (Pty) Ltd and another*).

List what the fiduciary duty entails.

11.6.3 Remedies in case of breach

Note the following with regard to **section 50 of the Close Corporations Act 69 of 1984:**

This section provides for an action to be instituted by a member against fellow-members on behalf of the close corporation for liability to the company on the specified grounds, including a breach of a fiduciary duty or the duty of care and skill. This is thus a statutory derivative action. **(Note that the textbook incorrectly refers to s 51, instead of s 50, in the last line on p 229.)**

Activity 11.5

Read the section in the textbook and answer the following questions:

(1) When can an action in terms of section 50 be instituted?

(2) Stella, one of the members of a close corporation comes to you for advice.

She alleges that another member purchased goods in her personal capacity and sold them to the close corporation at a profit.

Stella feels that the close corporation is entitled to repayment of the profit the member had made. What action would you advise Stella to institute against the member?

Feedback

The duties of members of a close corporation are similar to those of directors of companies. Members must act in good faith and perform their functions with a reasonable degree of care and skill. If a member breaches his or her duty any other member may institute proceedings against such member on behalf of the close corporation. The fact that the person instituting the action will be liable for the legal costs if the claim is unsuccessful and found to have been without *prima facie* grounds, is aimed at preventing abuse.

11.7 CESSATION OF MEMBERSHIP BY ORDER OF COURT

Prescribed study material

- Paragraph 13.6 in the textbook
- Sections 36 and 49 of the Close Corporations Act

Note the following two remedies for members against other members:

(1) section 36: order of court terminating membership
(2) section 49: assistance from court regarding unfairly prejudicial conduct

Activity 11.6

Read *Gatenby v Gatenby* and *De Franca v Exhaust Pro CC* and section 49, and answer the following questions:

(1) When can a member institute an action in accordance with section 49?
(2) What order may a Court make if a member successfully relies upon section 49?
(3) When can the statutory derivative action be implemented on behalf of the close corporation?

Feedback

Section 49 is a remedy available to a member where there was a single act or omission in the conduct or affairs of the business by the corporation or other member/s which was unfairly prejudicial to such member. The court will only intervene if it is just and equitable to do so. The court may then direct that the aggrieved act or omission be stopped, order the corporation to amend the founding statement or association agreement, or in certain cases, upon application, make an order to wind up the corporation.

11.8 ACQUISITION OF MEMBER'S INTEREST BY THE CORPORATION

Prescribed study material

- Paragraph 13.7 in the textbook
- Sections 37 to 40 of the Close Corporations Act

Key terms

Solvency: The corporation's assets, fairly valued, must exceed its liabilities.

Liquidity: The corporation must be able to and remain able to pay its debts as they become due in the normal course of business.

It is possible for a close corporation to acquire a member's interest from one of its members.

Note the following **requirements for acquisition of member's interest by a close corporation:**

- The close corporation must have at least one other member.
- The aggregate members' interests must remain 100%.
- There must be written consent from all members prior to payment.
- The corporation must be solvent and liquid.

It is also possible for a close corporation to render financial assistance to a person to enable him or her to acquire a member's interest in the close corporation. In order to do so, section 40 of the Close Corporations Act 69 of 1984 requires

- prior written consent from every member
- solvency and liquidity of the close corporation

11.9 INTERNAL RELATIONS AND ASSOCIATION AGREEMENTS

Prescribed study material

- Paragraph 13.8 in the textbook
- Section 44 of the Close Corporations Act

Key terms

Association agreements: This a noncompulsory agreement to arrange internal affairs within the close corporation.

Internal relationships: These are the relationships between members *inter se* (amongst each other) and the relationship between the close corporation and its members.

Although it is advisable for members to conclude such an agreement, it is not compulsory. The internal relations between members may be regulated by an association agreement. The members of the corporation may change provisions to suit their specific needs in an association agreement on condition that it is not inconsistent with the Act.

They may arrange

- the rights of the members to conduct business and manage the close corporation
- the requirements for making a decision and voting
- the procedure and proportions of payments to members

An association agreement is not lodged with the Registrar and is not a public document. However, should such an agreement be concluded, it must be held at the registered offices of the business.

Activity 11.7

(1) (a) What is an association agreement?
(b) Who may participate in the management of a close corporation?

(2) Draw up a table in which you indicate which matters may be altered by an association agreement and which may not.

Feedback

Close corporations have only one compulsory constitutive document, namely the founding statement. Although association agreements are optional, it is preferable for members to conclude such an agreement to regulate internal relationships in the management of the business.

An association agreement must be in writing and signed by or on behalf of each member. This document is not viewed as a public document and only members may inspect it.

In the association agreement, the members may agree how the corporation will be managed, how decisions will be taken and establish the proportion of payments to members.

No stipulation in contravention of the Close Corporations Act, which is included in the association agreement, will be valid.

The Close Corporation Act clearly sets out certain issues that may not be varied by any agreement between the members. A clause stating that certain members will not be permitted to call a meeting, or allowing disqualified members to participate in the management, or specifying how the member's interest of an insolvent member will be disposed of will therefore be void.

11.10 POWER OF MEMBERS TO CONTRACT ON BEHALF OF THE CLOSE CORPORATION

Prescribed study material

- Paragraph 13.9 in the textbook
- Section 54 of the Close Corporations Act

Activity 11.8

(1) Read *J& K Timbers (Pty) Ltd v GL& S Furniture Enterprises CC* 2005 (3) SA 223 (N) on page 236 in the textbook. Summarise the case in your own words.

(2) Answer the following questions:

(e) Who may represent a close corporation?

(f) In what circumstances would a close corporation not be bound by a contract concluded on its behalf by a member?

Feedback

Section 54 of the Close Corporations Act states that every member has the authority to conclude contracts on behalf of the close corporation in relation to a person who is not a member (an outsider or third party).

The doctrine of constructive notice does not apply to close corporations. This means that even if the association agreement (which is in any event not a public document) states otherwise, every member can conclude contracts on the corporation's behalf. It does not matter whether or not the transaction falls within the scope of the corporation's main business.

A close corporation will therefore be bound to most agreements concluded on its behalf by its members. However, corporations will not be held liable if the outsider or third party knew or reasonably should have known that the member who concluded the contract on behalf of the close corporation lacked authority.

11.11 PAYMENTS BY CORPORATION TO MEMBERS

Prescribed study material

- Paragraph 13.10 of the textbook
- Section 51 of the Close Corporations Act

Note that section 51 applies only to instances where payments are made to members in their capacity as members and not if the payment is made to a member in his or her capacity as creditor.

Activity 11.9

Quatro CC concluded a loan agreement with Stella, one of its members, for the amount of R15 000. The amount is now due and payable. Johannes, another member of Quatro CC, informs you that the close corporation cannot currently pay its debts in the normal course of business.

Consider whether the close corporation may refuse to pay the R15 000.

What requirements must be adhered to before a close corporation can make a payment to one of its members?

Feedback

Before any type of distribution can be made to members in their capacity as members, the requirements set out in section 51 must be adhered to. If a payment has to be made to a member in his or her capacity as a creditor, these principles will not apply. Should a creditor claim payment when it is due and payable, the close corporation will be liable. Should the close corporation be unable to pay, such creditor may apply for the winding-up of the corporation.

11.12 PROHIBITION ON LOANS TO AND SECURITY ON BEHALF OF MEMBERS

Prescribed study material

- Paragraph 13.11 in the textbook
- Section 52 of the Close Corporations Act

Activity 11.10

(1) Johannes, a member of Quatro CC, wishes to purchase a new car. However, he is experiencing cash-flow problems and will only be able to pay the purchase price within about two months. The seller is willing to accept the payment arrangement if the close corporation stands surety for the purchase price. Advise Johannes whether or not this would be possible.

Hint: Remember the correct structure for answering a problem-type question.

(1) Identify the problem.
(2) Briefly state the law discuss the relevant sections from the legislation and applicable case law.
(3) Apply the law to the given facts.
(4) Draw a conclusion that answers the question.

(2) Read *Hanekom v Builders Market Klerksdorp (Pty) Ltd & Others* 2007 (3) SA 95 (SCA) on pages 237 to 239 in the textbook and summarise it in your own words.

Hint: Bear in mind that the decision is the most important part of the case.

Feedback

The Close Corporations Act contains a prohibition against the provision of loans and security to members. Only if all the other members consent in writing may such loan or security be extended. Should the requirements of section 52 not be adhered to, any loan or security provided will be invalid and members who permitted the transaction will incur liability.

11.13 ACCOUNTING OFFICER, RECORDS AND FINANCIAL STATEMENTS

Prescribed study material

- Paragraph 13.12 in the textbook
- Section 58(2) of the Close Corporations Act

Close corporations are not exempt from financial reporting. An annual financial statement must be drawn up. The annual financial statement must be approved by or on behalf of members holding at least 51% of the members' interest in the close corporation. The appointed accounting officer must compile a report.

Activity 11.11

Read *Maccelari and others v Help U Build Project Management CC* on page 240 in the textbook, and answer the following questions:

(1) What are the duties of the close corporation in respect of financial reporting?
(2) Discuss the duties of the accounting officer of a close corporation.

Feedback

A close corporation need not appoint an auditor. However, it must appoint an accounting officer. Accounting records must be kept and approved by members annually. The accounting records need not be submitted to the Registrar.

The accounting officer must account in conformity with generally accepted accounting practice. He or she also plays a crucial reporting function. If an accounting officer becomes aware of irregularities in the accounting policies or practices in the corporation, he or she must disclose thisinformation to the members. The Registrar must also be informed if the accounting officer is removed, the corporation is not conducting business or if its liabilities exceed its assets at the end of the financial year.

11.14 CIRCUMSTANCES IN WHICH MEMBERS AND OTHERS CAN BE LIABLE FOR A CORPORATION'S DEBTS

Prescribed study material

- Paragraph 13.13 in the textbook
- Sections 23, 52, 64 and 65 of the Close Corporations Act

Activity 11.12

(1) Read the decisions in *Haygro Catering BK v Van der Merwe and others* 1996 (4) SA 1063 (C) and *Airport Cold Storage (Pty) Ltd v Ebrahim and others* 2008(2) SA 303, as discussed in the textbook on page 224. Look specifically at which section of the Close Corporations Act was applied in relation to the facts. Now briefly summarise these cases in your own words.
(2) Quatro CC is experiencing financial difficulties as a result of mismanagement.

FNT Bank loans Quatro CC the amount of R100 000, despite being aware of the problems the close corporation is experiencing.

The amount is due and payable by Quatro CC, but it is unable to pay. Advise FNT Bank whether or not it can hold the members of the CC personally liable for payment of the debt.

Hint: In answering the question you should consider the following:

- *the separate legal personality of the close corporation*
- *instances in which the separate legal personality may be disregarded*

(3) In what instances would a person be held personally liable for a close corporation's debts? Name the persons who may be held liable in each instance.

(4) What is meant by "reckless or fraudulent" running of the business of a close corporation?

Feedback

A close corporation is a separate legal person. Despite this fact, the court at times may "pierce the corporate veil" to hold the guilty parties liable.

In some instances the members and/or other guilty parties (such as the accounting officer) incur personal liability (ss 23, 26, 42, 43, 52, 55 & 65) and in other circumstances they are held jointly liable (s 63) for the losses incurred as a result of their actions.

A person who knowingly conducts or is party to conducting the business of the close corporation in a reckless or fraudulent manner will be held liable for all debts of the corporation.

See paragraph 13.13 on page 243 in the textbook.

REFLECTION

The Companies Act 2008 provides for coexistence with the Close Corporations Act 69 of 1984. Although this means that the Close Corporations Act will continue, close corporations can only be registered until section 13 of the Companies Act of 2008 comes into effect. What do you think the implications of this change will be?

REVIEW

Close corporations originated as a result of a proposal to introduce a new form of enterprise specifically aimed at small businesses. Since its introduction, this form of enterprise has become increasingly popular. Close corporations have been an extremely attractive option because they offer the advantages relating to separate legal personality, the legislative framework is less complex than in companies and the management structure is also simpler.

You have now been exposed to some material aspects of the formation and operations of this form of enterprise.

Please ensure that you are able to answer the questions at the beginning of this study unit.

In the next study unit you will be introduced to a new form of business, namely the business trust. The characteristics of this type of business will be explained by first exposing you to the principles applicable to trusts in general.

Study unit 12

TRUSTS

PRESCRIBED STUDY MATERIAL

- Study chapter 14 in the textbook.

12.1 INTRODUCTION

A trust is quite an adaptable concept, allowing it to be used in various ways, including carrying on a business. Although originally an English legal concept, it has found favour in South African law because of its practical value. As a business form, the main advantage of a trust over a company and close corporation is that it enjoys limited liability without the complexities and expenses associated with the other two business forms.

You will know that you have understood this unit if you are able to answer the following **key questions:**

- What is meant by a trust and how is it created?
- Who are the parties to a trust?
- What are the different types of trusts?
- What are the essential elements of a trust?
- What are the duties and obligations of a trustee?
- How does one ascertain the powers of a trustee and rights of a beneficiary?
- What is the nature of a business trust?

This study unit will follow the structure indicated below.

Meaning of "trust"

Parties to a trust

The trust deed, deed of trust or trust instrument

Types of trusts

The legal nature of trust

Consequences once a valid trust has been formed

How to form a valid trust

Authorisation of trustees

Duties of trustees

Powers of a trustees

Rights of beneficiaries

Business or trading trust

12.2 MEANING OF "TRUST"

Prescribed study material

- Paragraph 14.1 in the textbook

See the discussion of *Land and Agricultural Bank of South Africa v Parker and Others* 2005 (2) SA 77 (SCA) on page 251 in the textbook on the importance of separating the roles of trustees and beneficiaries.

Activity 12.1

What was the primary reason behind the invention of the concept of trust?

Feedback

From the outset, trusts were designed to protect the weak and safeguard the interests of those who are absent or dead. See *Land and Agricultural Bank of South Africa v Parker and others* (supra).

12.3 PARTIES TO A TRUST

Prescribed study material

- Paragraph 14.2 in the textbook

Activity 12.2

Explain the role of each of the main parties to a trust.

Feedback

The founder creates the trust, the trustee manages and controls trust property and the beneficiary is the party on whose behalf the trust is created and managed.

12.4 THE TRUST DEED, DEED OF TRUST OR TRUST INSTRUMENT

Prescribed study material

- Paragraph 14.3 in the textbook

A trust is created by a document called a trust deed. A trust deed comes either in the form of a contract (for an *inter vivos* trust) or a will of a testator (for a testamentary trust). It constitutes a trust's constitutive charter.

Activity 12.3

Distinguish between an *inter vivos* trust and a testamentary trust.

Feedback

An *inter vivos* trust is created during the lifetime of the founder, while a testamentary trust is created upon the founder's death.

12.5 TYPES OF TRUSTS

Prescribed study material

- Paragraph 14.4 in the textbook

There are different types and classifications of trusts in South Africa:

- *Testamentary trusts.* These are formed upon the death of the founder as part of his or her will.
- *Inter vivos trusts.* These are formed while the founder is still alive, often as part of an estate plan to avoid payment of estate duty and other taxes.
- *Business (trading) trusts.* These give trustees wide powers to carry on business, while granting the beneficiaries the right to sell their interests in the trust. They can be either public or private.

- *Public trading trusts.* The public are invited to become income beneficiaries by contributing money or assets to the trust and then issued with certificates as proof of their share.
- *Private trading trusts.* These are created by private individuals wishing to channel funds towards a business and used to drive the business. They act as alternatives to entities such as companies and close corporations.
- *Realisation trusts.* These are formed specifically for developing and selling fixed property.
- *Statutory trusts.* These are created by a particular statute to achieve a specific objective.
- *Court order trusts.* These are set up in terms of an order of court.
- *Offshore (international) trusts.* These are established outside of South Africa and therefore exempt from the jurisdiction of the Master of the High Court.

Activity 12.4

List and distinguish between the different types of trusts

Feedback

See paragraph 14.4 in the textbook and make sure you are able to differentiate between the various types of trusts.

12.6 THE LEGAL NATURE OF TRUSTS

Prescribed study material

- Paragraph 14.5 in the textbook

A trust is either created by a contract (an *inter vivos* trust) or through a will of a testator (a testamentary trust). It must be reduced to writing and its existence evidenced by a document.

See *Crookes NO and Another v Watson and others* 1956 (1) SA 277on *inter vivos* trusts and *Braun v Blann and Botha NNO and another* 1984 (2) SA 850 (A) (p 253 in the textbook) on testamentary trusts.

Some of the legal attributes of a trust include the following:

- Not being a legal person, a trust has no separate existence and cannot contract in its own name.

- While the trustee is legally the owner of the trust assets, a distinction is drawn between the trust's assets and the trustee's private assets.
- Insolvency of any of the two estates does not entitle its creditors to attach the assets of the other estate, and official acts of the trustee will not bind his or her private estate.
- The trust deed may provide for continued existence of a trust despite changes in trustees.
- Both natural and legal persons may be parties to a trust, whether as founders, trustees or beneficiaries.
- Parties to a trust enjoy protection against liability for the debts of the trust.

Activity 12.5

During his lifetime, Simphiwe appointed Sizwe and Taelo as trustees of a trust he wished to set up for his young children upon his death. However, the arrangement has not been reduced to writing. Would a valid trust come into being after Simphiwe's death?

Feedback

A trust has to be reduced to writing either in the form of a contract or a will. Simphiwe's failure to reduce the arrangement with Sizwe and Taelo to writing means that a valid trust will not come into being when he dies.

12.7 CONSEQUENCES ONCE A VALID TRUST HAS BEEN FORMED

Prescribed study material

- Paragraph 14.6 in the textbook

Upon the formation of a trust, trustees incur certain obligations/duties and acquire some powers. These are found in the Trust Property Control Act, the common law and the trust deed. The beneficiaries also acquire some rights and protection which are set out in the trust deed and the Trust Property Control Act.

Activity 12.6

Thuso is appointed a trustee of a newly established trust. The relevant trust deed states that Thuso is protected from liability for acts performed in the management of the trust. Advise Thuso on the validity of this protection.

Feedback

A trustee incurs certain obligations and duties when a trust is formed. These are to be found in the Trust Property Control Act, the common law and the provisions of the trust deed. Section 9(2) of the Trust Property Control Act specifically states that a provision in the trust deed which has the effect of exempting a trustee from one of these duties, namely to exercise due care and skill, is void.

12.8 HOW TO FORM A VALID TRUST

Prescribed study material

- Paragraph 14.7 in the textbook

Refer to *Estate Price v Barker and Price* (1905) 22 SC 321 (C) (p 254 in the textbook) on the requirement that the instruction to the trustee to manage the trust assets for the beneficiaries must be expressed as an obligation.

Activity 12.7

Fred wishes to create a trust, and is uncertain about how this should be done. Advise him.

Feedback

Certain essential elements are required to form a valid trust. You should explain the essential elements to Fred. See paragraph 14.7 in the textbook for a list of all the essential elements for the creation of a valid trust.

12.9 AUTHORISATION OF TRUSTEES

Prescribed study naterial

- Paragraph 14.8 in the textbook

Only after a written authorisation by the Master can a trustee act as such (s 6(1) of the Trust Property Control Act).

See *Simplex (Pty) Ltd v van der Merwe and others NNO* 1996 (1) SA 111 (W) (p 254 in the textbook) for details of this requirement.

Activity 12.8

Sam entered into a lease agreement on behalf of Verona trust one day before he was formally authorised to act as its trustee. Advise Sam on whether his subsequent authorisation would render the contract valid.

Feedback

In terms of section 6 (1) of the Trust Property Control Act, only after authorisation by the Master can a trustee act as such, which means that any of Sam's actions for the trust prior to his formal authorisation are not legally binding.

12.10 DUTIES OF TRUSTEES

Prescribed study material

- Paragraph 14.9 in the textbook

Owing to the fiduciary nature of the trustees' responsibilities, onerous duties are imposed on them. These duties are discussed in detail in the textbook.

See *Sackville West v Nourse and Another* 1925 AD 516 on the duty not to expose trust assets to risk; *Administrators Estate Richards v Nichol and Another* 1999 (1) SA 551 (A) on a trustee's duty to invest the trust property productively; and *Doyle v Board of Executors* 1999 (2) SA 805 (c) on the duty of good faith and to account to beneficiaries.

Activity 12.9

Samuel is asked to act as a trustee of the Jordan Family Trust. He asks your advice on the duties that such an appointment would entail. Advise Samuel.

Feedback

See paragraph 14.9 in the textbook to familiarise yourself with the various duties imposed on a trustee.

12.11 POWERS OF A TRUSTEE

Prescribed study material

- Paragraph 14.10 in the textbook

The powers of a trustee are stipulated in the trust deed. No other powers not provided for in the trust deed may be inferred.

Activity 12.10

Tsepo is a trustee of a business trust involved in furniture retail. Although the relevant trust deed makes no provision for it, Tsepo buys a bakkie to transport the furniture. Given the requirement that a trustee must preserve trust assets, advise whether Tsepo has acted unlawfully.

Feedback

Tsepo's appointment as a trustee of the trust, empowered him to perform activities that are inherent in the type of business carried on by the trust. Even though the trust deed made no provision for buying a bakkie, the nature of the business carried on by the particular trust is such that transporting furniture is necessary. In the circumstances, Tsepo's conduct is lawful.

12.12 RIGHTS OF BENEFICIARIES

Prescribed study material

- Paragraph 14.11 in the textbook

The extent of the beneficiaries' rights is set out in the trust deed. Unless otherwise prohibited by the trust deed, these rights can be ceded or otherwise disposed of.

Activity 12.11

Thuso has been a beneficiary of a business trust for the past five years and now wishes to dispose of his interest in the trust by selling it to Bonolo. The trust deed is silent on Thuso's rights in this regard. Advise Thuso on the legality of his intended action.

Feedback

Unless specifically prohibited by the trust deed, a beneficiary can freely cede any of his or her rights in a trust, including discretionary rights. Thuso can therefore sell his interest in the trust to Bonolo.

12.13 BUSINESS OR TRADING TRUSTS

Prescribed study material

- Paragraph 14.12 in the textbook

Although a trustee is usually precluded from exposing trust assets to risks, a trustee in a business trust is empowered to carry on a business or to trade. This implies authority to expose the trust to risks inherent in the type of business concerned. The main advantage of a business trust is that the beneficiaries enjoy limited liability without the complexities and expenses of a company or close corporation. Its disadvantage is the danger of being deemed a partnership because of the two entities often sharing similar elements.

Activity 12.12

Explain the advantages of a business trust over a company or close corporation.

Feedback

A business trust can be structured in such a way that it resembles a company or close corporation, including the enjoyment of limited liability, but without being burdened with the complexities and expenses associated with either a company or close corporation.

REFLECTION

In the past, close corporations were viewed as a simple, cheap method of obtaining the benefits attached to legal personality. However, much has changed as a result of the enactment of the Companies Act 2008. Considering these changes, do you think that the popularity of business trusts as an enterprise form will increase?

REVIEW

In this study unit you were exposed to the essential elements relating to trusts in general as background to a specific type of trust, namely business trusts. Trusts enjoy many benefits: the formation is cheap, there is no complex legislative structure and they enjoy limited liability. You also learnt the different parties to trusts, namely the founder, trustee and the beneficiary. You should also know how trusts are formed, how they function and what the powers and duties of trustees entail.

Please ensure that you are able to answer the questions at the beginning of this study unit.

CONCLUSION

You have now been introduced to partnerships, close corporations, companies and business trusts. Remember that all you have learnt will be of little use if you do not study all the prescribed material in conjunction with this guide. You should now be able to refer to important sections in the various pieces of legislation applicable to the different forms of South African business forms. You should also be able to discuss the application of these sections by referring to the interpretation given to them by our courts in case law.

You should now be able to advise clients on the main characteristics of these different forms of enterprises, indicating the advantages and disadvantages of each business form. You should also be able to explain some of the most pertinent regulatory measures in the respective enterprises.

We trust that you are now in a position to apply what you have learnt in practice.