Learning unit 1: Legal personality and lifting of the veil

- When does a company acquire legal personality?
  
  Once a company is incorporated and a **certificate of incorporation is issued**.

- With reference to case law explain the meaning and effects of separate legal personality

  **Salomon v Salomon & Co Ltd:**
  
  - The estate of the company is assessed apart from the estates of individual shareholders or members, therefore the debts of the company are the company’s debts and separate from those of its shareholders or members. They enjoy limited liability;
  - The profits of the company belong to the company and not its shareholders and only after the company has declared a dividend may the shareholders claim that dividend;
  - The assets of the company are its exclusive property and the shareholders have no proportionate proprietary rights therein; and
  - No one is qualified by virtue of his or her shareholding to act on behalf of the company. Only those who are appointed as representatives of the company in accordance with the articles (which has been replaced by the Memorandum of Incorporation) can bind the company.

- Do different branches or divisions of companies have separate legal personality from one another?
  
  The **branches or divisions** of a company are part of the company itself and do **not have their own separate legal existence** (*ABSA Bank Ltd v Blignaut and Another and Four Similar Cases* 1996 (4) SA 100 (O)).

**Lifting of the corporate veil**

- What does lifting the corporate veil entail? What is the purpose and under what circumstances can it occur?
  
  In certain cases the courts have disregarded the separate legal personality of a company in order to recognise the substance or practical realities of a situation rather than the form.
  
  ‘**Piercing the corporate veil**’ refers to those exceptional circumstances where the court **ignores the separate legal existence of the company** and treats the shareholders as if they were the owners of the assets and had conducted the business of the company in their personal capacities OR attributes certain rights or obligations of the shareholders to the company.
Examples of questions on this learning unit from previous examinations:

- Explain the advantages attached to legal personality. Refer to relevant case law. (6)

Refer to the benefits as enumerated in *Salomon v Salomon & Co Ltd*

- Under which circumstances may the courts lift the corporate veil and ignore the separate legal personality of a company? Refer to relevant case law. (6)

There are no hard and fast rules regarding the lifting of the corporate veil. *Botha v Van Niekerk*-case:
The seller must have suffered an "unconscionable injustice" before the court could lift the veil.
*Cape Pacific*-case:
The court confirmed that it has no general discretion simply to disregard a company’s separate legal personality. The separate legal personality of a company should not be easily ignored. However, circumstances do exist for example fraud, dishonesty or other improper conduct where it would be justifiable to pierce the corporate veil. *Botha v Van Niekerk* was too rigid. The court indicated that it would adopt a more flexible approach namely of taking all the facts of each case into consideration when determining if the veil should be pierced. A balance must be struck between the need to persevere the separate legal identity of the company against policy considerations in favour of piercing the corporate veil. The veil could also be pierced in relation to a specific transaction.
*Hülse-Reutter*-case:
Agreed that court has no general discretion simply to disregard a company’s separate legal personality.
The corporate veil would only be lifted if there was evidence of misuse or abuse of the distinction between the company and those who control it and this has enabled those who control the company to gain an unfair advantage.
Therefore a dual test was introduced: by adding the element of unfair advantage.
The court further confirmed that much depended on a close analysis of the facts of each case and considerations of policy.
*Ex parte Gore NO*:
An unconscionable abuse is not as onerous to prove as a gross abuse.
The remedy in s 20(9) can be available if a corporation is used as a sham or device. Section 20(9) is not available as a remedy of last resort only.

Mention could also have been made to *Bargaining Council for the Furniture Manufacturing Industry KZN and UKD Marketing CC & others and Mohlotsane v Mobile Telephone Network (Pty) Ltd* (available under additional resources on myUnisa)
*Die Dros (Pty) Ltd*-case:
Where fraud, dishonesty and other improper conduct is present, the need to preserve the separate legal personality of a company must be balanced against policy considerations favouring piercing the corporate veil.

*Le’Bergo Fashions CC*-case:
The Court will pierce the corporate veil where a natural person, who is subject to a restraint of trade uses a close corporation or a company to front to engage in the activity that is prohibited by the agreement.

**The Companies Act 2008: Disregarding the separate legal personality of a company Section 20(9) of the Companies Act 71 of 2008:**

The Companies Act 71 of 2008 follows the example of the Close Corporations Act by codifying the general principle of piercing the corporate veil. Section 20(9) of the Companies Act 71 of 2008 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 rights, liabilities and obligations relating to the abuse. The wording of the section is a combination of section 65 of the Close Corporations Act and the judgment in *Botha v Van Niekerk*. It ignores the view expressed in *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* that described the test in *Botha v van Niekerk* as too rigid.

John operated a fast food establishment in Durban under a franchise agreement with McTucky’s CC. In terms of the agreement, John is not allowed to operate a similar business in the Durban area within three years after the end of the agreement. John does not renew the franchise agreement when its term ends, but continues to operate a fast food restaurant from the same premises that he previously occupied. McTucky’s CC wants to institute an action against John for breach of the original franchise agreement. John’s defence is that the new business is owned by a newly incorporated corporation MacFries CC, which is not a party to the original agreement. John is the sole member of MacFries CC.

Discuss the possibility that the court may lift the corporate veil in these circumstances. Refer to relevant case law in your answer. (5)

Piercing the corporate veil is dealt with under Section 65 of the Close Corporations Act. In exceptional circumstances the courts have lifted or pierced the corporate veil to recognize the substance or practical realities of a situation rather than the form. Piercing the corporate veil means holding persons inside the close corporation personally responsible.

Refer to cases:

*Le’Bergo Fashions CC v Lee and another*: The court may under these circumstances pierce the corporate veil. The Court will pierce the corporate veil where a natural person, who is subject to a restraint of trade uses a close corporation or a company to front to engage in the activity that is prohibited by the agreement.

*Die Dros (Pty) Ltd and another v Telefon Beverages CC and others*: Where fraud, dishonesty and other improper conduct is present, the need to preserve the separate legal personality of a company must be balanced against policy considerations favouring piercing the corporate veil.

You could also have referred to the following cases:

*Botha v Van Niekerk* 1983 (3) SA 513 (W);
*Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* 1995 (4) SA 790;
*Hülse-Reutter*;
*Ex parte Gore NO*;
*Bargaining Council for the Furniture Manufacturing Industry KZN and*
Activity 1
In 2005 Pat and Tracy Morgan established NetMedia (Pty) Ltd that offered internet-based news, until June 2011 when the company was liquidated as a result of its inability to 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 (Pty) Ltd and consequently the proceeds of the sale of the company’s assets must be utilized to settle all debts owed by the company to its other ordinary creditors. Mr and Mrs Morgan believed that NetMedia (Pty) Ltd’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. Advise both parties with regard to their respective positions.

You should have advised Pat and Tracy regarding the company’s separate legal personality. You could have referred to a number of cases dealing with the rights that companies enjoy including Dadoo Ltd and others v Krugersdorp Municipality Council, Salomon v Salomon & Co Ltd, Ngcwase v Terblanche etcetera.

The liquidator should be advised regarding the concept of piercing the corporate veil. You should therefore have referred to section 20(9) of the Companies Act. In addition you should indicate that the court will not easily pierce the corporate veil. In this regard you could refer to the case law discussed above (Botha v Van Niekerk, Cape Pacific, Hülse Reutter etc as discussed above).

Considering the fact that the loan was made and secured long before the company was liquidated, it will be very difficult to prove that the Morgans had the intention to defraud creditors when securing the loan.

Activity 2
Read Bargaining Council for the Furniture Manufacturing Industry KZN and UKD Marketing CC & others.

PLEASE NOTE THAT THIS CASE IS AVAILABLE UNDER ADDITIONAL RESOURCES ON MYUNISA IF YOU ARE UNABLE TO ACCESS IT IN THE LIBRARY

Answer the following questions:

a. Who is/are the presiding officer/s in this matter?

Davis JA

b. In what year was this case decided?

2012

c. What kind of enterprise is the first respondent in this matter?
A close corporation

d. This is an employment law case. What is the importance of this matter in as far as entrepreneurial (corporate) law is concerned? (Hint: read paragraph [7] of the case)

“[7] Notwithstanding this detailed description of the structure, appellant still contends that the entire ‘setup’ was created as a ‘device, stratagem or sham’ by Premraj to avoid the consequences of an employment relationship between first respondent and its employees, being the balance of respondents together with those persons employed by respondents.

Accordingly, it sought to have the ‘corporate veil’ behind which it contested first respondent sought to hide its employees pierced or lifted so as to justify a conclusion that first respondent was in fact and therefore in law the employer of all those who were members of the close corporations or ‘employees’ thereof. In this, appellant contended that all were employees of first respondent in the furniture manufacturing industry. This would mean that all those persons engaged upon the various activities which created the readymade kitchens, which were the subject of orders procured by the first respondent, would be regarded as employees of first respondent.”

e. Did the court consider any section of legislation in making its decision?

No

f. Did the court apply any particular common law principle in its dictum?

Yes, piercing the corporate veil (see para [21])

g. What legislation would be most appropriate to apply in this specific case, and why?

As this matter involves a close corporation (first respondent) section 65 of the Close Corporations Act would be more appropriate than would section 20(9) of the Companies Act.

h. What case/s did the court refer in its dictum regarding the pertinent corporate law issue?

Cape Pacific Ltd-case

i. Name two more recent cases to which the court could also have referred.

Le’Bergo Fashions CC v Lee and another and Die Dros (Pty) Ltd and another v Telefon Beverages CC and others

Activity 3

Read Mohlotsane v Mobile Telephone Network (Pty) Ltd

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Please note that this case is available under additional resources on MyUNISA if you are unable to access it in the library.

Answer the following questions:

a. Who is/are the presiding officer/s in this matter?

Molahleli J

b. Is it made clear in this case that holding and subsidiary companies are considered to be legal entities separate from one another? If so, in what paragraph/s?

Yes. Para [2].

c. In what court is this matter heard?

In the Labour Court.

d. This is a Labour Law matter. What is the importance of this matter in as far as entrepreneurial (corporate) law is concerned? (read para [28] and further)

"[28] Before dealing with the general principles governing a fair retrenchment, it is convenient to deal firstly with the relationship between Group and MTN SA and what its impact, if any that had on the fairness of the dismissal. The essence of the applicant’s case in this regard is that the Court should uplift the corporate veil and find that the fiction in law that the two are separate entities does not apply because of the manner in which both conducted themselves in.” “[33] The Court further held that the relief under section 20(9) of the Act may be granted on application by any interested party or *mero motu* in any proceedings in which a company is involved.”

e. Which piece of legislation does the court refer to here? Refer to the particular section which is applied and correct the court’s mistake.

The court refers to section 20(9) of the Company’s Amendment Act 3 of 2011. It should be section 20(9) of the Companies Act.

f. To which recent cases does the court refer concerning this section/ common law principle?

- *Chandler v Cape PLC* [2012] EWCA Civ 525
- *Ex parte Gore NO*

g. Why did the court find that it would be wrong to hold the Group accountable despite the fact that the two entities are not clearly distinct from one another?

Group had not been afforded an opportunity to respond as it was not joined (para [34]).
Learning Unit 2: Types of company

a) What is the difference between profit companies and non-profit companies?

A profit company aims to make a profit which is to be divided between its shareholders. The purpose for incorporation of a non-profit company is much different. It must be for a cultural, social or public benefit or other object than financial gain for its shareholders.

b) What is an external company?

A foreign company carrying on business or non-profit activities in South Africa.

c) What is a domesticated company?

A foreign company whose registration has been transferred to South Africa.

Exercise:

o Candy Ltd is a **public** company.

o Rand Water SOC Ltd is a **state-owned enterprise/ company**.

o Front End (Pty) Ltd is a **private. company**.

o Dandala and Associates Inc. is a **personal liability company**.

o Estcourt View Home Owners' Association NPC is a **non-profit company**.

Examples of questions from previous exams on this topic:

1. Name the different types of companies for which the Companies Act 71 of 2008 provides. (5)

   a. Profit companies
      - public companies, private companies, personal liability companies, state-owned companies

   b. Non-profit companies

2. Compare the different profit companies for which the Companies Act 71 of 2008 provides. (4)

   **A public company (‘Ltd’)**

   Shares may be offered to the public and are freely transferable;
   This company can be listed on the JSE Limited;
   Can be formed by 1 person
   Must have at least 3 directors
   Obliged to hold annual general meetings
   Obliged to appoint an auditor
   Obliged to appoint a company secretary
   Obliged to appoint an audit committee
### A state-owned company (‘SOC Ltd’)

Registered in terms of the Companies Act and either listed as a public entity in Schedule 2 or 3 of the Public Finance Management Act, or owned by a municipality; Examples of state-owned companies: ACSA; Denel; South African Airways. The majority of the provisions applicable to public companies apply to state-owned companies except if an exemption has been granted by the Minister.

- Obliged to appoint a company secretary
- Obliged to appoint an audit committee
- Chapter 3 of the Companies Act applies except to the extent that the company has been exempted by the Minister

### A personal liability company (‘Inc’ or ‘Incorporated’)

Must meet the criteria for a private company, mainly used by professional associations (such as attorneys);

- Memorandum of Incorporation must state that it is a personal liability company
- 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 directors’ liability to contractual debts, and to exclude delictual and statutory liabilities.

A provision that the directors and past directors will be liable jointly and severally, together with the company, for debts and liabilities of the company that were contracted during their periods of office must be included in the Memorandum of Incorporation of a personal liability company. The effect of the inclusion of such a clause is that creditors would be able to hold the directors jointly and severally liable for the company’s contractual debts and liabilities. A director who had paid the debts will have a right of recourse against his or her fellow-directors for their proportionate share (*Sonnenberg McCloughlin Inc v Spiro* 2004 (1) SA 90).

- Can be formed by 1 person
- Must have at least 1 director

The doctrine of constructive notice applies in terms of section 19(5) of the Companies Act

### A private company (‘(Pty) Ltd’)

- Its Memorandum of Incorporation prohibits offering of any securities to the public and restricts the transferability of its securities;
- Private companies are no longer limited to 50 shareholders as was the case under the Companies Act of 1973.

In terms of section 8(2)(b) of the Companies Act, a private company’s Memorandum of Incorporation must contain a prohibition against offering of its securities to the public and restrict the transferability of its securities.

- Can be formed by one person
- Must have at least 1 director
3. Sarah wishes to incorporate a company in order to raise funds for wildlife conservation. Advise Sarah what type of company would be most appropriate, and on the requirements for this type of company. (6)

A **non-profit company** is a company that is not formed with the aim of making a profit for its **members** (note that a non-profit company has members and not shareholders like profit companies). Its objects must relate to social activities, public benefits, cultural activities or group interests. A non-profit company must be formed by at least 3 persons who will be the company’s first directors.

It must have at least 3 directors, but they are not allowed to obtain any financial gain from the company other than remuneration for the work they performed. A non-profit company does not have to have members. If these companies have members, some members may enjoy voting rights while others may not. The income and property of non-profit companies are not distributable to its incorporators, members, directors, officers or persons related to any of them. Upon liquidation, income and assets must be paid over to another non-profit company, voluntary association or trust with a similar purpose.

4. Explain whether or not Gangnam's Tile (Pty) Ltd can list shares on the Johannesburg Stock Exchange Ltd. (3)

No, this is a private company. Its Memorandum of Incorporation prohibits offering of any securities to the public and restricts the transferability of its securities.

5. Indicate what type of company Dandala and Associates Inc. is and what makes this type of company different from other types of company. (2)

This is a personal liability company. This is a particular type of profit company in which the directors and previous directors are held personally liable for the contractual debts of the company.

6. Explain the main difference between private companies and public companies. (3)

<table>
<thead>
<tr>
<th><strong>Public company</strong></th>
<th>A profit company that can issue its shares to the public and whose shares can be listed on the Johannesburg Stock Exchange.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Private company</strong></td>
<td>A profit company that prohibits the issue of shares to the public and restricts the transfer of shares in its Memorandum of Incorporation.</td>
</tr>
</tbody>
</table>
7. How would you determine whether or not the doctrine of disclosure is applicable to a specific company in a set of facts? Provide an example of how these companies' names would look.

The doctrine of constructive notice has been abolished in terms of the Companies Act 71 of 2008 (section 19(4) save for the exceptions mentioned in section 19(5):

Section 15(2)(b) of the Companies Act determines that a company may include restrictions and conditions in its Memorandum of Incorporation pertaining to the company's capacity. Before a third party dealing with the company would be required to acquaint themselves with these restrictions and conditions, certain requirements must be met in terms of the Companies Act:

1. There must be a restriction or conditions in the Memorandum of Incorporation of the particular company.
2. A prohibition against amendment of the restriction or condition must be included in the Memorandum of Incorporation.
3. The company's name must be followed by “RF” to warn the third party of the Restrictions or conditions.
4. The Notice of Incorporation that is lodged together with the Memorandum of Incorporation must include a provision that draws attention to the fact that special restrictions or conditions apply to the company. The second exception applies to a personal liability company. A person is also regarded as having received notice and to have 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.

The company names should either be followed by ‘RF’ or by ‘Inc’ before the doctrine of constructive notice would apply. Examples: Turquand (Pty) Ltd RF or Estoppel Incorporated.
Activity 1

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.

See section 15 of the Companies Act. 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 Companies Act?

Companies may accept or alter the following alterable provisions as long as the alteration remains consistent with the Companies Act.

Alterable provisions

- A company enjoys all the legal powers and capacity of an individual, except to the extent that a juristic person is incapable of exercising any such powers, or having any such capacity; or the company’s Memorandum of Incorporation provides otherwise (e.g. it may determine that the company’s activities will be limited to a specific business).
- Private, non-profit and incorporated companies may elect to comply with the extended accountability requirements of Chapter 3 (section (2)).
- Shares within the same class have the same rights, limitations and terms, unless the Memorandum of Incorporation provides otherwise (section 37(1)).
- The Memorandum of Incorporation may exclude the right of first refusal of current shareholders of a private company in respect of shares issued by the company (section 39(3)).
- The Memorandum of Incorporation may forbid the board to render financial assistance to parties wanting to acquire shares in the company (section 45(2)).
- The Memorandum of Incorporation may provide for longer minimum notice periods for meetings.
- Electronic notice and electronic participation in meetings are allowed unless the Memorandum of Incorporation prohibits it (section 63(2)).
- Companies may determine a higher number of minimum directors than that prescribed by the Companies Act (section 66(2)).

Activity 2

Vanitha and Sandra have just moved to a new town. There they meet a mutual friend, Wilma, from their days in boarding school. The town has many orphans who are homeless. Vanitha, Sandra and Wilma have decided to form a non-profit 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 want to start operating before the winter season arrives. 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 since 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 proceed to 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?

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

**Activity 3**

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 regarding 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 taken place yet.

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

The board of directors has the power to make rules concerning the governance of the company, provided that they are not addressed in the Companies Act or in the Memorandum of Incorporation. A rule made by the board which is inconsistent with the Memorandum of Incorporation or with the Companies Act will be void, but only to the extent of its inconsistency. Although the rule becomes effective 10 business days after publication, ratification by an ordinary resolution at the next shareholders’ general meeting is important. *The Memorandum of Incorporation and the Rules are binding:*

- between the company and each shareholder;
- between or among the shareholders of the company;
- between the company and each director or prescribed officer of the company;
- between the company and any other person serving the company as a member of a committee of the board;

The relationship created in terms of section 15 of the Companies Act seems to be of a contractual nature.
Activity 4

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 regarding 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?

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.

Activity 5

Punch (Pty) Ltd has made alterations to its Memorandum of Incorporation three times within the past year. The Companies and Intellectual Property 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 problem be addressed?

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.

Activity 6

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 as he is worried about the fact that the Memorandum is made up of 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.

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

As you advise the director, you may inform him about the possibility of consolidating the Memorandum of Incorporation.

Activity 7

Ryno has been appointed as a director of a private company. He becomes aware of an agreement between the shareholders of the company. 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.
Although shareholders are allowed to enter into agreements on matters concerning the company, such agreements must be consistent with the Companies Act and with the Memorandum of Incorporation. Provisions that are inconsistent are void to the extent of the inconsistency.

Examples of questions in previous exams dealing with this topic:

QUESTION 1:

Gangnam’s Tile Ltd has decided to translate its Memorandum of Incorporation. The document is currently being translated into 9 of the official South African languages. Consequently, there are some variations in respect of the content. Certain concepts are difficult to explain in some of the languages, often leaving them open to varying interpretation. Since the translation has taken such a long time, there are currently 3 different versions of the Memorandum of Incorporation. Explain the procedure that should be followed in order to give effect to the translation. In addition, indicate how the problem regarding the different versions will be addressed. (5)

Translations of the MOI may be in 1 or more of the official languages. A notice of translation must be filed with the Commission. A copy of the translation/s must be filed. A sworn statement by the translator indicating that it is a true, accurate and complete translation must be filed. A filing fee is payable. In the event of a conflict between versions of the Memorandum of Incorporation, the original prevails. The company may consolidate the different versions.

QUESTION 2:

Explain the procedure for amending a company’s Memorandum of Incorporation. (3)

Changes may 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).

Such amendments may be in the form of
• a new Memorandum of Incorporation, or
• amendments to the existing provisions of the Memorandum of Incorporation

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

A company’s Memorandum of Incorporation may be amended
• in compliance with a court order (An amendment in terms of a court order is given effect via a board resolution and there is no need for a shareholders’ special resolution.)
• by the board in terms of sections 36(3) and (4) (These allow the board to amend the authorised share capital of the company, unless the Memorandum of Incorporation provides otherwise.)
by a special resolution of the shareholders proposed by
- the board of directors, or
- shareholders who collectively exercise not less than 10% of the voting rights

There is no need to convene a shareholders’ meeting to adopt this special resolution. As it is sometimes difficult for some shareholders to attend meetings, the proposal to amend the Memorandum of Incorporation may be sent or hand-delivered to the shareholders who are entitled to vote. The proposal will be adopted, if approved by the required majority who voted in writing, within 20 days after the resolution was delivered to them (section 60 of the Companies Act).

- in terms of the procedure set out in the company’s Memorandum of Incorporation

To effect the amendment, a form CoR 15.2 must be filed. Unless the amendment is made by a company that existed before the Companies Act came into operation, and the amendment is pursuant to compliance with the Companies Act, a filing fee must be paid. A copy of the special resolution (if this is required in terms of a company’s Memorandum of Incorporation), or a copy of the amended Memorandum, must accompany the notice.

An amendment may result in a profit company no longer meeting the criteria for that category of profit company. When this happens, the name and the ending expression must also be amended in such a way that it reflects the new category that the profit company falls under.

If an amendment to the Memorandum of Incorporation of a personal liability company has the effect that the company falls into another category of company, the company must give at least ten days prior notice of the filing of the notice of amendment to any professional or industry regulatory authority that has jurisdiction over the business of the company, and to any person who may have relied on the personal liability of the directors in dealings with the company and who could suffer prejudice if that liability is terminated.

QUESTION 3:

If there is a contradiction between a stipulation contained in the Companies Act 71 of 2008 and a stipulation in the Memorandum of Incorporation, or between a stipulation in the Memorandum of Incorporation and one of the rules of the company, which stipulation would enjoy preference? (3)

Rules must not be in conflict with the Memorandum of Incorporation of the company or with the Companies Act. In terms of section 15(4)(a), where there is a conflict between a rule made by the board of directors and the Companies Act or the Memorandum of Incorporation, the rule will be void but only to the extent of its inconsistency. If a stipulation in the Memorandum of Incorporation contradicts the Companies Act, that stipulation will be void in as far as it contradicts the legislation. So, the Companies Act enjoys preference over the Memorandum of Incorporation, which in turn takes preference over the rules.

QUESTION 4:
To register a company, a Notice of Incorporation and a copy of the Memorandum of Incorporation must be lodged with the Commission and the prescribed registration fee must be paid. Section 1 of the Companies Act determines that to “lodge” the documents means to deliver them to the Commission (CIPC), which is responsible for registration.

QUESTION 5:

What documents need to be lodged in order to register a company, and where should they be lodged?

To register a company, a Notice of Incorporation and a copy of the Memorandum of Incorporation must be lodged with the Commission.

QUESTION 6:

Explain the restrictions placed on the choice of the company name in terms of the Companies Act 71 of 2008.

The Companies Act restricts a company name only as far as it is necessary to protect the public from misleading names which falsely imply an association that does not exist and to protect the interest of the owners of names and other forms of intellectual property (such as trademarks) from other persons passing themselves off as such owners or coat-tailing on the owners’ reputation and good standing, and protect the public from names that would fall within the ambit of expression that does not enjoy constitutional protection because of its harmful or other negative nature.

To avoid deception of the public, the name of a company may not be the same as the name of another company, external company, close corporation or cooperative; or the name of a business which has already been registered in terms of the Business Names Act 27 of 1960; or a trademark which has been filed for registration in terms of the Trade Marks Act 194 of 1993; or a mark, word or expression protected in terms of the Merchandise Marks Act of 1941; be confusingly similar to a name, trademark, mark, word or expression as described above (subject to a few specific exceptions);
give the false impression that the company is associated with the government or with a particular person or government office, etc., and include any word, expression or symbol that may constitute propaganda for war, incitement of imminent violence, or advocacy of hatred based on race, ethnicity, gender or religion, or incitement to cause harm.

Also note the following:
The Companies Act does not make provision for the registration of a shortened or translated name. A name reservation in a foreign language must be accompanied by a certified translation and certificate of translation. In terms of the Consumer Protection Act 68 of 2008, members of the public are required to register their business/trading name/sole proprietorship/partnership names with the Commission. 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 trademark, 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. If the company’s name is to be associated with another existing business, the Commission will require proof from the applicant company that the associated company was made aware before registration that a similar name would accordingly be allowed. The Companies 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 Companies Act.

**QUESTION 7:**

a. Veronica and Precious want to incorporate a public company called Aspex Ltd. Briefly state the legal requirements that they must comply with in terms of the Companies Act 71 of 2008 to register the business. (5)

To register a company, a Notice of Incorporation and a copy of the Memorandum of Incorporation must be lodged with the Commission and the prescribed registration fee must be paid. As this is a public company 3 incorporators are required.

b. How would your answer have been different if Veronica and Precious were incorporating a company called Aspex (Pty) Ltd instead? (2)

As this is a private company only one person can now incorporate the company.

**QUESTION 8:**

List five matters that must be contained in a company’s Memorandum of Incorporation. (5)

The **Memorandum of Incorporation** contains the following information:

- details of the incorporators
- the number of directors and alternate directors
- the share capital (maximum issued)
- the content of the Memorandum of Incorporation
- **Unalterable provisions:** provisions of the Companies Act which a company’s Memorandum of Incorporation may not change, except to impose a higher standard, greater restriction, longer period of time, or any similar more onerous requirement than contained in an unalterable provision of the Companies Act. For instance, directors’ duties and responsibilities, and accountability requirements for public and state-owned companies, cannot be excluded in the Memorandum of Incorporation. The Companies Act allows for companies to add provisions to address matters that are not covered in the Companies Act itself. However, all provisions in the Memorandum of Incorporation must be consistent with the Act (section 15(1)(a) and (b)).
Learning Unit 4: Pre-incorporation contracts

1. How is ‘pre-incorporation contract’ defined in the Companies Act 71 of 2008?

Section 1 of the Companies Act describes a **pre-incorporation contract** as “a written 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 proposed company, with the intention or understanding that the proposed company will be incorporated, and will thereafter be bound by the agreement”.

2. What are the formal requirements for a contract to be binding upon a company under section 21 of the Companies Act?

In terms of **section 21 of the Companies Act**, a pre-incorporation contract will be binding on a company if

1. it is concluded by a person in the name of, or purporting to act in the name of or on behalf of, a company yet to be incorporated in terms of the Companies Act
2. the contract was concluded in writing, and
3. the board of that company ratifies the transaction or does not reject the contract within the stipulated three-month period after its incorporation (In other words, if the above two formal requirements are complied with, and after the company’s incorporation, the board “does nothing” about the transaction (i.e. neither ratifies nor rejects it), the contract will become binding on the company.)

3. Who is liable for performance if a pre-incorporation contract is concluded under section 21 of the Companies Act and the company is subsequently not registered?

Section 21 provides for **joint and several liability** of the person or persons who concluded the contract on behalf of the company for liabilities created in terms of the pre-incorporation contract if the company is not incorporated. Note, however, that joint and several liability does not apply where the contract is replaced with another similar contract after incorporation.

4. Who is liable for performance in terms of a pre-incorporation contract concluded under section 21 of the Companies Act if the company subsequently rejects the contract?

Section 21 provides for **joint and several liability** of the person or persons who concluded the contract on behalf of the company for liabilities created in terms of the pre-incorporation contract if

- the board rejects the contract partially or in full (In such a case, the person who acted on behalf of the company may claim any benefit from the company that it receives in terms of the contract, but may apparently not claim any benefit from the other contracting party.)

Note, however, that joint and several liability does not apply where the contract is replaced with another similar contract after incorporation.

5. List the common law alternatives to conclude a pre-incorporation contract.

- Cession and delegation
- Nomination
- Option
6. **Explain the process for the conclusion of a contract to the benefit of a third party (stipulatio alteri)**

A person concludes a contract with another contracting party in terms of which the last-mentioned will offer certain benefits to the company to be formed. If the company is formed, it can accept the offer or decline it. The risk is that the company may not come into existence or may not accept the offer. The person who concluded the contract will only incur liability under the contract if specifically so provided.

7. **Explain the process of nomination of a company to be bound to terms of an agreement under the common law.**

A person concludes the pre-incorporation contract subject to a term that he or she will have the option to nominate a third party in his or her place within a specified period. Upon incorporation of the yet-to-be-formed company, this person then nominates the company to become a party to the contract in his or her place. The risk is that the company may refuse the nomination or not be able to comply with the obligations in terms of the agreement. In such circumstances, the original debtor will only incur liability if this is specifically agreed on.

8. **Explain what is meant by cession and delegation. What is the risk attached to this alternative means of conclusion of a pre-incorporation contract?**

“Cession” is the transfer of rights and “delegation” means the transfer of duties or liabilities. When using this cession and delegation method, which is a combination of the two processes, to conclude a pre-incorporation contract, a person concludes the contract in his or her own name. After the company is registered, this person cedes the rights and delegates the obligations under the contract to the company. The risk associated with this method is that the consent of all three parties is required for delegation of duties. In other words, the company and the other contracting party must agree to the substitution of the company as the new debtor. All rights and duties not accepted by the company will remain with the original person unless it is specifically agreed otherwise.

9. **What are the benefits of concluding a pre-incorporation contract under the common law instead of under section 21 of the Companies Act?**

The common law alternatives (except for agency, which is impossible) could be used more effectively and safely to avoid possible personal liability. The common law constructions have a major advantage over the statutory method because, in terms of the common law, the person acting on behalf of the proposed company is not automatically liable if the company is not incorporated or fails to ratify the contract completely.

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**Activity 1**

John and Jane want to incorporate a catering company, De-lish Pty (Ltd), together. Before the company is registered Jane sees a delivery vehicle that would be perfect for use in their catering business.

(a) Advise Jane regarding the formal requirements to conclude a contract on behalf of the yet to be formed company in terms of section 21 of the Companies Act.
To conclude a binding contract under section 21 of the Companies Act the following formal requirements must be met:

- The contract must be concluded in writing;
- The person concluding the contract on behalf of the yet to be formed company must act or profess to be acting as an agent for a company that is not yet registered;
- The board of the company must within 3 months of its incorporation ratify the contract.

(b) If De-lish (Pty) Ltd is never incorporated would Jane incur liability for performance in terms of the contract?

Section 21 of the Companies Act provides for joint and several liability of the person or persons who concluded the contract on behalf of the proposed company. In other words, should the company fail to ratify the contract completely or reject it, or not be registered this person or persons will incur liability toward the other contracting party for liabilities created in terms of the agreement.

(c) Advise Jane of alternative common law methods of concluding the contract to avoid possible personal liability.

To avoid possible personal liability, an option agreement, cession of rights and delegation of duties, a nomination or a contract to the benefit of a third party could provide a safer option. The promoter must however ensure that the contract is properly formulated to specifically exclude personal liability.

Examples of questions in previous exams dealing with this topic:

**QUESTION 1:**

Busi wishes to conclude a contract for the purchase of a property on behalf of a company which she intends to incorporate next year. Advise Busi of the requirements that need to be adhered to in terms of the Companies Act 71 of 2008 in order for the contract to be binding on the company when it is formed. (4)

To conclude a binding contract under section 21 of the Companies Act the following formal requirements must be met:

- The contract must be concluded in writing;
- The person concluding the contract on behalf of the yet to be formed company must act or profess to be acting as an agent for a company that is not yet registered;
- The board of the company must within 3 months of its incorporation ratify the contract or not reject it.
QUESTION 2:
Anne, Jack and Sam are three friends who wish to start their own publishing company. While driving one Saturday afternoon, Jack comes across the perfect office building. He wishes to purchase this building on behalf of the proposed company. Advise Jack of two common law alternatives of concluding a contract that will bind the company when it is registered. Explain the process of transfer of liability from him to the company in each instance.?

<table>
<thead>
<tr>
<th>Cession and delegation</th>
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<tr>
<td>“Cession” is the <strong>transfer of rights</strong> and “delegation” means the transfer of duties or liabilities. When using this cession and delegation method, which is a combination of the two processes, to conclude a pre-incorporation contract, a person concludes the contract in his or her own name. After the company is registered, this person cedes the rights and delegates the obligations under the contract to the company.</td>
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The risk associated with this method is that the consent of all three parties is required for delegation of duties. In other words, the company and the other contracting party must agree to the substitution of the company as the new debtor. All rights and duties not accepted by the company will remain with the original person unless it is specifically agreed otherwise.

<table>
<thead>
<tr>
<th>Nomination</th>
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<tr>
<td>A person concludes the pre-incorporation contract subject to a term that he or she will have the option to nominate a third party in his or her place within a specified period.</td>
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</table>

Upon incorporation of the yet-to-be-formed company, this person then nominates the company to become a party to the contract in his or her place. The risk is that the company may refuse the nomination or not be able to comply with the obligations in terms of the agreement. In such circumstances, the original debtor will only incur liability if this is specifically agreed on.

<table>
<thead>
<tr>
<th>Option</th>
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<tbody>
<tr>
<td>The option granter (offeror) undertakes to keep the substantive offer open for a period of time. The option is then ceded to the company upon its incorporation.</td>
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</table>

If the company accepts the offer, a contract comes into being. Otherwise, the person who concluded the option agreement will only remain personally liable if the option agreement provides for liability.

<table>
<thead>
<tr>
<th>Contract for the benefit of a third party (<strong>stipulatio alteri</strong>)</th>
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---end of unit---
## Learning Unit 5: Registration of company names

1. What are the criteria for the names of companies in terms of the Companies Act 71 of 2008?

The Companies Act restricts a company name only as far as it is necessary to

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<td>• protect the public from misleading names which falsely imply an association that does not exist</td>
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<tr>
<td>• protect the interest of the owners of names and other forms of intellectual property (such as trademarks) from other persons passing themselves off as such owners or coat-tailing on the owners’ reputation and good standing, and</td>
</tr>
<tr>
<td>• protect the public from names that would fall within the ambit of expression that does not enjoy constitutional protection because of its harmful or other negative nature</td>
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To avoid deception of the public, the name of a company may not

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<td>• be the same as the name of another company, external company, close corporation or cooperative; or the name of a business which has already been registered in terms of the Business Names Act 27 of 1960; or a trademark which has been filed for registration in terms of the Trade Marks Act 194 of 1993; or a mark, word or expression protected in terms of the Merchandise Marks Act of 1941</td>
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<tr>
<td>• be confusingly similar to a name, trademark, mark, word or expression as described above (subject to a few specific exceptions)</td>
</tr>
<tr>
<td>• give the false impression that the company is associated with the government or with a particular person or government office, etc., and</td>
</tr>
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<td>• include any word, expression or symbol that may constitute propaganda for war, incitement of imminent violence, or advocacy of hatred based on race, ethnicity, gender or religion, or incitement to cause harm</td>
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Also note the following:

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<td>• The Companies Act does not make provision for the registration of a shortened or translated name.</td>
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<td>• A name reservation in a foreign language must be accompanied by a certified translation and certificate of translation.</td>
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<td>• In terms of the Consumer Protection Act 68 of 2008, members of the public are required to register their business/trading name/sole proprietorship/partnership names with the Commission.</td>
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<td>• 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 trademark, 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. If the company’s name is to be associated with another existing business, the Commission will require proof from the applicant company that the associated company was made aware before registration that a similar name would accordingly be allowed.</td>
</tr>
</tbody>
</table>
• The Companies 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 Companies Act.

2. Is it always necessary for a company to reserve a name before registration?

No. If a proposed name is rejected, the company may usually still be registered and the registration number then becomes the name of the company at incorporation until an appropriate name has been reserved or approved.

3. Is it possible to reserve a company name for future use?

Yes. In order to reserve a name, a form CoR 9.1 must be completed and a filing fee is payable. A name reservation is valid for six months. It is possible to apply for an extension of a name reservation for an additional 60 business days by lodging a form CoR 9.2 and paying a filing fee. In terms of section 12 of the Companies Act, 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 an existing name of a company.

4. Would it be possible for one company to transfer a name to a different company?

Yes. Someone who has applied for the reservation of a name may transfer the reserved name to another person by lodging a form CoR 11.1.

5. Which types of companies cannot function without an acceptable name (cannot be registered under a registration number only by the Commission?)

Non-profit companies are not allowed to have registration numbers as their names.

6. Who can order a name change where a name to be registered is similar to an existent company’s name?

The High Court can make an order to change a name if the matter is referred to it and passing-off is successfully proven. Disputes regarding names may also be referred to the Companies Tribunal or the Human Rights Commission in terms of section 160 of the Companies Act.

7. What factors are considered in order to ascertain whether or not a name is objectionable?

_Peregrine Group (Pty) Ltd & others v Peregrine Holdings Ltd & others:_

- **The activities** that the companies engaged in;
- **The similarity in the names** and whether it would cause confusion;
- **The client bases of the respective companies**;
- **whether** the name is undesirable and calculated to cause harm to the other company;
- **The likelihood that members of the public would be confused** in their dealings with the competing companies;
- **The date of registration of the companies** would also play a role.
8. How should the name and registration number of a company be used?

Section 32 of the Companies Act 71 of 2008 requires that a company furnish 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. A company must use its registered name at all times, and not a modified version of such name. In the case of a profit company, the name may consist of a registration number only, followed by the words “South Africa”. If the Registration Certificate is issued with an interim name by the Commission, the company is obliged to use its interim name. The interim name is used until the company’s name has been amended.

9. What happens when the name and registration number of a company is not reflected properly on its stationery etc?

Such a contravention would constitute an offence. In terms of section 32 (6) and 32(7) of the Companies Act: “A company, or incorporator, shareholder or director of a company, or a person acting with the authority or on behalf of the company, must not, by any act or omission, misrepresent to any person, in any way or to any degree, the true legal status of the company. If a person contravenes subsection (6), a court, on application by any person affected by that failure, may impose personal liability on any shareholder, director or incorporator of the company for any liability or obligation of the company, to the extent that the court determines to be just and equitable in the circumstances”.

Activity 1

Suppose that John, who was previously a franchisee of McTucky’s Ltd, wants to incorporate a company with the name MacTuckies Ltd. The new company will run substantially the same business as McTucky’s Ltd, namely selling fried chicken. Consider whether or not McTucky’s Ltd has grounds to object to the registration of the name. (3)

See the answer provided in 7 above. Remember to apply the factors enumerated in Peregrine to the facts provided in the question and then reach a conclusion that answers the question.

Examples of questions from previous exams dealing with this topic:

QUESTION 1:

What factors would the court consider to ascertain whether or not a proposed name is undesirable? Refer to relevant case law in your answer. (5)

See the answer provided in 7 above. Peregrine Group (Pty) Ltd & others v Peregrine Holdings Ltd & others:
- The activities that the companies engaged in;
- The similarity in the names and whether it would cause confusion;
- The client bases of the respective companies;
- whether the name is undesirable and calculated to cause harm to the other company;
- The likelihood that members of the public would be confused in their dealings with the competing companies;
- The date of registration of the companies would also play a role.
1. What is meant by the capacity of a company?

A company’s capacity is determined by the **sphere of actions that it 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. In other words, if a company’s principal business is, for instance, catering, it would be outside the company’s capacity to buy an expensive yacht on behalf of the company. 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 the catering example mentioned above, it would be within the scope of the principal business (*intra vires*) for the company to purchase a refrigerator that it needs for catering.

**BUT...**

Section 19(1)(b) of the Companies 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, or the company’s Memorandum of Incorporation provides otherwise. Therefore, the capacity of a company is no longer limited by its main or ancillary objects or business, and these objects need not even be stated in the Memorandum of Incorporation.

2. What is the *ultra vires* doctrine?

In terms of our **common law**, a contract is *ultra vires* the company when the conclusion of the transaction is beyond its legal capacity. In other words, if a company’s principal business is, for instance, catering, it would be outside the company’s capacity to buy an expensive yacht on behalf of the company. 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.

3. Under which circumstances does a person have the authority to represent a company and bind it to an agreement?

**Representation relates to a person acting under the company’s authority.** Authority can be given expressly (in writing or orally) or by implication. Whether authority has been conferred is a question of fact.

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. A company may also be bound by 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**.
In other words, a company may be liable to a bona fide third party if it is represented by someone who does not have actual authority, and where the company allows such a person to represent the company as if that person did have authority.

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

The *Turquand* rule was formulated to keep an outsider’s duty to inquire into the affairs of the company within reasonable bounds. The *Turquand* rule was derived from *Royal British Bank v Turquand*. According to the common law *Turquand* rule, if the person acting on behalf of the company has the authority to do so, but this is subject to an internal formality, such as approval by the board, an outsider contracting with the company in good faith is entitled to assume that this internal requirement has been complied with. The company will be bound by the contract even if the internal formality has not been complied with. The exceptions are: if the outsider was aware of the fact that the internal formality had not been complied with; or if the circumstances in which the contract was concluded were suspicious.

Section 20(7) of the Companies Act now contains a provision that in some respects resembles the *Turquand* rule by providing that a person dealing with a company in good faith is entitled to presume that the company, in making any decision in the exercise of its powers, has complied with all the formal and 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 any such requirement.

However, this provision does not replace the *Turquand* rule, because section 20(8) provides that subsection (7) must be interpreted concurrently with, and not in substitution for, any relevant common law principle relating to the presumed validity of the actions of a company.

The exceptions to the application of the statutory rule are not expressed in exactly the same way as the common law exceptions: section 20(7) determines that the rule will not apply if the third party knew or reasonably ought to have known that the internal requirement had not been complied with.

Activity 1

The Memorandum of Incorporation of ToyZ Ltd states that the company only has the power to sell toys. The board of directors of ToyZ Ltd decides to buy a luxury yacht on behalf of the company.

(a) Will the contract of purchase and sale be valid?

Yes. **Section 19(1)(b) of the Companies 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, or the company’s Memorandum of Incorporation provides otherwise. Therefore, the capacity of a company is no longer limited by its main or ancillary objects or business, and these objects need not even be stated in the Memorandum of Incorporation.

(b) Do the shareholders have any remedies against the board of directors?

Even though an *ultra vires* transaction will be binding on the company, the shareholders are provided with recourse to claim back their losses from the person who acted beyond the scope of the company’s capacity. **Section 20(6) of the**
Companies 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 Companies 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.

If the company or directors have not as yet performed the planned action (e.g. 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 may obtain a court order restraining (i.e. preventing) the company or directors from doing so. (section 20(4)).

Activity 2

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 behalf of the company. 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 behalf of the company. 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.

He however assumes that the approval of the general meeting has been obtained since it had always been obtained for previous transactions. Is the company bound by the contract concluded by Mr Buckley?

The company is bound by the contract concluded because of the operation of section 20(7) of the Companies 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 formal and procedural requirements in terms of the Companies Act and the company’s Memorandum of Incorporation and rules 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.

The contract will also be binding because of the common-law Turquand rule since Mr Buckley is authorised to act on behalf of the company but this is subject to an internal formality. Although Mr Mathews knew about the internal formality, he was entitled to presume that it had been complied with and there is no evidence that he knew it had not been complied with or that there was anything to raise his suspicion. In some instances both the Turquand rule and section 20(7) of the Companies Act will apply, as in this case. This is however not always the case. PLEASE READ QUESTIONS CAREFULLY IN THE EXAM AS WE MAY RESTRICT THE SCOPE
Activity 3

The Memorandum of Incorporation of Concord Ceramics (Pty) Ltd (RF) provides that the board of directors have authority to contract on behalf of the company subject to the condition that if the value of a contract exceeds R1 million the approval of shareholders by special resolution is required. The Memorandum of Incorporation further provides that this last-mentioned provision may only be amended by unanimous approval of all the shareholders.

(a) Are third parties deemed to be aware that the consent of the general meeting is required for transactions in excess of R1 million?

Yes, as this is a RF-company. Section 19(5) of the Companies Act determines that 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 name of the company includes the ending “RF” and that the company’s Notice of Incorporation contains a prominent statement drawing attention to such a provision as required by section 13(3).

(b) To what extent is the doctrine of constructive notice still applicable to this company?

Section 15(2)(b) of the Companies Act determines that a company may include restrictions and conditions in its Memorandum of Incorporation pertaining to the company’s capacity. Before a third party dealing with the company would be required to acquaint themselves with these restrictions and conditions, certain requirements must be met in terms of the Companies Act:
- There must be a restriction or conditions in the Memorandum of Incorporation of the particular company.
- A prohibition against amendment of the restriction or condition must be included in the Memorandum of Incorporation.
- The company’s name must be followed by “RF” to warn the third party of the special restrictions or conditions.
- The Notice of Incorporation that is lodged together with the Memorandum of Incorporation must include a provision that draws attention to the fact that special restrictions or conditions apply to the company.

(c) Suppose that Mike, a site manager on one of the company’s plants, regularly contracts on behalf of the company without having a mandate to do so. The board of directors takes note of this behaviour, but never takes any steps to caution Mike against contracting on behalf of the company. Mike enters into a contract with Timothy for the purchase of raw materials. The company now argues that Mike did not have authority to enter into the contract and that it is not bound to the contract. Advise Timothy on whether the company can be held bound to the contract.

Estoppel applies only when the agent did not have actual authority to bind the company. Take particular note of the fact that the misrepresentation (i.e. that the agent had the necessary authority when, in fact, he or she did not) must have been made by the company as principal. In Freeman and Lockyer v Buckhurst Part Properties (Mangal) Ltd, the court decided that estoppel could not only arise from the
Articles (note that this would be the Memorandum of Incorporation in terms of the current Companies Act), but also because the company with full knowledge and approval allowed an ordinary director to act as the managing director and, in this manner, culpably represented that he was entitled to act. Based on such misrepresentation, the company will be prevented (estopped) from denying liability if the third party can prove that
- the company misrepresented, intentionally or negligently, that the agent concerned had the necessary authority to represent the company
- the misrepresentation was made by the company
- the third party was induced to deal with the agent because of the misrepresentation

Example of questions from previous exams dealing with this topic:

**QUESTION 1:**

By means of an example, explain the operation of the provision similar to the Turquand Rule that has been included in the Companies Act 71 of 2008, (4)

To trigger the protection provided by the Turquand rule, there must have been an internal requirement present.

- A company’s Memorandum of Incorporation determines who has authority to act on behalf of the company.
- The Turquand rule applies where the authority is subject to an internal requirement.

Example: Company A’s Memorandum of Incorporation determines that the board of directors has authority to conclude all contracts on behalf of the company. If the amount of the transaction exceeds R50 000, consent must be obtained from the shareholders at a general meeting.

The underlined part in the block above contains an internal requirement. Even though the Memorandum of Incorporation is registered and available to the public, a third party contracting with the company would have to conduct a further investigation to ascertain whether or not consent was obtained from the shareholders.

The Turquand rule makes this unnecessary, as, in terms of this rule, third parties who act in good faith may assume that such internal requirement has been complied with.

**QUESTION 2:**

Read the following statement and explain whether or not it is correct:

“In terms of the Companies Act 71 of 2008 companies have all the legal capacity and powers of a natural person, and such capacity cannot be restricted”.

No, the statement is not completely accurate. Section 19(1)(b) of the Companies 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, or the company's Memorandum of Incorporation provides otherwise. Although, the capacity of a company is no longer limited by its main or ancillary objects or business, and these objects need not even be stated in the Memorandum of Incorporation, it is still possible to restrict the company's capacity and companies can still not perform all acts that a natural person can, for instance getting married.

QUESTION 3:

The main object of ABC (Pty) Ltd is manufacturing furniture. The Memorandum of Incorporation provides that the board of directors may appoint a managing director who will be authorised to enter into contracts on behalf of the company. Should the contract, however, exceed the amount of R150 000, prior consent of the general meeting is required. Godfried, one of the directors, buys a beach house for R3,5 million from Nomagugu on behalf of ABC (Pty) Ltd.

With reference to the set of facts above, answer the following questions:

(a) Explain whether or not ABC (Pty) Ltd can raise the restrictions to its capacity as contained in its Memorandum of Incorporation as grounds to avoid being bound to the contract. (5)

No. Section 19(1)(b) of the Companies 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, or the company’s Memorandum of Incorporation provides otherwise. Therefore, the capacity of a company is no longer limited by its main or ancillary objects or business, and these objects need not even be stated in the Memorandum of Incorporation.

(b) Assume that Godfried had contracted on behalf of ABC (Pty) Ltd with Nomagugu on previous occasions. What would Nomagugu have to prove if ABC (Pty) Ltd denies being bound to the contract on the basis that Godfried lacked express authority to conclude the contract? Refer to relevant case law in your answer. (5)

Estoppel applies only when the agent did not have actual authority to bind the company. Take particular note of the fact that the misrepresentation (i.e. that the agent had the necessary authority when, in fact, he or she did not) must have been made by the company as principal.

In Freeman and Lockyer v Buckhurst Part Properties (Mangal) Ltd, the court decided that estoppel could not only arise from the Articles (note that this would be the Memorandum of Incorporation in terms of the current Companies Act), but also because the company with full knowledge and approval allowed an ordinary director to act as the managing director and, in this manner, culpably represented that he was entitled to act.

Based on such misrepresentation, the company will be prevented (estopped) from denying liability if the third party can prove that

- the company misrepresented, intentionally or negligently, that the agent concerned had the necessary authority to represent the company
- the misrepresentation was made by the company

Estoppel applies only when the agent did not have actual authority to bind the company. Take particular note of the fact that the misrepresentation (i.e. that the agent had the necessary authority when, in fact, he or she did not) must have been made by the company as principal.

In Freeman and Lockyer v Buckhurst Part Properties (Mangal) Ltd, the court decided that estoppel could not only arise from the Articles (note that this would be the Memorandum of Incorporation in terms of the current Companies Act), but also because the company with full knowledge and approval allowed an ordinary director to act as the managing director and, in this manner, culpably represented that he was entitled to act.

Based on such misrepresentation, the company will be prevented (estopped) from denying liability if the third party can prove that

- the company misrepresented, intentionally or negligently, that the agent concerned had the necessary authority to represent the company
- the misrepresentation was made by the company
QUESTION 4:
The Memorandum of Incorporation of ABC Learning (Pty) Ltd states that the main object of the company is to provide books, learning services and computers to students. The Memorandum of Incorporation also provides that any contract which is to be concluded by the managing director on behalf the company which exceeds the amount of R10 000, must first be authorised by the general meeting by means of an ordinary resolution. Gideon, the managing director of the company concludes a contract on behalf of the company with Dewald of Books 4 U (Pty) Ltd without the authorisation of the general meeting. The contract is for the purchase of textbooks to the value of R12 000. Discuss whether or not this contract will bind ABC Learning (Pty) Ltd. (5)

The company is bound by the contract concluded because of the operation of section 20(7) of the Companies 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 formal and procedural requirements in terms of the Companies Act and the company's Memorandum of Incorporation and rules 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 Dewald was aware of the fact that Gideon did not comply with procedural requirement and had acted in bad faith. Based on these facts, the company is bound by the contract.

The contract will also be binding because of the common-law Turquand rule.

QUESTION 5:
Indicate what a third party would need to prove in order to rely on the doctrine of estoppel in order to hold a company liable for performance in terms of a contract concluded on its behalf. Refer to relevant case law in your answer. (5)

Refer to the answer in 3(b) above. The third party must prove that
- the company misrepresented, intentionally or negligently, that the agent concerned had the necessary authority to represent the company
- the misrepresentation was made by the company
- the third party was induced to deal with the agent because of the misrepresentation

Freeman and Lockyer v Buckhurst Part Properties (Mangal) Ltd

QUESTION 6:
The Memorandum of Propco (Pty) Ltd states that the company’s principle business is “the delivery of estate agent services”. One of the directors purchases a racing horse on behalf of the company at a racing horse auction.

With reference to the set of facts above, answer the following questions:

(a) What would the common-law consequences of concluding a contract such as the one in the set of facts have been? (2)

In terms of our common law, a contract is ultra vires the company when the conclusion of the transaction is beyond its legal capacity. In other words, if a company’s principal business is, for instance, catering, it would be outside the company’s capacity to buy an expensive yacht on behalf of the company. 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.

(b) How has the common-law position been changed by the Companies Act 71 of 2008? (5)

Section 19(1)(b) of the Companies 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, or the company’s Memorandum of Incorporation provides otherwise. Therefore, the capacity of a company is no longer limited by its main or ancillary objects or business, and these objects need not even be stated in the Memorandum of Incorporation.
LEARNING UNIT 7: CORPORATE FINANCE, SHARES, DEBENTURES AND DISTRIBUTIONS

1. What is the legal definition of a share?

The Companies Act in section 1 defines a “share” as “one of the units into which the proprietary interest in a profit company is divided.”

2. What types of preference shares may be issued by a company?

*Cumulative preference shares:* Holders enjoy a right of priority in respect of both arrear dividends and current dividends. 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. Additionally, 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.

3. When must the board of directors obtain the approval of the shareholders before issuing shares?

- where the shares are issued to a current or future director or prescribed officer 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
- where the shares are issued to a nominee of a director of prescribed officer
- where the shares are issued to a nominee of any of the persons mentioned above
- where the voting power of the shares to be issued will exceed 30% of the voting power of the shares of that class held immediately before the issue

4. What are the differences between shares and debentures?

A shareholder of a company has the right to a share in the profits of that company (provided that a dividend is declared by the company), and a right to a share in the net assets of the company if it is wound up. However, a shareholder is also under a duty to abide by the company’s Memorandum of Incorporation.

As a debenture is a debt instrument, the holder of a debenture has effectively loaned a sum of money to the company on certain terms.

Accordingly, the debenture holder is entitled to repayment of the sum of money loaned to the company and is, therefore, a creditor of the company. A debenture is a document issued by a company acknowledging that it is indebted to the debenture holder in the amount stated therein (Coetzee v Rand Sporting Club 1918 WLD 74).

Debenture holders may have a right to attend and vote at general meetings and to appoint directors, and have special privileges regarding the allotment of securities, unless the Memorandum of Incorporation provides otherwise (section 43(3)).
was, however, not previously the case under the Companies Act 61 of 1973.

5. What is meant by the pre-emptive rights of shareholders in private companies?

The general rule is that 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 shares must be offered to existing shareholders first, pro rata to their current shareholdings. However, the right of pre-emption will not apply if the shares are issued in terms of options or conversion rights as capitalisation shares or if the shares are issued for future consideration. The reason why this provision was included in the Companies Act is to guard against the dilution of ownership in private companies.

**Activity 1.**

The directors of Rainbow (Pty) Ltd want to issue shares to Fred. Fred is not currently a shareholder of Rainbow (Pty) Ltd, but he 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 they may take the decision to issue the shares to Fred without shareholder approval. Further consider whether the current shareholders’ right of pre-emption applies.

Before the board can issue new shares, approval must be acquired in certain circumstances, including where the shares are issued to a current or future director or prescribed officer 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.) Fred is a future director of the company and therefore shareholder approval is required by way of a special resolution. In terms of section 39 of the Companies Act, every shareholder in a private company (and a personal liability company) has the right, before any other person who is not a shareholder of the company, to be offered and to subscribe (within a reasonable time) for a percentage of any shares issued or proposed to be issued equal to the voting power of that shareholder’s general voting rights immediately before the offer was made. However, the right of pre-emption will not apply if the shares are issued in terms of options or conversion rights as capitalisation shares or if the shares are issued for future consideration.

**Activity 2**

Prosperity Ltd wants to decrease its issued share capital by a repurchase of shares. Advise the board of directors of Prosperity Ltd of the requirements before they may proceed with this transaction.

A company is allowed to repurchase its shares. This is considered a distribution, which means that the solvency and liquidity tests must be met. A company may make distributions out of profits or share capital as long as solvency and liquidity is maintained.
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.

Suppose that it emerges after the transaction is approved by the board of directors that one of the company’s main debtors is insolvent and will not be able to pay its debts to the company. This means in turn that Prosperity Ltd will not be able to pay its debts after the repurchase of the shares. Advise Prosperity Ltd on possible steps it may take to remedy the situation.

If the company agreed to repurchase shares and it emerges that the company will not be able to meet its obligations in terms of the agreement because it will not meet the requirements of section 48(2) and (3), which includes the requirements set by section 46 for a distribution and thus the solvency and liquidity tests, the agreement between the shareholder and the company in terms of which the company would repurchase his 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 cannot meet the requirements of the Companies Act. The court may make any order it deems just and equitable and that ensures that the person from whom the shares are bought will be paid at the earliest possible time that the company will also be able to fulfil its other financial obligations as they fall due and payable.

If the repurchase has been completed but it now appears that the acquisition was in contravention of the requirements of sections 46 or 48, the company must within two years after the acquisition, 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 the same number and class of shares as those it acquired 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.

Activity 3

David wants to subscribe for shares in Free-4-All (Pty) Ltd. He does not have money available, but he offers to sell some computer equipment left over from a previously unsuccessful business to the company. He will then use this money to pay for the 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 before they may enter into this agreement with David.

One would have to ascertain whether or not the transaction qualifies as financial assistance. In *Lipschitz v UDC Bank Ltd*, it was held that the transaction must be assessed in two phases: Firstly, it must be ascertained whether there was financial assistance. In *Gradwell (Pty) Ltd v Rostra Printers Ltd*, 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 will have been provided. In *Lipschitz*, the court held that this is not the only measure of financial assistance, but that exposing the company to risk will 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, this will count as financial assistance. If the company buys an asset from the person in order 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 the company paid a fair price for it. Secondly, 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 of the Companies Act in order to be valid.

**Activity 4**

Vusi, a shareholder and director of Securities (Pty) Ltd agrees to sell his shares in the company to Jonathan for R20 000. To enable Jonathan to acquire the shares, Securities (Pty) Ltd agrees to lend Jonathan the sum of R20 000. Explain whether this transaction amounts to financial assistance and if so, what requirements have to be satisfied in order for it to be a valid transaction.

In *Lipschitz v UDC Bank Ltd*, it was held that the transaction must be assessed in two phases: Firstly, it must be ascertained whether there was financial assistance. In *Gradwell (Pty) Ltd v Rostra Printers Ltd*, 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 will have been provided. In *Lipschitz*, the court held that this is not the only measure of financial assistance, but that exposing the company to risk will 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, this will count as financial assistance. If the company buys an asset from the person in order 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 the company paid a fair price for it.

Secondly, 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. This transaction appears to pass both these phases and it will have to comply with section 44 of the Companies Act in order to be valid.
In terms of section 44 of the Companies Act, a company may give financial assistance by way of a loan, guarantee, provision of security, or otherwise to a person for the purpose of, or in connection with, the acquisition of 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 taken within the previous two years authorised such assistance to a specific person, or to persons that 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.

Section 44 further requires that the board must be satisfied that the solvency and liquidity requirements will be satisfied immediately after providing the financial assistance (see question 1 above), and that the assistance is given on 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.

Examples of questions from previous exams dealing with this topic:

QUESTION 1:
Under which circumstances may a company declare dividends and what procedure must be followed to declare dividends? (5)

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 tests immediately after the distribution has been made.
- The board must acknowledge by way of a resolution that it has applied the solvency and liquidity tests and reasonably concluded that the company will satisfy the tests immediately after completion of the proposed distribution.

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

Solvency test: That, in 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: That, in 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.
QUESTION 2:

Explain what the legal concept “share” means. Refer to relevant case law. (3)

The Companies Act in section 1 defines a “share” as “one of the units into which the proprietary interest in a profit company is divided” It is incorporeal, movable property transferable in the manner provided for by the Companies Act. In Standard Bank of SA Ltd v Ocean Commodities Inc, the court held that a share usually entitles its holder to vote at a shareholders’ meeting, to share in dividends if declared by the board, and to share in any assets of the company after it has been wound up. Therefore, it is clear that there are personal rights attached to shares. The extent of these rights depends on the class of shares held.

QUESTION 3:

What types of preference shares can a company’s Memorandum of Incorporation provide for? (3)

**Cumulative preference shares:** Holders enjoy a right of priority in respect of both arrear dividends and current dividends. 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. Additionally, 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.

QUESTION 4:

Anthony, Brett, Carl and Daniel are employees of Beta Ltd. Beta Ltd makes loans to them in order to allow them to acquire shares in the company. What requirements must be complied with in terms of the Companies Act 71 of 2008 to provide valid financial assistance? (5)

In terms of section 44 of the Companies Act, a company may give financial assistance by way of a loan, guarantee, provision of security, or otherwise to a person for the purpose of, or in connection with, the acquisition of 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 taken within the
previous two years authorised such assistance to a specific person, or to persons that 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.

Section 44 further requires that the board must be satisfied that the **solvency and liquidity requirements** will be satisfied immediately after providing the financial assistance (see question 1 above), and that the assistance is given on 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.

**QUESTION 5:**

Vusi, a shareholder and director of Securities (Pty) Ltd, agrees to sell his shares in the company to Jonathan for R20 000. In order to enable Jonathan to acquire the shares, Securities (Pty) Ltd agrees to loan Jonathan the amount of R20 000. Explain how one would determine whether or not this transaction qualifies as financial assistance. (5)

In *Lipschitz v UDC Bank Ltd*, it was held that the transaction must be assessed in two phases: Firstly, it must be ascertained whether there was financial assistance. In *Gradwell (Pty) Ltd v Rostra Printers Ltd*, 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 will have been provided. In *Lipschitz*, the court held that this is not the only measure of financial assistance, but that exposing the company to risk will 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, this will count as financial assistance. If the company buys an asset from the person in order 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 the company paid a fair price for it.

Secondly, 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. This transaction appears to pass both these phases and it will have to comply with **section 44 of the Companies Act in order to be valid**.

**QUESTION 6:**

Explain the main differences between shares and debentures. (3)

A shareholder of a company has the right to a share in the profits of that company (provided that a dividend is declared by the company), and a right to a share in the
net assets of the company if it is wound up. However, a shareholder is also under a duty to abide by the company’s Memorandum of Incorporation.

As a debenture is a debt instrument, the holder of a debenture has effectively loaned a sum of money to the company on certain terms.

Accordingly, the debenture holder is entitled to repayment of the sum of money loaned to the company and is, therefore, a creditor of the company. A debenture is a document issued by a company acknowledging that it is indebted to the debenture holder in the amount stated therein (Coetzee v Rand Sporting Club 1918 WLD 74).

Debenture holders may have a right to attend and vote at general meetings and to appoint directors, and have special privileges regarding the allotment of securities, unless the Memorandum of Incorporation provides otherwise (section 43(3)). This was, however, not previously the case under the Companies Act 61 of 1973.

QUESTION 7:
Figozo Ltd showed an increase in profits for the 2015 financial year. At a board meeting, the directors decide that dividends should be paid out to the company’s shareholders. Indicate what the requirements are in terms of the Companies Act 71 of 2008 that must be complied with before dividends may be declared and paid.

Section 46 of the Companies Act regulates distributions. A distribution is any direct or indirect transfer by a company of money or other property of the company (except its shares) to one or more of its shareholders or beneficial holders of shares, whether as the payment of dividends, payment for 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 shareholders of the company.

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 tests immediately after the distribution has been made.
• The board must acknowledge by way of a resolution that it has applied the solvency and liquidity tests and reasonably concluded that the company will satisfy the tests immediately after completion of the proposed distribution.

The solvency and liquidity tests are set out in section 4 of the Companies Act:
Solvency test: That, in 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: That, in 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.
QUESTION 8:
A company’s Memorandum of Incorporation may confer different rights to shareholders, particularly regarding the payment of dividends. Name the different classes if shares that a company may issue. Do not discuss the various categories of these classes of shares in your answer.

Preference shares, ordinary shares and deferred shares.
LEARNIING UNIT 8: SHAREHOLDERS AND COMPANY MEETINGS

1. Why and how are meetings convened?

Decisions are taken (resolutions passed) by companies in meetings. A shareholders’ meeting may be called by the board of directors or any person authorised to do so by the Memorandum of Incorporation. A meeting must be convened if required by the Companies Act or the Memorandum of Incorporation, or if demanded by shareholders holding at least 10% of the voting rights that may be exercised at that meeting. If a company cannot convene a meeting because it has no directors, or all its directors are incapacitated, section 61(11) of the Companies Act applies. In terms of this section, it is possible to authorise another person in terms of the Memorandum of Incorporation to convene a meeting in these circumstances. Should it happen that no provision is made in the Memorandum of Incorporation, any shareholder may request the Companies Tribunal to convene a meeting. Section 61(12) of the Companies Act applies to the situation where, for reasons other than the lack of or incapacity of directors, a company fails to convene its annual general meeting or a meeting required by its Memorandum of Incorporation or shareholders. In these circumstances, any shareholder may apply to court for an order to convene a meeting.

2. Under which circumstances must a company hold a meeting?

A meeting must be convened if required by the Companies Act or the Memorandum of Incorporation, or if demanded by shareholders holding at least 10% of the voting rights that may be exercised at that meeting.

3. What is the effect of a company’s failure to hold a meeting when it is required to do so?

A failure by the company to hold a meeting would not affect the existence of the company or the validity of any action by the company.

4. What is the quorum requirement under the Companies Act?

Section 64 of the Companies Act provides that a meeting may not begin until sufficient persons holding at least 25% of all the voting rights in respect of at least one matter to be decided on at the meeting are present. The percentage (25%) may be increased or reduced in the Memorandum of Incorporation. However, if a company has more than two shareholders, at least three shareholders must be present.

5. What are the requirements for valid notice of a meeting under section 62 of the Companies Act?

A section 62 notice of a meeting must be in writing, indicate the date, time and place of the meeting, indicate the general purpose of the meeting, contain a statement that a shareholder is entitled to appoint a proxy who may participate in the meeting and vote on his or her behalf, indicate that participants in the meeting have to provide proof of identification, be accompanied by a copy of any proposed resolution to be discusses at the
6. What is representation by proxy?
A shareholder may appoint someone (including someone who is not a shareholder) to act, speak or vote on his or her behalf at a shareholders’ meeting or provide or withhold consent in terms of section 60.

7. What is the difference between an ordinary and a special resolution?
Section 65(7) and (9) of the Companies Act provides for two types of resolution that may be taken by shareholders: an ordinary resolution, requiring more than 50% of the votes exercised, and a special resolution, requiring at least 75% of the voting rights exercised. A company is allowed to stipulate a higher percentage for approval of an ordinary resolution (except for the removal of a director) or a different percentage (i.e. higher or lower) for special resolutions in its Memorandum of Incorporation, on condition that there must always be a difference of at least 10% between the highest percentage required for an ordinary resolution and the lowest percentage required for any special resolution.

8. Is it possible to pass a resolution without holding a formal meeting?
Yes, by unanimous assent or in terms of section 60 of the Companies Act 71 of 2008.

9. What matters must be dealt with in the annual general meeting?
Section 61 of the Companies Act stipulates that at least the following matters must be transacted at the AGM:
- election of directors to the extent required by the Companies Act or the company’s Memorandum of Incorporation
- appointment of an auditor for the following financial year
- appointment of an audit committee
- presentation of the directors’ report
- presentation of audited financial statements for the immediately preceding financial year
- presentation of an audit committee report
- any matter raised by shareholders

10. When must a meeting be postponed or adjourned?
If, after one hour of the appointed time of a meeting, a quorum is not present, the meeting must be postponed for one week. In exceptional circumstances, it is possible to extend the one-hour period. A company’s Memorandum of Incorporation or rules may specify other time limits. No new notice needs to be issued regarding the meeting that has been postponed for one week, unless the venue changes.

The shareholders entitled to vote may, despite achieving a quorum, at any time decide to adjourn a meeting and set a date for a subsequent meeting at any agreed-upon time, as long as it is not later than 120 business days after the date of the original adjourned meeting.
**Activity 1**

The shareholders of Zithulele (Pty) Ltd want to pass a resolution regarding directors’ remuneration. Advise the shareholders regarding a possible alternative to holding a formal meeting as provided for under common law and in terms of the Companies Act to appoint the new director.

In English and South African case law, the common law rule of **unanimous assent** has been accepted. In terms of this rule, certain decisions may be valid without a meeting being held, provided that all the members are fully aware of the facts and all of them have assented thereto, The Companies Act also now provides another option. In terms of **section 60** of the Companies Act, 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. This means that the unanimous assent (where it is required that each and every shareholder agrees) is not required under **section 60**. As long as the **required majority agrees** in writing, a decision may be validly passed without convening a shareholders’ meeting. However, any business of a company that must be **conducted at an annual general meeting may not be conducted by using the section 60 procedure**. The appointment of new directors is a matter that could in terms of section 61 of the Companies Act be transacted at the company’s annual general meeting, so whether the option is available would be dependent on what the company’s Memorandum of Incorporation determines in respect of appointment of directors.

Electronic notice and electronic participation in meetings are allowed unless the Memorandum of Incorporation prohibits it (section 63(2) of the Companies Act).

**Activity 2**

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.

Zithulele (Pty) Ltd is a private company. Where every shareholder is also a director of the company (except in the case of a state-owned company), they can decide on any matter that must be referred to the shareholders by the board without having to give notice or comply with any other internal formalities, except as provided otherwise in the Memorandum of Incorporation (section 57(4)). Every director must be present at the board meeting at which the matter is referred to them in their capacity as shareholders. Both the quorum requirements for the meeting and the requirements pertaining to the taking of the decision must be complied with, irrespective of whether it is an ordinary or a special resolution.

**Activity 3**

At the shareholders’ meeting of Zithulele (Pty) Ltd, the chairperson, Mr Phakathi wants to adjourn the meeting because there are not enough shareholders to form a quorum. Advise the shareholders whether the meeting may be validly adjourned.
If, after one hour of the appointed time of a meeting, a quorum is not present, the meeting must be postponed for one week. In exceptional circumstances, it is possible to extend the one-hour period. A company’s Memorandum of Incorporation or rules may specify other time limits. No new notice needs to be issued regarding the meeting that has been postponed for one week, unless the venue changes.

The shareholders entitled to vote may, despite achieving a quorum, at any time decide to adjourn a meeting and set a date for a subsequent meeting at any agreed-upon time, as long as it is not later than 120 business days after the date of the original adjourned meeting.

Examples of questions from previous exams dealing with this topic:

**QUESTION 1:**

Explain whether or not it is possible for a resolution of shareholders to be passed without holding a general meeting of shareholders. Refer to the position in terms of the common law as well as the Companies Act 71 of 2008.

In English and South African case law, the common law rule of unanimous assent has been accepted. In terms of this rule, certain decisions may be valid without a meeting being held, provided that all the members are fully aware of the facts and all of them have assented thereto, although this need not be in writing. In *Gohlke and Schneider v Westies Minerals (Pty) Ltd*, 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*, 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.

Although it is still possible to apply the common law principle of unanimous assent, the Companies Act now provides another option. The general principle still remains that shareholders exercise their rights through resolutions at meetings. However, in terms of section 60 of the Companies Act, 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. This means that the unanimous assent (where it is required that each and every shareholder agrees) is not required under section 60. As long as the **required majority agrees** in writing, a decision may be validly passed without convening a shareholders’ meeting. However, any business of a company that must be **conducted at an annual general meeting may not be conducted by using the section 60 procedure**.

If there are dissenting shareholders (i.e. some shareholders who are not in agreement), it may be possible to use the procedure as prescribed in section 60 of the Companies Act, as long as the required majority agrees and it is not a matter reserved for the annual general meeting in terms of the Companies Act (see list below). The shareholders may by written polling of all shareholders entitled to vote on the election, pass the resolution. The company must deliver a statement within
QUESTION 2:

In terms of the company’s Memorandum of Incorporation, the preference shareholders do not enjoy voting rights at the general meeting. Ten per cent of the shareholders of Antlax Ltd are preference shareholders. A general meeting is called to decide on a proposed resolution that will materially alter the class rights of the preference shareholders. Tony, a preference shareholder, is very upset about the situation. He is convinced that the resolution forms part of a campaign of the other shareholders to get rid of the preference shareholders. Are the preference shareholders entitled to vote at the meeting? (2)

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.

QUESTION 3:

WoodInn (Pty) Ltd has two shareholders, Tom and Sue, each holding 50% of the issued share capital. Tom, Sue and Jack are the appointed directors of the company. Advise them regarding the following:

(a) Is the company required to hold an Annual General Meeting? (2)

In terms of the Companies Act, only public companies have a statutory obligation to convene annual general meetings. However, other companies may voluntarily hold such meetings. WoodInn (Pty) Ltd is a private company.

(b) What matters must be discussed at a company’s annual general meeting? (4)

Section 61 of the Companies Act stipulates that at least the following matters must be transacted at the AGM:

- election of directors to the extent required by the Companies Act or the company’s Memorandum of Incorporation
- appointment of an auditor for the following financial year
- appointment of an audit committee
- presentation of the directors’ report
- presentation of audited financial statements for the immediately preceding financial year
- presentation of an audit committee report
- any matter raised by shareholders
QUESTION 4:

Explain what is meant by a “right of pre-emption” on issue of shares. (2)

In terms of section 39 of the Companies Act, every shareholder in a private company (and a personal liability company) has the right, before any other person who is not a shareholder of the company, to be offered and to subscribe (within a reasonable time) for a percentage of any shares issued or proposed to be issued equal to the voting power of that shareholder’s general voting rights immediately before the offer was made. However, a company’s Memorandum of Incorporation may limit, negate or restrict this right with respect to any or all classes of shares of that company.

QUESTION 5:

Briefly discuss the different resolutions that can be taken in companies. Also indicate the quorum and majority requirements for passing different types of company resolutions. (6)

Section 64 of the Companies Act provides that a meeting may not begin until sufficient persons holding at least 25% of all the voting rights in respect of at least one matter to be decided on at the meeting are present. The percentage (25%) may be increased or reduced in the Memorandum of Incorporation. However, if a company has more than two shareholders, at least three shareholders must be present.

Section 65(7) and (9) of the Companies Act provides for two types of resolution that may be taken by shareholders: an ordinary resolution, requiring more than 50% of the votes exercised, and a special resolution, requiring at least 75% of the voting rights exercised. A company is allowed to stipulate a higher percentage for approval of an ordinary resolution (except for the removal of a director) or a different percentage (i.e. higher or lower) for special resolutions in its Memorandum of Incorporation, on condition that there must always be a difference of at least 10% between the highest percentage required for an ordinary resolution and the lowest percentage required for any special resolution.

QUESTION 6:

The Memorandum of Incorporation of Lynton (Pty) Ltd is silent on the issue of resolutions and the quorum requirements for meetings. In a general meeting it was proposed that Lynton (Pty) Ltd should enter into a joint venture with another company to tender for the building of a new railway. A special meeting was convened at which this matter would be voted on. Mr Khumalo, who holds 5% of the votes, Mr Selepe also holding 5%, Mr Moleke who holds 20% of the votes and Mrs Mbatha who holds 15% of the votes were in attendance. Mr Phiri, attending as a representative of Lincol Ltd that holds 40% of the votes and Mr Moloi as proxy for Mr Hurter who holds 5% of the votes were also present. On a vote by poll, Mr Moloi, Mrs Mbatha, Mr Moleke and Mr Selepe voted in favour of the resolution, whiel all the other persons in attendance voted against the resolution, except for Mr Khumalo who abstained from voting.
Indicate by considering the votes on this matter, what type of resolution could have been passed. Also explain the quorum requirements and the different majority requirements for the different types of resolutions that may be passed in companies.

Ordinary resolution: 50% plus 1 of exercised voting rights. Special resolution: 75% of exercised voting rights. MOI may indicate a different percentage of voting rights to approve any special resolution. Difference between ordinary and special resolution must remain at least 10%. An ordinary resolution was passed here.

**QUESTION 7:**

Bernadette is a shareholder of Sevenster Ltd. She is going to be overseas at the time that the company’s annual general meeting is to be held. She would have liked to vote on some of the matters that are going to be discussed at the meeting. Advise her regarding the possibility of appointing someone else to vote on her behalf at the meeting and set out the requirements that must be adhered to in terms of the Companies Act 71 of 2008.

Section 58 of the Companies Act 71 of 2008 determines that a proxy can be appointed. The appointment must be in writing and will be valid for one year, or for a specified period of time. The same person may be appointed as a proxy for more than one shareholder. The proxy can delegate the authority to act on the shareholder’s behalf to someone else. A copy of the appointment instrument must be available/presented at the meeting. A shareholder can cancel a proxy in writing or withdraw the appointment in writing.

**QUESTION 8:**

The board of directors of Speedy (Pty) Ltd proposed that a shareholders’ meeting be convened in order to discuss the liquidation on the company. Some of the shareholders received an agenda of the meeting, while others were not informed at all of the meeting or about what would be discussed at the meeting. With reference to the relevant provisions of the Companies Act 71 of 2008, discuss whether or not the statutory notice requirements for this meeting has been complied with.

A section 62 notice of a meeting must be in writing, indicate the date, time and place of the meeting, indicate the general purpose of the meeting, contain a statement that a shareholder is entitled to appoint a proxy who may participate in the meeting and vote on his or her behalf, indicate that participants in the meeting have to provide proof of identification, be accompanied by a copy of any proposed resolution to be discusses at the meeting, be given at least ten days prior to the meeting (15 days for public companies and non-profit companies with members). Speedy (Pty) Ltd is a private company and at least 10 days notice should have been given to all the shareholders in writing. The requirements have clearly not been complied with.
Learning Unit 9: Directors

1. What are the different type of directors recognised in the Companies Act and the King Code?

| executive directors | non-executive directors | independent directors |

2. How many directors do there have to be in a private company?

One

3. How many directors do there have to be in a public company?

Three

4. Who are ineligible to become a director?

- a juristic person
- an unemancipated minor/a person under legal disability
- a person who is ineligible in terms of the provisions of the Memorandum of Incorporation

5. Who are disqualified from becoming directors?

- a declared delinquent
- an unrehabilitated insolvent
- a person prohibited from being director in terms of a public regulation
- a person removed from an office of trust for misconduct/dishonesty
- a person convicted of fraud, dishonesty, theft or a related offence
- a person disqualified in terms of the provisions of the Memorandum of Incorporation

6. How are directors appointed and removed?

Upon 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. A person becomes a director of a company when that person

- 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 person to be an ex officio director of the company

A person will only become a director once he or she has delivered written consent accepting such a position. A director can be removed by shareholders and, in some circumstances, by the board of directors. Despite any provision contained in the company’s Memorandum of Incorporation or any agreement between the company and the director, removal may be affected by an ordinary resolution. The director must receive notice of the contemplated removal and be afforded the opportunity to make representations before the resolution to remove him/her is put to the vote.

A director who has been removed from office may apply to a court to review the determination of the board. This application must be brought within 20 business days from the date of a decision taken by the board. The court has a discretion whether to confirm the determination of the board. A removal in terms of section 71 does not detract from any right that the director so removed has to claim compensation or damages resulting from the loss of his/her office.

7. What are the duties of directors under the Companies Act?
The Companies Act of 2008 introduced a partially codified regime of directors’ duties, which includes the common law fiduciary duties and the duty to perform their functions with reasonable care and skill. The common law is not excluded by the statutory provisions and will continue to apply, except insofar as it is specifically amended by the Companies Act or is in conflict with its provisions.

Briefly summarised, the partly codified (statutory) duties of directors in the Companies Act entail the following:

- For the first time, the Companies Act places a specific duty on the board of directors to manage the company (section 66(1)).
- To disclose to the board any personal financial interest in matters of the company (section 75).
- Not to use the position of director or information obtained as director to gain an advantage for himself/herself or another person, or to cause harm to the company or a subsidiary (section 76(2)(a)).
- To disclose to the board of directors any material information (section 76(2)(b)).
- To act in good faith and for a proper purpose (section 76(3)(a)).
- To act in the best interests of the company (section 76(3)(b)).
- To act with reasonable care, skill and diligence (section 76(3)(c)).

The provisions in the Companies Act are subject to, and not in substitution of, any of the duties of directors under the common law.

8. What does the business judgment rule entail?

Section 76(4) of the Companies Act 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 the director

- 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/her 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 Companies Act.

In any proceedings against a director, other than for wilful misconduct or wilful breach of trust, a court may relieve the director of liability if it appears to the court that the director acted honestly and reasonably or it would be fair to excuse the director. A director will also escape liability where he or she had a rational basis for believing, and actually believed, that the decision was in the best interests of the company.

Activity 1

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 the day-to-day operations of the company.

Linda was elected as a director by the shareholders. However, he does not participate in the management of ABC Ltd or any of its subsidiaries. He 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 and the King Code. Indicate which types of directors Sam, Linda, Jack and Calvin would be classified as.

<table>
<thead>
<tr>
<th>You should have indicated that:</th>
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<tbody>
<tr>
<td>• Sam is an executive director.</td>
</tr>
<tr>
<td>• Linda is an elected director. Due to the fact that he does not participate in the daily</td>
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<tr>
<td>running of the business he is also a non-executive director.</td>
</tr>
<tr>
<td>• Jack is an <em>ex officio</em> director, because he is only a director due to his other appointment</td>
</tr>
<tr>
<td>in the company and was not elected as such.</td>
</tr>
<tr>
<td>• Calvin is a temporary director and an executive director.</td>
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</tbody>
</table>

**Activity 2**

Gary 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 very upset about this. Explain whether Centro Pharmaceuticals (Pty) Ltd will be able to lodge an application to have Gary declared as delinquent. If so, also explain what the effect of such an order will be.

In order to answer the question you will have to know and understand the following:

- Who may 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 as 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 consider appropriate and will be for at least seven years from the date of the order.

**Activity 3**

Steven was a director of Hamilton (Pty) Ltd but in 2015 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 will be able to apply to a court to suspend the order of delinquency.

Steven will be able to apply for the suspension of the order of delinquency as 3 years have passed 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.

**Activity 4**

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.

In your answer you should include the following points:

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 the Sibex Construction-case the directors resigned from their office to form a close corporation which competed directly with the 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.

**Activity 5**

Tinyiko is a non-executive director of Verytaste (Pty) Ltd. She attended a meeting where she became aware of the fact that the company defaulted on certain payments due to Distribo (Pty) Ltd who is responsible for the distribution of the company’s products. Distribo (Pty) Ltd had threatened to cancel the contract. However, Verytaste (Pty) Ltd's chief financial officer assured the board that this was only due to a temporary cash flow problem. Tinyiko relied on this assurance. Tinyiko does not attend the next two board meetings. At a subsequent board meeting Tinyiko learns that Distribo (Pty) Ltd cancelled the contract as a result of continual non-payments by Verytaste (Pty) Ltd. As a result of the interruption in distribution, Verytaste suffered a loss in excess of R5 million to the company. As a result, Verytaste (Pty) Ltd is placed in liquidation.

Answer the following questions relating to the set of facts provided above:

(a) On what basis can the liquidator possibly hold the directors liable for the loss that the company had suffered?

If a company fails as a result of decisions made or lack of proper decision making by the directors, the directors may under certain circumstances be held liable for breach of their duty to act with reasonable care, skill and diligence.
(b) How will the court determine whether or not the directors are liable for the loss? Refer to relevant case law in your answer.

In determining whether or not a director has breached the duty of care, skill and diligence *Fisheries Development Corporation of SA v Jorgenson* is of relevance. In this case it was held that:

- The extent of the director’s duty of care and skill depends to a considerable degree on the nature of the company’s business and on any particular obligations assumed by or assigned to him.
- The law does not require of a director to have special business acumen and that directors may assume that officials will perform their duties honestly.
- The fact that someone is a non-executive director does not exclude assumption of liability as section 76(1) of the Companies Act does not distinguish between a director and a non-executive director.

(c) Explain the defence that could possibly be raised by Tinyiko in terms of the Companies Act to avoid liability.

The Companies Act introduces the business judgment rule as a defence for directors. It is possible to escape liability despite having failed to act with the required degree of care, skill and diligence if the director 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.

In the set of facts in the question, the liquidator may try to hold the directors accountable for not performing their functions with reasonable care and skill. Because the common law remains despite the enactment of the Companies Act, the courts would look at decisions like *Fisheries Development Corporation of SA*. The Companies Act has a new defence that could be raised by directors who allegedly breached their duties. Whether or not Tinyiko would be able to rely on this defence must be determined on the facts of the specific matter. Perhaps you could also argue that she could escape liability because in terms of the Companies Act directors are allowed to rely upon information acquired from specific persons.

**Activity 6**

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.

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.

**Examples of questions from previous exams dealing with this topic:**
QUESTION 1:

Tim is a director of Kenza Ltd. A meeting is held where a decision has to be taken regarding the provision of financial assistance to one of Tim’s close friends, Jerry. Tim, knowing that the transaction would render it impossible for the company to pay its debts as they become due in the ordinary course of business, allows the decision to be passed.

With reference to the facts above, explain the procedure that must be followed against Tim in terms of section 162 of the Companies Act 71 of 2008. In your answer, you must discuss the following:

(a) Who can bring such an application. (3)

<table>
<thead>
<tr>
<th>Any one of the following may apply for a delinquency order:</th>
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<tbody>
<tr>
<td>• a company</td>
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<tr>
<td>• a shareholder</td>
</tr>
<tr>
<td>• a director</td>
</tr>
<tr>
<td>• a company secretary or prescribed officer</td>
</tr>
<tr>
<td>• a registered trade union/other employee representative</td>
</tr>
<tr>
<td>The <strong>Commission or Takeover Regulation Panel or a state organ</strong> may also in certain circumstances apply to declare a director delinquent.</td>
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</tbody>
</table>

(b) The grounds upon which such an order can be brought. (3)

<table>
<thead>
<tr>
<th>Grounds for the order:</th>
</tr>
</thead>
<tbody>
<tr>
<td>The person</td>
</tr>
<tr>
<td>• served as a director while disqualified, or</td>
</tr>
<tr>
<td>• acted as a director while under probation in a manner that contravened the order of probation</td>
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<tr>
<td>• grossly abused the position of director</td>
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<tr>
<td>• took personal advantage of information/an opportunity</td>
</tr>
<tr>
<td>• intentionally/ as a result of gross negligence inflicted harm on the company/subsidiary</td>
</tr>
<tr>
<td>• acted in a manner that amounts to gross negligence, wilful misconduct or breach of trust</td>
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</tbody>
</table>

(c) The relevant order sought. (1)

<table>
<thead>
<tr>
<th>The court may, in a declaration of delinquency, order that the person</th>
</tr>
</thead>
<tbody>
<tr>
<td>• undergo remedial education</td>
</tr>
<tr>
<td>• carry out a designated programme of community service</td>
</tr>
<tr>
<td>• pay compensation</td>
</tr>
</tbody>
</table>

(d) The consequences of such an order. (3)

| The person will not be allowed to serve as a director for a specific period of time. 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.

QUESTION 2:

List the different types of directors provided for under the Companies Act 71 of 2008.

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

QUESTION 3:

Andile is a director of Oldco Ltd. The company’s Memorandum of Incorporation determines that the directors are appointed for a period of two years. Six months after Andile’s appointment as director, the shareholders want to remove Andile from his post as director. Advise Oldco Ltd regarding the following:

(a) What type of resolution is required to remove a director from his position as director? (1)
Ordinary resolution

(b) Will Andile be able to claim damages from the company if he had not concluded a separate contract of employment with the company? (2)
Yes. In terms of section 15(6) of the Companies Act 71 of 2008 the Memorandum of Incorporation is binding between the company and each director. Section 71 of the Companies Act 71 of 2008 determines that a director may claim based on breach of contract.

QUESTION 4:

List the duties of directors in terms of the common law, and the Companies Act 71 of 2008. (5)

Briefly summarised, the partly codified (statutory) duties of directors in the Companies Act entail the following:

- For the first time, the Companies Act places a specific duty on the board of directors to manage the company (section 66(1)).
- To disclose to the board any personal financial interest in matters of the company (section 75).
- Not to use the position of director or information obtained as director to gain an advantage for himself/herself or another person, or to cause harm to the company or a subsidiary (section 76(2)(a)).
- To disclose to the board of directors any material information (section 76(2)(b)).
- To act in good faith and for a proper purpose (section 76(3)(a)).
- To act in the best interests of the company (section 76(3)(b)).
- To act with reasonable care, skill and diligence (section 76(3)(c)).
At common law, directors also have a duty of care and skill and a fiduciary duty.

**QUESTION 5:**

List three grounds on which an application can be brought against a director for an order declaring him or her delinquent in terms of section 162 of the Companies Act 71 of 2008.

The person
- served as a director while disqualified, or
- acted as a director while under probation in a manner that contravened the order of probation
- grossly abused the position of director
- took personal advantage of information/an opportunity
- intentionally/ as a result of gross negligence inflicted harm on the company/subsidiary
- acted in a manner that amounts to gross negligence, wilful misconduct or breach of trust

**QUESTION 6:**

The Memorandum of Incorporation of ABC (Pty) Ltd contains the following provisions:

1. If the company issues new shares, it must first be offered to existing shareholders.
2. Directors hold their office for life.

Azaria is a director of ABC (Pty) Ltd. The board of directors want to remove Azaria as director. Can she invoke the provisions in the Memorandum of Incorporation to prevent her removal, or to claim damages for her premature removal?

Azaria cannot prevent her removal. However, in terms of section 15(6) of the Companies Act 71 of 2008 the Memorandum of Incorporation is binding between the company and each director. Section 71 of the Companies Act 71 of 2008 determines that a director may claim based on breach of contract. So, she will be able to claim damages under the Memorandum of Incorporation even if she does not have a separate contract of employment.

**QUESTION 7:**

Phumudzo is a newly appointed director of Teebo Ltd. He has no previous experience as a director, and no special management qualifications. His son, Siphiso, is a second-year law student. Siphiso told Phumudzo that he need not be concerned about his new appointment, as the business judgment rule has been adopted into the South African corporate law. Siphiso requires some additional information regarding the application of this rule. Briefly explain what the business judgment rule entails and what must be proven in order to rely upon the rule.

The Companies Act introduces the business judgment rule as a defence for directors. It is possible to escape liability despite having failed to act with the required degree of care, skill
and diligence if the director 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.

QUESTION 8:

Phumudzo is a non-executive director of Rubberz (Pty) Ltd, a company that manufactures tyres. Phumudzo in his capacity as a director obtains information that a limited amount of rubber, which is used for the manufacture of tyres, is being sold very cheaply by a foreign company. Phumudzo resigns as a director of Rubberz (Pty) Ltd and incorporates Greatyears (Pty) Ltd. His company also manufactures tyres. Phumudzo then enters into a contract with the foreign company on behalf of Greatyears (Pty) Ltd for the purchase of the entire rubber stock.

Advise the directors of Rubberz (Pty) Ltd whether or not Phumudzo has acted in breach of his duties towards the company. Refer to relevant case law. (6)

There was a conflict between the directors’ interests and the interests of the company. When this is the case, it is indicative of a potential breach of fiduciary duties. 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 the Sibex Construction-case the directors resigned from their office to form a close corporation which competed directly with the 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.

In your answer you should 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 the Sibex Construction case the directors resigned from their office to form a close corporation which competed directly with the 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.

QUESTION 9:

Capricorn Construction (Pty) Ltd wishes to purchase a crane. Michael, one of the company’s directors, is instructed to buy the crane on behalf of the company. However, he fails to reach an agreement with the owner of the crane on behalf of the company. He resigns as a director of Capricorn Construction (Pty) Ltd and then concludes an agreement with the owner of the crane in his personal capacity. He purchases the crane for R50 000, and then sells it to Capricorn Constructions (Pty) Ltd at a fair price of R70 000. Discuss whether or not Michael’s conduct would qualify as a breach of his duties towards Capricorn Constructions (Pty) Ltd.

(6)
There was a conflict between the directors’ interests and the interests of the company. When this is the case, it is indicative of a potential breach of **fiduciary duties**. 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 the *Sibex Construction* case the directors resigned from their office to form a close corporation which competed directly with the 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.

When answering a question concerning the duties of directors, you should keep in mind that the standards of conduct as laid down in section 76 of the Companies Act, is only a partial codification of the common law duties. In other words, the cases decided before the enactment of the new legislation remains relevant. In the second activity you are asked specifically to refer to the cases. Let the wording of the question and the mark allocation to guide you in the exam.

**QUESTION 10:**

Identify the different types of directors in the following scenario’s:

| (a) Thandi is a director of Clean Ltd, and is also employed in terms of a contract of employment concluded with the company. | (1) |
| (b) Busi was elected as director by Clean Ltd’s shareholders. However, he is not employed by the company, and he only attends meetings and participates in the company’s business on an intermittent basis. | (1) |
| (c) Charl was elected as a director by the shareholders to stand in for Anna while she is on maternity leave. | (1) |
| (d) The Memorandum of Incorporation of Clean Ltd determines that the Chief Executive Officer (CEO) of Clean Ltd will also be a director. Percival has recently been appointed as the CEO. | (1) |
| (e) The Memorandum of Incorporation of Clean Ltd determines that the debenture holders of the company may appoint a director in order to promote their interests. They appoint Themba. | (1) |

- Thandi is an executive director
- Busi is a non-executive director
- Charl is a temporary director
- Percival is an *ex officio* director
- Themba is a Memorandum of incorporation (appointed) director

**QUESTION 11:**

Herman is an experienced quantity surveyor. He has extensive knowledge on the valuation of immovable property. Herman is approached to serve as a director of PropSite (Pty) Ltd, a small company that deals in property speculation. He agrees
to serve as a director on the understanding that he will not be involved in the day-
to-day running of the company. After two years, Herman has made a significant
coretribution to the company in terms of property valuation advice, but only when
he was specifically asked, and on an intermittent basis. He never attended the
board meetings and he has trusted the rest of the board to take all the other
decisions.

Herman is informed by the managing director that it was decided at the previous
evening’s board meeting that PropSite (Pty) Ltd should invest in a new property
development. The development site is in a rural area. Herman is aware of the fact
that potential losses are always higher in rural areas. However, he agrees that
the company should take the risk and invest in the development. PropSite (Pty) Ltd
proceeds with the development. After six months it becomes apparent that the
development is a failure. The company suffers a loss of R5 million. The
shareholders want to institute legal action on behalf of the company against the
board for breach of their duty of care and skill. Herman has heard that the
Companies Act 71 of 2008 has introduced the business judgment rule, which
apparently affects directors’ liability. Explain to Herman what the business
judgment rule entails. Also advise him whether or not it could protect him in these
particular circumstances.

- You should have mentioned that the court would use an objective test to
determine whether Herman had acted like a director would usually have acted
in the same situation. The court will also take into consideration objective
elements, such as Herman’s experience and qualification as a quantity
surveyor.
- Section 76(4) of the Companies Act 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 the director
  - 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/her
    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 Companies Act.
  - In any proceedings against a director, other than for wilful misconduct or wilful breach
    of trust, a court may relieve the director of liability if it appears to the court that the
   director acted honestly and reasonably or it would be fair to excuse the director. A
director will also escape liability where he or she had a rational basis for believing,
   and actually believed, that the decision was in the best interests of the company.

**QUESTION 12:**

Tshepo and Phineas are the directors of Dino (Pty) Ltd. The company’s liabilities
exceed its assets. Tshepo and Phineas are aware of the company’s financial
problems, but continue running the business in the hope that the company will
become profitable again. Dino (Pty) Ltd borrows R4 million from HelpU Bank Ltd.
Consider whether Tshepo and Phineas can be held personally liable in terms of
the Companies Act 71 of 2008 if the loan amount cannot be repaid.
Section 22(1) of the Companies Act 71 of 2008 regulates reckless and fraudulent trading. If directors continued running business knowing that company is insolvent with the intention to defraud creditor they can incur personal liability in terms of section 77 of the Companies Act 71 of 2008. (1)

QUESTION 13:

Indicate which groups of people are ineligible to be appointed as directors of companies in terms of the Companies Act 71 of 2008. (3)

- a juristic person
- an unemancipated minor/a person under legal disability
- a person who is ineligible in terms of the provisions of the Memorandum of Incorporation

QUESTION 14:

Which groups of persons may only become directors with the consent of the court, but are disqualified otherwise? (3)

- a declared delinquent
- an unrehabilitated insolvent
- a person prohibited from being director in terms of a public regulation
- a person removed from an office of trust for misconduct/dishonesty
- a person convicted of fraud, dishonesty, theft or a related offence
- a person disqualified in terms of the provisions of the Memorandum of Incorporation
1. Which companies are obliged to appoint an auditor?

Public companies and state-owned companies have to. Other companies such as private companies, personal liability companies or non-profit companies need not comply with the extensive accounting requirements set out in Chapter 3, except to the extent that the company’s Memorandum of Incorporation provides otherwise (section 34 of the Companies Act).

2. Who may be appointed as an auditor?

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, 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 to 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 a person who has complied with the prescribed education, training and competency requirements, who has made arrangements regarding his or her continued professional development where that individual is not a member of an accredited professional body, who is a “fit and proper person” to act as an auditor, and who 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 as a result of misconduct, who has been convicted of theft, fraud or forgery or other act of dishonesty or corruption, or who 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.

3. Which people are disqualified from becoming an auditor?

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.

4. At which meeting must an auditor be appointed?

At the annual general meeting

5. How often must an auditor be appointed?

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, and also does not apply to private companies. If a company appointed two or more joint auditors, the company is obliged to manage the rotation requirement in a way so as to ensure that all of the auditors do not stop acting as auditors within the same year.

If an auditor has served for two or more consecutive years and then ceases to be an auditor of the company, he or she will not be permitted to return before the expiry of at least another two financial years.

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. A new auditor must be appointed to replace an auditor who resigns within 40 business days after the filing of his or her resignation.

6. Which companies are obliged to appoint an audit committee?

Public and state-owned companies are required to have an audit committee.

7. For how long may the position of auditor remain vacant in a company?

A new auditor must be appointed to replace an auditor who resigns within 40 business days after the filing of his or her resignation.

8. Explain the procedure for the appointment of an auditor to fill a vacancy.

Before making an appointment, the board must propose to the audit committee, within 15 business days after the vacancy occurs, the name of at least one registered auditor to be considered to replace the auditor who resigned. The board of directors 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.

9. For how many consecutive years may the same auditor compile a company’s financial statements?

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.

10. What rights do company auditors enjoy?

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

11. How is the audit committee appointed?

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.

12. What are the duties of the auditing committee?

The audit committee must, for the year it is appointed, perform the following functions:

- nominate and appoint a registered, independent auditor
- determine the fees to be paid to the auditor and the auditor’s terms of engagement
- ensure that the appointment of the auditor complies with the Companies Act and other legislation
- determine the nature and extent of non-audit services that the auditor may provide or must not provide
- pre-approve any proposed agreement with the auditor for the provision of non-audit services
- prepare a report to be included in the annual financial statements
- describing how the audit committee has performed its functions
- indicating that the audit committee is satisfied that the auditor was independent of the company
- stating that accounting practices have been complied with in the company and that internal financial control has been exercised by the company
- receive and deal with complaints pertaining to the accounting practices and internal audit of the company or related matters
- make submissions to the board on accounting policies, financial control,
records and reporting

• perform other functions as determined by the board, including the development of policy in order to improve governance
• consider whether the auditor’s independence may have been prejudiced
• consider compliance with other criteria relating to independence or conflict of interest as prescribed by the IRBA

Activity 1

Suppose that Given is appointed as 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 through Europe and resigns from his position as auditor. On his return from Europe, Given re-applies for the position as auditor of Moonblue Ltd. Can Given be reappointed?

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 re-appointed as auditor of that company until after the expiry of at least two further financial years. Given would therefore not be able to be re-appointed as auditor of Moonblue Ltd after a six month period.

Activity 2

Suppose Hamid is appointed as auditor of Moonblue Ltd after Given resigns. 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.

Section 93 of the Companies Act provides that the company auditor has a right to access, at all times, the accounting records and all books and documents of the company. 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 (section 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 (section 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.

Examples of questions from a previous exams dealing with this topic:

QUESTION 1:

The Companies Act 71 of 2008 provides for the establishment of certain committees in companies, one of which is the audit committee.

(a) Which companies are obliged to appoint an audit committee?
Public and state-owned companies are required to have an audit committee.

(b) List three of the duties of the audit committee. (3)

The audit committee must, for the year it is appointed, perform the following functions:

- nominate and appoint a registered, independent auditor
- determine the fees to be paid to the auditor and the auditor’s terms of engagement
- ensure that the appointment of the auditor complies with the Companies Act and other legislation
- determine the nature and extent of non-audit services that the auditor may provide or must not provide
- pre-approve any proposed agreement with the auditor for the provision of non-audit services
- prepare a report to be included in the annual financial statements
  - describing how the audit committee has performed its functions
  - indicating that the audit committee is satisfied that the auditor was independent of the company
  - stating that accounting practices have been complied with in the company and that internal financial control has been exercised by the company
- receive and deal with complaints pertaining to the accounting practices and internal audit of the company or related matters
- make submissions to the board on accounting policies, financial control, records and reporting
- perform other functions as determined by the board, including the development of policy in order to improve governance
- consider whether the auditor’s independence may have been prejudiced
- consider compliance with other criteria relating to independence or conflict of interest as prescribed by the IRBA

QUESTION 2:

Explain how it is determined whether a corporation is required to audit its financial statements. Indicate four of the factors that are considered in doing so. (5)

The Companies Regulations of 2011 include a Public Interest Score (PIS) calculation which determines what the reporting duties of other categories of companies are. If a company holds assets in a fiduciary capacity with an aggregate value of over R5 million, an audit is required. The Companies Regulations of 2011 provide for both activity and size criteria to determine whether or not companies require audited financial statements.

The Regulations state that every entity is required to calculate its PIS at the end of each financial year. The score is calculated as the sum of the following:

- a number of points equal to the average number of employees (as determined by the Labour Relations Act 66 of 1995) of the company during the financial year;
- one point for every R1 million (or portion thereof) in third-party liabilities at year-end (these exclude shareholder loans and intercompany loans with
common shareholdings);

- one point for every R1 million (or portion thereof) in turnover during the financial year; and
- one point for every individual who, at the end of the financial year, is known by the company to directly or indirectly have a beneficial interest in the business.

Furthermore:

- For companies with a score below 100, an independent review is required if such companies are not owner-managed.
- If the company has a score below 100 and is owner-managed, there is no requirement for outside professional assistance.
- “Owner-managed” means that all shareholders are directors, or, in the case of a trust, that at least one of the trustees is a director.
- If the company is not owner-managed, and obtains a PIS score of 100 to 350, an audit is required if reports are internally compiled or an independent review if they are externally compiled.
- If the company is owner-managed with a score of 100 to 350, no professional intervention is required if reports are externally compiled, but an audit will be needed if the reports are internally compiled.
- If a company scores over 350 points, an audit is required regardless of whether the company is owner-managed or not.
- A company can subject itself to audits by choice (voluntarily).
### Learning Unit 11: The company secretary

1. **What types of company must appoint a company secretary?**

   Every public company or state-owned enterprise must appoint a company secretary who is knowledgeable about, or experienced in, the relevant laws. A private company, personal liability company or a non-profit company may voluntarily appoint a company secretary.

2. **Who is disqualified from appointment as a company secretary?**

   A person is disqualified from being appointed as a company secretary if he or she has been prohibited from being 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 from being 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.

3. **What are the duties of a company secretary?**

   Section 33(3) of the Companies Act provides that every company must, in its annual return, designate a director, employee or other person as the company’s compliance officer. Therefore, in the case of a company having a company secretary, the company secretary will automatically be the compliance officer. Section 88 of the Companies Act provides that a company secretary is accountable to the company’s board.

   The company secretary’s duties include, but are not restricted to,
   - 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 the Companies Act
   - ensuring that minutes of all shareholders’ meetings, board meetings and meetings of any committees of the directors, or of the company’s audit committee, are properly recorded in accordance with the Companies Act
   - certifying, in the company’s annual financial statements, whether the company has filed required returns and notices in terms of the Companies 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 the Companies Act, to every person who is entitled to it
   - carrying out the functions of a person designated in terms of section 33(3) (i.e. a person responsible for filing the company’s annual return)

4. **How can a company secretary be removed?**

   A company secretary can be removed from office by the company’s board, the company secretary may require the company to include a statement in its annual financial statements relating to that financial year setting out the company secretary’s contention as to the circumstances that resulted in the removal.
Activity 1

Mike is one of the directors of Oak Ridge Ltd. The company wants 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 by whom this company officer should be appointed. Advise Mike.

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. 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 assigned to the secretary by the directors. The secretary should be appointed by the directors of an existing company. The first secretary (i.e. of a new company) should be appointed as provided in section 86.

Examples of questions from previous exams dealing with this topic:

QUESTION 1:

Gontra Ltd, a company that was incorporated two days ago by Wendy, Tim and Nomagugu, does not have a company secretary. Explain whether or not it is necessary to appoint a company secretary. Also indicate what the duties of company secretaries entail. (6)

Gontra Ltd is a public company. In terms of the Companies Act 71 of 2008, a public company is obliged to appoint a company secretary. Yes, it is necessary to appoint a company secretary.

Duties of secretaries include:

- Providing the directors 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 the Companies Act;
- Ensuring that minutes of all shareholders’ meeting, board meetings and the meetings of committees or the directors or audit committee are properly recorded in accordance with the Companies Act;
- Certifying in the company’s annual financial statements whether the company has filed required returns and notices in terms of the Act and whether 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 the Companies Act to every person who is entitled thereto; and
- Carrying out the functions of a person designated in terms of s 33(3) of the Companies Act 2008 (person designated to ensure that the company complies with the record-keeping and disclosure requirements in the Act).
Dunkelfinger Ltd wish to appoint Mulalo as the company secretary, but the directors are uncertain whether or not Mulalo is suitably qualified. List three circumstances under which a person will be disqualified from being appointed as a company secretary in terms of the Companies Act 71 of 2008. (3)

A person is disqualified from being appointed as a company secretary if he or she has been prohibited from being 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 from being 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.
LEARNING UNIT 12: REMEDIES AND ENFORCEMENT
QUESTIONS AND ACTIVITIES

What legal remedies are available against directors who have abused their positions?

Section 162: declare him or her delinquent/ place him or her on probation.
Section 165: derivative action.
Section 71: Removal of director.
Section 77: to recover all financial losses/ costs suffered.

Who may make application for a director to be declared delinquent or be placed under probation?

- a company
- a shareholder
- a director
- a company secretary or prescribed officer
- a registered trade union/other employee representative

The Commission or Takeover Regulation Panel may also in certain circumstances bring an application.

What are the consequences for directors who have been declared delinquent?

The person may not serve as a director for the period for which he is declared disqualified/ until the order is suspended or set aside. In addition The court may, in a declaration of delinquency, order that the person undergo remedial education, carry out a designated programme of community service, and/or pay compensation.

When may a court place a director under probation?

A person may be placed under probation on the same grounds as for delinquency, and, in addition, on the following grounds:

- while serving as a director, the person was present at a meeting and failed to vote against a resolution despite the inability of the company to satisfy the solvency and liquidity tests
- while serving as a director, the person acted in a manner materially inconsistent with the duties of a director
- while serving as a director, the person acted in a way that had a result that was oppressive or unfairly prejudicial to a shareholder or another director, or that unfairly disregarded the interests of a shareholder or another director
- while serving as a director, the person acted in a way that had a result that the business of the company, or a related person, was being or had been carried on or conducted in a manner that was oppressive or unfairly prejudicial to a shareholder or another director, or that unfairly disregarded the interests of a shareholder or another director
- while serving as a director, the person exercised his or her powers in a manner that was oppressive or unfairly prejudicial to a shareholder or another director, or that unfairly disregarded the interests of a shareholder or another director
- within any period of ten years after the effective date, the person has been a director of more than one company, or a managing member of more than one close corporation, irrespective of whether concurrently, sequentially or at unrelated times; and during this time two or more of those companies or close corporations each failed to fully pay all of their creditors or meet all of their...
Discuss the derivative action in terms of section 165 of the Companies Act.

A derivative action is a lawsuit brought by a corporation shareholder against the directors, management and/or other shareholders of the corporation for a failure by management (In effect, the suing shareholder claims to be acting on behalf of the corporation, because the directors and management are failing to exercise their authority for the benefit of the company and all of its shareholders.)

Specific steps must be taken to institute an action in terms of section 165. The 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.

Demand (notice) to company:
A person can deliver a notice to a company demanding that it institute legal proceedings or take other steps to protect the company’s legal interests.

A demand may be delivered by
- a shareholder/person entitled to be registered as a shareholder
- a director
- a prescribed officer
- a registered trade union that represents employees, or another representative of the employees
- any person who is granted leave by the court to do so

The company may apply to court within 15 days of receipt of a demand to have the demand set aside if it is frivolous, vexatious or without merit. If the demand is not set aside, the company must appoint an independent person or committee to investigate the demand. This person or committee must report to the board. Within 60 days (or as long a court permits), action must be instituted or a refusal notice must be served on the person who made the demand.

Personal derivative action
The person who made the demand may apply to the court for leave to continue with proceedings in the name of or on behalf of the company if
- the company failed to take steps as required;
- the company appointed a person or committee that is not independent;
- the company accepted an inadequate report;
- the company acted in a way inconsistent with the reasonable report of an independent, impartial investigator; or
- the company has served a refusal notice.

What remedies are available to shareholders in order to protect their own rights?

Relief from oppressive or prejudicial conduct (section 163 of the Companies Act),
Dissenting shareholders’ appraisal rights (section 164 of the Companies Act), and
Application in terms of section 161 - declaration of rights.

In terms of section 163 of the Companies Act, a shareholder or a director may bring an application for the court to provide relief against oppressive or unfairly prejudicial conduct by the company.
The court enjoys a wide discretion to provide such relief. The order may include

- restraining the conduct complained of;
- appointing a liquidator if the company appears to be insolvent;
- placing the company under supervision and commencing business rescue proceedings;
- regulating the company affairs by amending the Memorandum of Incorporation or amending a shareholders’ agreement;
- directing an issue or exchange of shares;
- appointing directors in place of, or in addition to, all directors in office, or declaring any person delinquent or under probation;
- directing the company or any other person to repay the consideration that the securities holder paid for shares with or without conditions;
- varying or setting aside a transaction/contract;
- requiring the company to produce financial statements for the court or an interested person;
- ordering payment of compensation to an aggrieved person;
- directing rectification of the registers or records of the company; or
- an order for the trial of any issue as determined by the court.

What procedure must be followed in order to implement a dissenting shareholder’s appraisal right in terms of section 164 of the Companies Act?

Dissenting shareholders may, before the meeting, lodge a written objection to the resolution of the company.

Within ten business days after adoption of the resolution, the company must send a notice that the resolution has been adopted to each security holder who filed an objection and has not withdrawn the objection, or who voted in favour of the resolution. The shareholder may then demand payment of a fair value for the shares held by him or her.

The demand must be sent within 20 business days after receiving notice from the company that the resolution has been adopted, or, if no notice is received, within 20 business days after learning that the resolution has been adopted. The company must then, within five business days, make a written offer to pay an amount considered by the company’s directors to be a fair value, accompanied by a statement showing how the value was determined.

The offers made by the company to dissenting shareholders must all be on the same terms. The offer must be accepted within 30 business days after it was made. The company must pay the agreed amount within ten business days after the shareholder accepted the offer and tendered the share certificates or transferred the shares to the company or the company’s transfer agent. If the company fails to make an offer, or the offer is considered to be inadequate, the shareholder may apply to court to determine a fair value and for an order requiring the company to pay the shareholder that fair value.

If compliance with a court order would result in a company being unable to pay its debts as they fall due and are payable for the next 12 months, the company may apply to court for an order varying its obligations.

Which body is responsible for enforcement of the Companies Act?

The Companies and Intellectual Property Commission.
Name four alternatives envisaged in the Companies Act for addressing suspected contraventions of the Companies Act.

- Refer the dispute to the court.
- Refer the dispute for resolution by mediation, conciliation or arbitration to either the Companies and Intellectual Property Commission, the Companies Tribunal, or to an accredited entity.

What are the functions of the Companies and Intellectual Property Commission?

Once it has received a complaint regarding an alleged contravention of the Companies Act 71 of 2008, the Commission must decide whether or not to issue a compliance notice in respect of that complaint. It will decide whether or not to issue such a notice after conducting an investigation into the complaint. However, the Commission has other objects and functions, including promoting the use of alternative dispute resolution (“ADR”) procedures by companies in resolving internal disputes, promoting the reliability of financial statements, establishing a register of companies, advising the Minister Finance on company law matters, issuing guidance to the public regarding the 2008 Act, and carrying out research relevant to the Companies Act 71 of 2008.

How may the Companies and Intellectual Property Commission respond to a complaint that has been lodged?

- It can refuse to investigate because the complaint is frivolous or vexatious (except for ministerial complaints);
- Refer the complaint to the Companies Tribunal or other ADR agent or Direct an investigator to investigate the complaint.

Upon receipt of the report from the investigator the CIPC can:

- Excuse any person as a respondent;
- Refer the complaint to the Companies Tribunal, or take-over regulation panel (as the case may be);
- Issue a notice of non-referral, with a statement advising the complainant of any rights he or she may have to seek a remedy in court;
- Can purpose that the person meets with the Companies Tribunal or CIPC to resolve the matter by consent order
- Commence proceedings in court in the name of the complainant or Report the matter to the National Prosecuting Authority if the person committed an offence under other legislation or
- It may issue a compliance notice.

What are the functions of the Companies Tribunal?

It serves as a forum for voluntary ADR in any matter arising under the Companies Act and carries out reviews of administrative decisions made by the Commission. The Companies 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 Companies Act.

What is alternative dispute resolution?

It is an alternative dispute resolution process than the normal court process. Disputes are resolved through mediation/conciliation and arbitration. This procedure must be agreed upon by the parties, and the less formal process may exclude the necessity for legal representation.
1. Veronica and Precious intend starting a business together. They are unsure about what type of enterprise would be the most suitable for their business.

1.1 Explain the advantages attached to legal personality to them; (5)

The business is a separate legal entity distinct from its members. It can enter into contracts in its own name and sue and be sued. Its members are not liable for its debts and enjoy limited liability.

1.2 Explain whether it is possible to register a new close corporation. (2)

It is no longer possible to register new close corporations. Existing companies are prohibited from converting into close corporations. Already existent close corporations are permitted to continue and the Close Corporations Act 69 of 1984 is not repealed. Provision is however made for close corporations to convert into companies.

1.3 Is it possible to convert a close corporation into a company? (3)

Yes, it is possible in terms of schedule 2 to the Companies Act

2 Briefly explain whether the doctrine of constructive notice applies to close corporations. (3)

No. Third parties dealing with close corporations are not deemed to know the contents of the registration documents of a company. All members are agents of the close corporation and unless one of the exceptions apply in the circumstances members can conclude binding contracts on behalf of the close corporation, whether or not they fall in the scope of the close corporation’s business (section 54 of the Close Corporations Act)

3 Briefly define the following terms or concepts:

3.1 Association agreement

Optional agreement concluded between members in a close corporation to regulate the internal affairs in the business.

3.2 Member’s interest

Member’s interest is an incorporeal, moveable thing that is transferrable in the way prescribed by the Close Corporations Act.

3.3 Founding statement

Form CK 1) The only constitutive document required for registration of a close corporation

3.4 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.)
4 Set out the requirements that must be adhered to in terms of the Close Corporations Act for a close corporation to make a payment to its members in their capacities as members. (3)

Section 51 of the Close Corporations Act applies to payments made to members in their capacity as members. Solvency and liquidity must be maintained. Written consent of all the members is required.

5 Three friends, Sello, Khomiso and Bonang run a catering business, Mnandi CC, together. They have decided that it would be beneficial to involve more people in the running of the business. Indicate whether or not the following persons can become a member of a close corporation. Also in each case note what (if any) further requirements need to be adhered to in order for them to become a member.

5.1 A minor. (2)
Yes. Must be supported by a parent/guardian.

5.2 A close corporation. (2)
No. Only natural persons may become members of close corporations.

5.3 An unrehabilitated insolvent. (2)
Yes. Requires support from a trustee/liquidator

5.4 A person under legal disability. (2)
Yes, but requires support from his/her curator or the court

5.5 A trustee of a trust. (2)
Yes. A natural or juristic person in the capacity of a trustee of a testamentary or *inter vivos* trust may become a member of a close corporation subject to conditions set out in the Close Corporations Act. However, the restriction in membership to the maximum of ten members still applies.

6 Johan, Aubrey and Barbara are the members of ProperT CC. The main business of the corporation is buying and selling of immovable property. The close corporation wishes to buy a certain property for development and resale. Barbara, being fully aware of the fact that the close corporation wishes to purchase the property, buys it in her personal capacity for R2 million. She then sells it to the close corporation for R3 million.

6.1 What duty could Barbara have breached under the circumstances and what does this duty entail? (Indicate to whom the duty is owed and the scope of this duty) (6)

The fiduciary duty. This duty is owed by members of the close corporation to the close corporation. The Close Corporations Act provides that a member should

- act honestly and in good faith, and, in particular,
- exercise powers in order to manage or represent the corporation in the interest of the corporation
- not act without or exceed such powers

- avoid a conflict of interest between his or her own interests and those of the close corporation, and, in particular,
6.2 What effect would the breach of this duty have on the validity of the agreement of sale of the property? (2)
The contract will be voidable at the option of the close corporation. Application can, however, be made to the court to declare the contract as binding on the parties despite the failure to disclose.

6.3 What possible legal action/s can possibly be instituted against Barbara and who should institute the action/s? (2)
In the event that the fiduciary duties are breached, a member may be held personally liable for any loss suffered by the corporation or for debts incurred as a result of such a transaction (s 42(3)). The member would, in such event, have to repay any profit made by him or her unless all the members approve this conduct in writing. Any of the other members can institute the action.

7 **TRUE OR FALSE**
Indicate whether the following statements are true or false. Please substantiate each of your answers.

7.1 If one of the members of a close corporation’s estate is sequestrated, the close corporation terminates automatically. (2)
False. A close corporation, like a company, has legal personality. One of the benefits is that a close corporation’s estate is separate from the estates of the composing members.

7.2 The Companies Act 71 of 2008 makes it impossible for new members to join a close corporation. (2)
False. In terms of the Companies Act, it is no longer possible for new close corporations to be incorporated, but it is possible for new members to join existing close corporations. Member’s interest can be acquired by
- acquiring member’s interest from existing members
- making a contribution to the close corporation

7.3 If a member of a close corporation fails to make his initial contribution to the close corporation, the only resulting disadvantage for him is that he will not be allowed to vote. (2)
False. A member who fails to make his or her agreed upon contribution can be held personally liable for the debts of the close corporation.

**QUESTION 8**
Indicate the CORRECT statement:

(1) An association agreement is not a prerequisite for the formation and running of a close corporation.
(2) The manner in which an insolvent member’s estate may be disposed of can be regulated in an association agreement.
(3) The manner in which members will settle disputes may not be regulated in the association agreement.
(4) The procedure to be followed at meetings may not be regulated in the association agreement.

QUESTION 9

Choose the CORRECT statement:

If a member of a close corporation fails to act with the required degree of care and skill…

(1) He or she will be liable for all the corporation’s debts.
(2) He or she will be liable even if the corporation did not incur a loss.
(3) He or she will be liable for the loss caused by his or her actions.
(4) He or she will incur liability for negligent acts even if all the other members had approved in writing.

QUESTION 10

Jo is a member of Best Bikes CC. The business of the close corporation is to manufacture motorcycles. The association agreement provides that Jo may not enter into contracts on behalf of the close corporation where the value of the contract exceeds R10 000. Jo, a keen sportsman, concludes a contract on behalf of the close corporation with Dina for the purchase of soccer balls to the value of R12 000.

Indicate the CORRECT statement:

(1) The contract will bind Best Bikes CC, because Jo is a member of the close corporation and Dina was unaware of the restriction on his authority.
(2) The contract will not bind Best Bikes CC, because the contract falls outside the close corporation’s main business.
(3) The contract will bind Best Bikes CC due to the operation of the Turquand rule.
(4) The contract will not bind Best Bikes CC, because Jo’s authority to bind the close corporation is limited by the association agreement.

QUESTION 11

Indicate the CORRECT statement:

(1) There is a division between the providers of capital and the management of a close corporation.
(2) Under certain circumstances a close corporation may repay capital amounts to its members.
(3) The aim of a close corporation must be to generate a profit.
(4) A close corporation can have shares and share capital.
1. Who was the presiding officer in this matter?

Plasket J

2. What kind of business is the 2nd respondent in this matter?

A close corporation

3. Was the member’s interest in this business awarded in terms of the members’ contributions? (para [10])

No. ‘There was no monetary and/or resource injection that determined the percentage allocation in the business on the part of the first respondent. I provided the necessary resources for the second respondent to get operational.’

4. In terms of which two sections of legislation did the applicant apply for relief? (refer to para [2])

Section 36 and 49 of the Close Corporations Act.

5. What orders is the applicant seeking? (paras [2], [21] – [22])

Termination of the first respondent’s membership, an order determining the method for valuation of the member’s interest and an order directing him to sell the interest to her.

6. Briefly summarise the facts that are relevant to the applicant’s claim that she had been prejudiced unfairly by the first respondent.

The first respondent gave 500 pregnant ewes to his brother and eight rams. He refused to listen to the applicant. He also refused to service the loans from Uvimba Finance. He appeared to be unconcerned that the applicant’s property had been encumbered as security for the loans and that she was consequently at risk. In the meantime, the interest on the loans increased. He also failed to pay the telephone and electricity accounts with the result that these services were terminated by the respective providers. The first respondent ejected the applicant from Westondale Farm. Not surprisingly, the applicant was of the view that by this stage her and the first respondent’s relationship had broken down completely. Great animosity existed between them. She had to be accompanied by the police to retrieve personal belongings from the farm. In January 2013, a property owned by the applicant was attached and sold in execution in order to repay part of the loan owed by Westondale Farming to Uvimba Finance. The first respondent continues to farm and he keeps the proceeds of the farming operation for himself. In addition, he has, from August 2009 to April 2013, made unauthorised
withdrawals from Westondale Farming’s account in excess of R1 600 000. He has refused to account to the applicant for his withdrawals of cash. The first respondent made sporadic payments of money into the applicant’s account in respect of three motor vehicles used by Westondale Farming but purchased by the applicant. Payments for the vehicles were, in turn, deducted from the applicant’s account. As a result of the sporadic nature of the payments, one of the vehicles was re-possessed and the applicant had to pay R16 684 in order to regain possession of it. However, he purchased a further three vehicles with funds of Westondale Farming. He gave these vehicles to a nephew, the brother of his lover and a second nephew.

How did the court in *De Franca v Exhaust Pro CC (De Franca Intervening)* explain when section 36 of the Close Corporations Act would apply and when section 49 would apply (para [25]).

In *De Franca v Exhaust Pro CC (De Franca Intervening)*, Nepgen J dealt with both s 49 and s 36 and their respective requirements in the context of a breakdown in the relationship between the two members of a close corporation. He said:

‘Section 49 deals with the situation where conduct (an act or an omission) of the close corporation or of one or more of its members, or where the manner in which the affairs of the close corporation are being conducted, is unfairly prejudicial, unjust or inequitable to a member of the close corporation. When this occurs such member may make application to the Court for an order that will have the effect of “settling the dispute” (s 252 of Act 61 of 1973 provides for an order having the effect of “bringing to an end the matters complained of”) . . . The Court has a wide discretion with regard to the order that it decides to make in the relationship between the two members of a close corporation, but such member is not required to establish conduct affecting him. It is the carrying on of the business of the close corporation that must be affected, either by the existence of circumstances envisaged by ss (1)(a) or by conduct as described in ss (1)(b) and (1)(c).

Subsection (1)(d), however, gives wide and virtually unlimited scope for the application of s 36 of the Act, the only limitation being the “just and equitable” requirement. The order that a Court can make in terms of s 36(1) of the Act is circumscribed, namely an order that a member shall cease to be a member of the close corporation. Once a Court decides that an order for such cessation of membership should be made, it has a discretion to make further orders as referred to in s 36(2) of the Act. While a Court could, applying the provisions of s 49 of the Act, make an order compelling one member to purchase the interest of another, which would have the effect of such member's membership in the close corporation ceasing, that which would have to be established before this is done is quite different to what would have to be established under s 36 of the Act.’

What section of the legislation does the court decide is more appropriate in these specific circumstances, and why? (paras [26] and further)

[26] On the facts of this matter either s 36 or s 49 could be applied. That said, it seems to me that s 49 is the most apposite section to apply: while the focus of s 36 is on the effect of a member’s capability or conduct on the business of the close corporation, the focus of s 49 is on the effect of conduct of either the close corporation or a member or members on another member. The applicant’s complaint in this matter is, ultimately, that the first respondent’s
conduct – his acts and omissions – are unfairly prejudicial, unjust or inequitable to her. I shall, accordingly, deal with the matter in terms of s 49, although I am of the view that the same result would follow from the application of s 36 and that the cases dealing with s 36 are, by and large, applicable to s 49 as well.