

COMPANY LAW

Only study guide for **LML406-T**

DEPARTMENT OF MERCANTILE LAW



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Introduction to the study guide

Welcome to Company Law (LML 406–T). This module consists of selected topics concerning company law and the law of close corporations.

The learning outcomes of this study module are that learners

- are able to identify, analyse and solve complex legal problems relating to certain aspects of company law and the law of close corporations
- can engage with legal text in order to critically evaluate different viewpoints on corporate law issues
- will acquire the academic knowledge and skills relating to corporate law to enter a career in law.

How to use the study guide

The purpose of this study guide is to guide and direct you through your prescribed textbook, the applicable legislation and the relevant cases. In order to use this study guide effectively, you must have your copy of the prescribed textbook and the casebook at hand. You will also need access to the relevant section(s) of the prescribed legislation. (A list of the prescribed material appears at the end of this introduction.)

We suggest that you start each study unit by reading through the chapter of the prescribed textbook referred to in the study unit. Then go back to the first heading of the study unit and read, study and attempt to understand the material from the textbook referred to under that heading. Also study any comments made in the study guide, as well as any legislation or cases to which you might have been referred. Note that the comments contained in the study guide are there to complement the textbook, the casebook and the legislation. These materials must therefore be studied in conjunction with one another. We advise you to make summaries incorporating the study guide and the textbook, any legislation and relevant cases. This will ensure that you have all the material conveniently at hand and you can use these summaries when you study for the examination.

Here are a few pointers for when you study the case extracts to which you have been referred. You need not memorise the full citation of the case but you must know its name. Read the extract through before you start making a summary. Sometimes a case establishes an important legal principle. Sometimes you will need to make a very short summary of the facts because those might be the type of facts you could be asked to consider and give advice on in an examination question. You must extract from the case what is relevant to the legal concept that you are studying.

As far as the relevant legislation is concerned, you do not have to learn the wording of any section exactly as it appears in the particular statute. You can put it into your own words and it is, in fact, advisable to do so to ensure that you understand it. However, you must know what the section prescribes. For example, if the section lists a number of requirements which must be satisfied before a valid act can occur you must know what these are.

After you have mastered the material under the first heading, we suggest that you complete the activity. Try to do the activity without looking at the feedback. The activities are a very important part of the study material and we encourage you to do them. They will help you come to grips with the relevant concepts and you will learn by doing them. They will also give you the practice you need to achieve the learning outcome(s) of the study unit. Completing the activities is the only way to keep a constant check on your progress through the prescribed material.

When you have finished the activity, compare your answer with the guidance provided in the feedback. This will make it clear to you whether you understood the study material and, if not which parts you did not fully grasp. If there was anything you clearly did not understand, go back and read the material again. If you still have problems, please contact one of your lecturers. Do not wait until you are trying to study for the final examination. If you feel you have mastered the work, then you should proceed to the next heading.

After you have gone through all the material in the study unit and you are confident that you understand and have learnt all the work, attempt the self-assessment question(s) for that unit. If you are able to successfully complete the questions under examination conditions, you have achieved the learning outcome of that study unit.

Use your integrated summaries of the study guide, the textbook, any legislation and relevant cases which you have made during the semester to study for the examination. Ensure that you have updated these with any material you might have received during the year in the tutorial letters.

If you understand all the concepts covered in the study material, we suggest that you **memorise** the work. Remember that when you write your examination you will not have access to the study material. You are not adequately prepared for the examination if you simply understand the work and have made lengthy summaries. Although understanding and summarising all the legal concepts, the legislation and the cases is a big step in the right direction, you are still required to learn the work and be able to apply it to a set of facts. No answer in the examination will be complete unless it is clear that the application is based on a proper understanding of the relevant legal principles.

Structure of each study unit

This study guide is divided into different **study units**. The structure of a study unit is explained below.

The learning outcome

At the beginning of each study unit there is a statement of the **learning outcome(s)** of that unit. The learning outcome(s) of each study unit is that you are able to apply the law dealt with in that unit to a factual situation. However, you will see that at the beginning of each study unit you are told exactly what you must understand and know in order to achieve the learning outcome of the unit. These include the law on a particular topic (the common law, as well as the applicable statutory provisions) and/or cases relevant to that topic. It is not sufficient to have only a general understanding of the legal concept and the cases considered in a study unit. Remember that in the examination you will not have the prescribed material at hand. To answer an examination question on a particular topic in a satisfactory manner, you will therefore need to have committed the law relating to the topic to memory. Do not underestimate the time this may take when preparing for an examination.

If you work through the study unit carefully and methodically and you understand and also **learn** the law and the cases which are prescribed, you will achieve the learning outcome(s) of the unit. You can check whether you have succeeded by answering the self-assessment question at the end of each study unit (without, of course, first looking at the feedback provided). See also the comments on the self-assessment and feedback.

Prescribed material

A statement of the **prescribed material** for that unit follows. You are referred to the relevant chapter or paragraphs in *Corporate Law* (the prescribed textbook), the applicable sections in the relevant statute and the relevant cases. Sometimes you are also referred to text or notes which appear in *Hahlo* (the prescribed casebook).

A number of sections of the Companies Act 61 of 1973, the Close Corporations Act 69 of 1984 and the Insider Trading Act 135 of 1998 form part of the prescribed material. The full name and number of the statute will not always be given but it will be clear which statute and which section are being referred to.

As far as the cases are concerned, you are referred to the case number which appears in *Hahlo*. **Note** however that *Hahlo* does not contain cases dealing with the law of close corporations and some cases dealing with company law. Important cases not dealt with in *Hahlo* will be specifically dealt with in the text of the relevant study unit. If

you are referred to a case in the study unit, you are required to study the extract which appears in *Hahlo* or the discussion which appears in the guide. You are **not** required to obtain and study the whole case.

Headings and sub-headings

The prescribed material you need to understand, study and apply in order to achieve the learning outcome(s) of the study unit is also set out under **different headings and sub-headings**.

You will find comments on some aspects of the prescribed material which fall under that heading. The length of the comment will vary depending on the complexity of the subject matter and how it is dealt with in the prescribed textbook.

Some comments on the relevant cases and legislation which form part of the prescribed material may also be included. These comments are **not** meant to replace or summarise what is contained in the textbook or casebook. They usually provide an explanation or an additional note in order to assist you to understand the material.

Activities and feedback

Activities and **feedback** on the activity are included under most headings. The activities contains questions relating to the subject matter which has been covered.

We strongly advise you to attempt the activities as you go through the relevant material. This will give you a good indication as to whether you understand the concepts, the provisions of the relevant statutes and the cases involved. In order to successfully complete an activity you will have to understand the work to which it relates. The feedback does not contain a full model answer, but it will direct you to the legal concepts, the legislation and the cases you will need to have mastered in order to successfully complete the activity.

Self-assessment and feedback

At the end of each study unit you will find one or more **self-assessment** question(s) and **feedback**. A self-assessment question is based on one or more of the important aspects of the work covered in the study unit and requires you to apply what you have learnt to a set of facts. The feedback will direct you to the legal concepts, the legislation and the cases you will need to have mastered to successfully complete the self-assessment.

The self-assessment question(s) exemplify the type of questions you can expect in the examination. The feedback will lead you to the type of answer we would expect from you if a similar question should appear in the examination paper.

Prescribed Material

In addition to this **study guide** and **tutorial letters** (which you will receive during the year) the prescribed material for this module consists of the following:

- Cilliers HS, Benade ML, Henning JJ, Du Plessis JJ, Delpont PA, De Koker L, Pretorius JT *Corporate Law* 3ed (2000)

Note that any reference to “Corporate Law”, “the prescribed textbook” or the “textbook” is a reference to this book.

- Pretorius JT, Delpont PA, Michele Havenga & Maria Vermaas *Hahlo’s South African Company Law Through the Cases* 6ed (1999)

Note that any reference to “Hahlo”, “the prescribed casebook” or “the casebook” is a reference to this book.

- The Companies Act 61 of 1973 (as amended)
- The Close Corporations Act 69 of 1984 (as amended)
- The Insider Trading Act 135 of 1998 (as amended)

These statutes are available in Pretorius *Companies Act 61 of 1973 and Close Corporations Act 69 of 1984 Including the Insider Trading Act 135 of 1998* (Juta) and Strydom *Company Legislation Handbook* (Butterworths).

Please ensure that you have an up-to-date version of the legislation.

Conclusion

We hope that this study guide will lead you through the prescribed textbook, the applicable legislation and the relevant cases and that you will acquire an understanding of the legal concepts which are important in the context of company law and the law of close corporations. We encourage you to contact one of your lecturers if you require any help with this module.

General introduction to company law

In this general introduction we briefly refer to those aspects of company law which we assume you already have a working knowledge and understanding of as you embark on this course. You will not be directly examined on this material, in other words no specific questions will be asked on aspects discussed here that are not also discussed in the prescribed study units. You may, however, need to draw on this information and knowledge in order to fully understand the legal principles discussed in the prescribed study material and apply those principles to factual situations. Should you wish to read further on any of these aspects, the relevant chapters in the prescribed textbook are indicated under the appropriate headings below.

The company as a legal person

Chapter 1 of the prescribed textbook deals with the concept of the company as a separate entity with a legal personality separate from those of its members (the shareholders). This has various consequences that are attractive to businessmen and investors alike. For example, a company can sue and be sued in its own name and has its own rights, assets and liabilities. Thus the entrepreneur and investor enjoy the benefit that their personal exposure to risk and liability is, generally, limited.

The concept of a company as a separate entity from the moment of its incorporation, often referred to as the principle in *Salomon v Salomon* after the decision in the leading English case of *Salomon v Salomon & Co Ltd* [1897] AC 22, is firmly entrenched in South African law. Thus the courts recognise a legal person's right to sue for defamation. Also, the rights of juristic persons are confirmed in the South African Constitution, which provides that a legal person is entitled to the rights contained in the Bill of Rights, to the extent required by the nature of the company and the nature of the rights concerned.

The benefit of legal personality can, however, be revoked. The corporate entity can be disregarded in various circumstances, either by the legislature, or by the courts. But generally the approach followed by the courts will be to try to give effect to a company's separate legal personality rather than to disregard it.

South African company legislation

The Companies Act of 1973 applies to every company incorporated under the Act, as well as to every external company with a place of business in South Africa and to every

company that was a company in terms of any Act repealed on the commencement of the Companies Act (of 1973). The Act is not a complete codification of the law applicable to the companies regulated by it and common-law principles form the wider backdrop.

The first Companies Acts in South Africa were modelled very closely on existing English law. The Companies Act of 1973, which came into operation following the report of the Van Wyk de Vries Commission, marked a clear divergence from English law. However, some of the old English doctrines are still to be found in our law despite having since been abolished or watered down in the English law, where they originated. You will, for example, encounter the doctrine of constructive notice and the *Turquand* rule in **Study unit 6**. The history of South African company law and envisaged future development are described in **Chapter 2** of the textbook.

Types and forms of companies

Two main types of companies can be incorporated in terms of the Companies Act of 1973, namely companies with a share capital and companies without a share capital (ie companies limited by guarantee). A further distinction is drawn between different forms of companies, namely public and private companies. Companies having a share capital can be either public or private companies, but all companies limited by guarantee are deemed to be public companies. The types and forms of companies are discussed in **Chapter 3** of the textbook. The characteristics of the particular kinds of companies are set out in **Chapter 4**. It is important to note that one kind of company may be converted into another. The requirements for the various permissible conversions are also discussed in **Chapter 4**.

Pre-incorporation contracts

In terms of the common law it is not possible for a person to act as the agent of a principal not yet in existence. If the principal does not yet exist, it is obviously impossible for the principal to authorise someone to act as his/her/its agent. **Section 35** of the Companies Act of 1973 was enacted to overcome this problem. It provides that, if the requirements of the section are met, a contract concluded on behalf of a yet to be incorporated company may bind the company, after its incorporation, as if the company had already been incorporated when the contract was concluded. This section is discussed in **Chapter 5** of the textbook. Also discussed in this Chapter are the various common-law methods which could be used to achieve the same result. The common-law methods have the advantage that details of the particular contract concluded on behalf of the company need not be disclosed. They may, however, carry certain other disadvantages. For example, the agent may incur personal liability if the company does not, after its incorporation, ratify the contract.

The constitution of the company

The formal requirements for the registration of a company are discussed in **Chapter 6** of the textbook. This Chapter also discusses the memorandum of association and articles of association of a company, which together form its **constitution**, as well as the legal nature of these two documents. The **memorandum** is the **founding document** of a company. It defines the company's structural qualities. The **articles of association** regulate the **internal affairs** and administration of the company, and determine the authority of persons acting on its behalf. A company having a share capital may have articles which consist of either Table A of Schedule 1 to the Companies Act of 1973, which applies to public companies, or of Table B of Schedule I, which applies to private companies (s 59 of the Companies Act of 1973). Alternatively, the company may have a completely original set of articles, drawn up to suit the particular needs of that company. A company limited by guarantee may not adopt Table A, because it does not have a share capital.

No provision in the articles may contravene the Companies Act of 1973, nor any other statutory or common-law rule. The memorandum and articles should be read together in the event of an obscurity in either of them. Should there be a conflict between these two documents, the memorandum will override the articles and the provision(s) in the articles will therefore be void to the extent of the conflict.

The memorandum and articles constitute a contract between the company and its members, in their capacity as members, as well as between the members amongst themselves. No other contractual relationship arises from the company's constitution. There is, for example, no contractual relationship between directors and the company, unless the parties have entered into a separate contract.

Division of corporate powers

General meetings are discussed in **Study unit 1** of this study guide and directors in **Study unit 2**. It is important to take note of the relationship between these two governing organs of a company. The **board of directors** carries out the active **management** of the company's affairs. If the constitution of the company has entrusted the board with certain functions, the board acts as an **autonomous organ** of the company and the general meeting cannot interfere with its decisions. In such matters the general meeting can only interfere if the board cannot or will not act. But the ultimate control rests in the hands of the general body of members, in the sense that for most major decisions the Companies Act of 1973 prescribes the requirement that the consent of the company in general meeting must be obtained. The general meeting is also normally empowered in the articles to prescribe regulations which the directors have to follow (Table A art 59; Table B art 60). It may further remove a director from office at any time, notwithstanding anything contained in the company's constitution or in a separate agreement between the company and the director (s 220 of the Companies Act of 1973).

It is common practice for directors to appoint one of their number as managing director of the company. The articles must specifically provide for such an appointment. The terms of the managing director's appointment are regulated in a separate agreement with the company. The position of the managing director is discussed in **Study unit 5**. Here it is important to note that the managing director is usually entrusted with the power to manage the whole or a material part of the company's business and to do everything that is necessary for that purpose. Thus the managing director may also act as an organ of the company.

Protection of minority interests

The protection of minority interests is not a prescribed topic for this module. You will, however, encounter references to possible actions by shareholders in some of the prescribed study units. Remember that company law is based on the principle of majority rule. The majority of votes in a company determine how its domestic affairs are run. There is, generally, no restriction on shareholders concerning how they should vote and, unlike directors, shareholders do not have any fiduciary obligation to their company. Also, since a company enjoys a separate existence, the company itself should act against wrongdoers. If the wrongdoers control the company, it is unlikely that this will be done. These principles have collectively become known as the rule in *Foss v Harbottle*, after the English decision in *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189. The application of this rule, and the need for personal or derivative shareholder actions to alleviate its operation, are discussed in **Chapter 19** of your textbook. Note that personal and derivative actions are available both at common law and in terms of the Companies Act of 1973. Members may also have remedies available in their private capacities (for example, a member who is also a director may enforce obligations which arise under a service contract). These private remedies are not affected by the rule in *Foss v Harbottle*.

General meetings

The learning outcome of this study unit is that you are able to apply the provisions of the Companies Act relating to voting rights and resolutions at meetings of members to a given set of facts.

In order to achieve this outcome you must know and understand:

- the different kinds of meetings that can be held by members of a company
- how the voting rights of members are determined
- the voting procedures that can be used at meetings
- the difference between ordinary and special resolutions
- how unanimous assent can replace resolutions at meetings.

Prescribed Material

Corporate Law Chapter 8 **excluding** paragraphs 8.06–8.41; 8.57–8.60

Companies Act sections 179; 193–195; 197–203

Pender v Lushington (1877) 6 ChD 70 [case 124]

In re Duomatic Ltd [1969] 2 Ch 365; [1969] 1 All ER 161 [case 136]

Gohlke and Schneider v Westies Minerale (Edms) Bpk 1970 (2) SA 685 (A) [case 36]

KINDS OF MEETINGS OF MEMBERS

***Corporate Law* pars 8.01–8.05**

***Companies Act* s 179**

In our **General Introduction to Company Law** we said that you should already be familiar with the relationship between the company organs, namely the general meeting, the board of directors and the managing director. You may recall from your previous studies that the division of powers depends on the provisions of the company's articles, that the management functions are usually entrusted to the directors but that the members retain control over the directors by their power to

appoint and remove directors. The members or shareholders of a company exercise their rights as well as the functions entrusted to them in the articles by adopting resolutions at meetings of members.

Separate meetings of the holders of special classes of shares are mentioned in paragraph 8.02. Exactly what constitutes a class of shares is explained in paragraphs 14.29–4.32 of your prescribed textbook. (See **Study unit 7**.)

Activity

Cybertrade (Pty) Ltd was incorporated on 31 August 2000 and its articles provide that its financial year ends on the last day of February each year. (If section 285 is applied to Cybertrade (Pty) Ltd's situation, it is clear that its first financial year runs from the date of incorporation to the end of February 2001.) Cybertrade (Pty) Ltd held its first annual general meeting on 31 July 2001, 11 months after incorporation.

- 1 What is the latest date on which Cybertrade (Pty) Ltd's second annual general meeting may be held?
- 2 What would the position be if the first annual general meeting was held on 15 December 2001?

Feedback

- 1 The second annual general meeting has to be held within 9 months after the end of the financial year ending on 28 February 2002 (thus before the end of November 2002) but the date may not be more than 15 months after the date of the previous annual general meeting (thus not later than the end of October 2002). The latest date is thus 31 October 2002.
- 2 If the first annual general meeting was held on 15 December 2001 (which is in order, since the first annual general meeting is not required to be held within 9 months after the end of the financial year, but only within 18 months of incorporation) the second meeting would have to be held by 30 November 2002, which is 9 months after the end of its second financial year (despite the fact that it is less than a year after the first annual general meeting).

VOTING RIGHTS

Corporate Law pars 8.42–8.43

Companies Act ss 193–195

Pender v Lushington [case 124]

Although the general principle as stated in section 193 is that of "one share, one vote", the voting rights of preference shares are almost always excluded in the articles. The

policy behind this is that the preferent shareholders' risk is diminished by the preferential right enjoyed in respect of the payment of dividends and/or the repayment of capital, thus they should not have the same say in the company as ordinary shareholders. As a result, preferent shareholders may usually only vote in the exceptional circumstances dealt with in section 194. Preference shares are dealt with in chapter 14 of the textbook (see **Study unit 7**).

Section 195 provides for important differences between public and private companies with regard to the determination of voting rights. In your textbook the principle of proportionality applicable to public companies is discussed in paragraph 8.42, and the position for private companies in paragraph 8.43(a). The exceptions in paragraph 8.43(b) and (c), as well as that in respect of preference shares in 8.43(d), apply equally to public and private companies.

The decision in *Pender v Lushington* [case 124] is important for two reasons. First, it confirms that shareholders, unlike directors, do not have to exercise their voting rights for the benefit of the company and can act entirely in their own interests. Secondly, it shows that a shareholder has a right to have his or her vote recorded even if it would not change the result of the voting. The right to vote is an important membership right and a shareholder may institute a personal action to enforce this right. Personal actions and the protection of minorities (which are discussed in chapter 19 of the textbook) do not, however, form part of this course.

Activity

The articles of association of Zeno (Pty) Ltd contain the following provisions regarding voting rights:

- 54 Holders of class A ordinary shares shall have one vote per share for the first 100 shares, and one vote for every following two shares, subject to a maximum of 300 votes per shareholder.
- 55 Holders of class B ordinary shares shall have two votes per share.
- 56 In the case of an equality of votes the chairman of the meeting shall have a casting vote.

The nominal value of class A shares is R1 and that of class B shares R10. The company wants to be converted into a public company. What changes will it have to make to its articles in respect of the voting rights?

Feedback

In a public company with a share capital divided into par value shares, the voting rights of shares must be in proportion to their nominal value. It will thus not be possible to

retain the present unequal ratio of voting rights between class A and class B shares. Since the class B shares have a nominal value of R10, they should each carry 10 votes if a class A share of R1 confers one vote. Article 55 should thus be amended. Article 54, which contains a scaling down of voting rights where one person holds more than 100 shares and which has a ceiling of 300 votes per shareholder, is acceptable in a public company and need not be changed. The casting vote of the chairman can also be retained.

VOTING PROCEDURE

Corporate Law pars 8.44–8.47

Companies Act ss 197–198

You will note that when voting takes place by a show of hands, the size of each members' shareholding is irrelevant. Even someone who represents a number of shareholders as proxy has only one vote. Voting by a show of hands is an easy way of determining the opinion of a meeting where it is expected that the opinion will not really be divided. The articles of a company may not restrict the right to demand a poll further than is set out in section 198.

Activity

A general meeting of Tangro (Pty) Ltd is attended by five persons. Angela holds 5% of the votes, Bobby 20%, and Carla 15%. Darryl is attending as representative of Chemco (Pty) Ltd, which holds 40% of the votes. Emma holds proxies from Faizel and Gugu, who each hold 10% of the votes and who instructed her to vote in favour of a particular resolution. On a vote by a show of hands, Bobby, Carla and Emma vote in favour of the resolution, while Angela and Darryl vote against it. Would you advise Darryl or Angela to demand a poll?

Feedback

On the vote by a show of hands, the resolution is carried by a majority of three to two in number. If a poll is demanded, each member may exercise his or her full voting rights. Assuming that the same members vote in favour of the resolution, the resolution will still be carried with a majority of 55%. It will thus not make any difference to the outcome if Darryl or Angela demands a poll.

RESOLUTIONS AT MEETINGS

Corporate Law pars 8.48–8.53

Companies Act ss 199–200

The requirements for a special resolution are important (paragraph 8.49). You should note that a special quorum applies to meetings where special resolutions are to be adopted, and that at least a quarter of the total **voting rights** (not number of shareholders) should be represented at the meeting. The resolution should then be adopted by at least three-quarters of the **number of shareholders** present if a show of hands is used, or by three-quarters of the **total votes represented at the meeting** if a poll has been demanded. The effect of these two rules together is that the minimum support required for taking a special resolution on a poll is 18,75% (75% of 25%) of the total voting rights in the company. If the voting on the special resolution takes place by show of hands, a lower percentage is possible.

Remember that a special resolution requires **not less than** (ie **at least**) three-quarters of the votes. An ordinary resolution, however, requires **more than** half of the votes.

It is very important that you should keep in mind the consequences of a special resolution when studying other parts of the work. Because a special resolution is registered with the Registrar of Companies as required by section 200, it becomes part of the public documents of the company. The doctrine of constructive notice thus applies to special resolutions. This can be a very important fact to bear in mind when answering a question on the *Turquand* rule, which is discussed in chapter 12 of the textbook (see **Study unit 6**). If you are faced with a set of facts in which the authority of the director depends on approval by a **special resolution**, you should not apply the *Turquand* rule, because the adoption of a special resolution enjoys publicity and is definitely not an **internal** formality or requirement.

Activity

The directors of Galaxy (Pty) Ltd have proposed that the company should amend its articles so as to allow it to make payments to its members in accordance with section 90 of the Companies Act 61 of 1973. A special resolution is required to effect this change in the articles (s 62). At the general meeting convened to adopt the special resolution, only 4 of the 20 shareholders are present. They are Lerato, who holds 15% of the votes, Cindy, who holds 5% of the votes, Tsepo, who holds 4% of the votes, and Ismael, who holds 1% of the votes. Voting takes place on a poll and Lerato and Tsepo vote in favour of the special resolution. Explain whether the special resolution has been validly adopted.

Feedback

The resolution has been adopted by the requisite majority. The first requirement is that members holding in the aggregate at least a quarter of the total votes in the company must be present in person or by proxy. The four members attending the meeting hold exactly a quarter of the votes, thus satisfying the quorum requirement. Of the votes present or represented at the meeting, at least three quarters must be exercised in favour of the resolution. In this case Lerato and Tsepo, who together hold 19% of the total votes, can validly pass the special resolution, because they hold more than 75% of the votes represented at the meeting. In fact, they hold 76% (19/25) of the votes at the meeting.

UNANIMOUS ASSENT

Corporate Law pars 8.54–8.56

***In re Duomatic Ltd* [case 136]**

***Gohlke and Schneider v Westies Minerale (Edms) Bpk* [case 36]**

When all the shareholders of a company agree to something, it is not necessary to convene a meeting and adopt a formal resolution. Although unanimous assent is an informal way of conducting the company's affairs, there are two important requirements: all the shareholders must be in agreement (not even a 90% majority will suffice) and the shareholders must be fully aware of the facts. From these requirements it should be apparent that this principle will be used mainly in smaller companies.

In *Gohlke and Schneider v Westies Minerale (Edms) Bpk* [case 36], there were three shareholders. Two of them signed a letter in which they, acting in terms of a shareholders agreement, appointed one Wiehahn as director. The third shareholder initially objected to this appointment, but later withdrew the objection in writing. The first part of the judgment of Trollip JA deals with whether the parties had agreed that the two shareholders could appoint a director by themselves. The court found that they could. However, it is the second part of the judgment (from the bottom half of page 78 of your casebook) that is relevant for this topic. The court said that even if one were to assume that the letter of appointment did not suffice to appoint a director, Wiehahn would nevertheless have been appointed as director because all the shareholders unanimously agreed on his appointment and it was thus not necessary to have convened a meeting to appoint him.

It is clear from *In re Duomatic Ltd* [case 136] that only the members who would have been entitled to vote on the issue needed to agree and not, for example, holders of non-voting preference shares. In this case the shareholders did not hold a meeting, but it was clear that the issue of directors' remuneration was, in fact, considered by them when they prepared the accounts of the company.

Activity

Mrs Gold and Dr Silver each hold 50% of the shares in Mineralrich (Pty) Ltd. They are also the only two directors of the company. The articles of Mineralrich (Pty) Ltd provide that the company in general meeting may declare final dividends and that no dividend shall exceed the amount recommended by the directors. At a meeting of the board of directors, they agree that the company must declare a dividend of 16%. The dividend is paid out to them without a general meeting having been held to consider the dividend. Consider whether the dividend has been validly declared.

Feedback

The principle of conduct by unanimous assent can be applied to these facts. Both the shareholders were present at the board meeting and agreed on the size of the dividend. They were both fully aware of what they consented to. For this reason, it does not matter that they did not convene a general meeting to adopt a resolution approving of the dividend. The dividend is valid. The principle of unanimous assent was recognised in our law by the court in *Gohlke and Schneider v Westies Minerale (Edms) Bpk*.

SELF-ASSESSMENT

The board of directors of Fedup Ltd have proposed that the company should go into voluntary winding-up. In terms of section 349 of the Companies Act a special resolution of members is required for this purpose. The issued share capital of the company consists of 5 000 ordinary shares with a nominal value of R10 each and 100 preference shares with a nominal value of R100 each. The articles of Fedup Ltd provide that each ordinary share shall carry one vote and that the preference shares shall, subject only to section 194, not carry any voting rights. At the meeting convened for the purpose of considering the special resolution, only the following members were present:

Maite, who holds all the preference shares and 500 ordinary shares
Kurt, who holds 500 ordinary shares
Amy, who holds 150 ordinary shares
Mmotho, who holds 50 ordinary shares

On a show of hands, Maite was the only shareholder to vote in favour of the resolution. She then demanded a poll and exercised all her votes in favour of the resolution. Amy changed her mind and also voted in favour of the resolution. The remaining two shareholders voted against it.

- 1 Explain what kind of meeting was held and what notice requirements would have had to be satisfied.

- 2 Explain whether or not the special resolution has been passed.
- 3 Assuming that the resolution has been validly adopted, explain whether any further steps are required to put it into effect.

Feedback

- 1 Since the decision to wind up the company affects all the members, the meeting would have been a general meeting of members. If a special resolution is to be proposed at a general meeting, 21 clear days' notice is required and the notice must state that a special resolution will be proposed. It must also set out the terms and effect of the resolution and the reasons for it. (See ss 199–203 on special resolutions.)
- 2 The meeting held to consider the special resolution must be attended by members, present in person or by proxy, who together hold at least a quarter of the total votes in the company. (In addition to this, the usual quorum requirement for general meetings of public companies is at least three members — s 190.) The resolution must be passed, on a show of hands, by at least three quarters of the number of members present and entitled to vote or, if a poll has been demanded, by at least three quarters of the total votes that can be exercised at the meeting. In order to conclude whether the resolution has been passed by the requisite majority, one has to consider the voting rights in Fedup Ltd. First, it is important to note that the holder of the preference shares is entitled to vote on this special resolution. Section 194 expressly states that a resolution to wind up the company directly affects the rights or interests of preferent shareholders and that the right to vote on such a resolution can thus not be excluded. In determining the voting rights attached to the preference shares, it has to be borne in mind that Fedup Ltd is a public company and that the principle of proportionality of voting rights must apply. This means that the voting rights must reflect the relative nominal values of the shares. Since each R10 ordinary share carries one vote, each R100 preference share must entitle its holder to ten votes. This means that the total votes in the company amount to 6 000, made up by the 5 000 votes on the ordinary shares and 1 000 votes on the preference shares. The members present at the meeting represent 2 200 of those votes, which is more than a quarter (25%) of the total votes in Fedup Ltd. For the resolution to be passed if a poll has been demanded, at least three quarters (75%) of the 2 200 votes, that is 1 650 votes, must be exercised in favour of the resolution. Maite exercised her 1 500 votes in favour of the resolution and Amy's 150 votes bring the total to exactly 75% of the votes. The resolution was thus passed.
- 3 The resolution will take effect only once it has been registered by the Registrar (s 203). In terms of section 200 a copy of the resolution has to be lodged, together with certain other documents, for registration within one month from its passing. The special resolution will lapse if not lodged and registered within six months from the date it was passed (s 202).

Directors: General

The learning outcome of this study unit is that you are able to apply the law relating to a director's office to a given sets of facts.

In order to achieve this outcome you must know and understand:

- the legal position of a company director and of the board of directors
- how a director is appointed to office
- the distinction between "de facto", "alternative", "executive", and "non-executive" directors
- the disqualifications from the office of director for which the Companies Act provides
- when a director may be removed from office
- the effect on directors of winding-up.

Prescribed Material

Corporate Law Chapter 9 **excluding** paragraphs 9.26–9.27 and 9.38–9.45

Hahlo text at 240; 242–243; 254–255

Companies Act sections 1 (only definition of "director"); 214; 218; 220

S v Marks 1965 (3) SA 834 (W) [case 221]

Ross & Co v Coleman 1920 AD 408 [case 146]

Re Hydrodam (Corby) Ltd [1994] 2 BCLC 180 (Ch); [1994] BCC 161 [case 138]

Swerdlow v Cohen 1977 (3) SA 1050 (T) [case 151]

Nourse v Farmers' Co-operative Co Ltd (1905) 19 EDC 291 [case 154]

DIRECTORS AND THE BOARD OF DIRECTORS

Corporate Law par 9.01

The functions and responsibilities of company directors arise by virtue of the nature of the company. As you know, a company is a legal entity which exists separately from its management and shareholders. Since the company cannot act on its own behalf, company acts are conducted by representatives. These representatives could act either

as organs or as agents (representatives in the strict sense of the word). The board of directors (all the directors acting collectively) is one of the organs through which a company acts. It is usual to entrust the board of directors with the management of the company's business in the articles of association.

It is important to ascertain whether a particular act has been performed by the board, or by a single director, or by just some of the directors. If the board has not acted, the first step in determining the validity of the particular transaction must necessarily be whether the person(s) who purported to contract on behalf of the company had the required authority to do so.

LEGAL POSITION OF DIRECTORS AND THE BOARD OF DIRECTORS

Corporate Law pars 9.02–9.08

Hahlo text at 240; text at 252

Companies Act s 1 (definition of “director”)

S v Marks [case 221]

Ross & Co v Coleman [case 146]

A director is described in the Companies Act (**section 1**) as including any person occupying the position of director or alternate director of a company, by whatever name he or she may be designated. Note that although directors are often rather confusingly referred to as “trustees”, “agents” et cetera, none of these terms adequately describe their unique position. It is therefore more correct to describe directors as being in a *sui generis* (of its own type) position. Note too that a director does not necessarily stand in a contractual relationship with his or her company. Such a relationship may, however, arise in any of the ways discussed in paragraph 9.06.

The articles of association are not a contract between the director and the company, although the articles may on occasion regulate aspects of the director's office. For example, they may determine the director's remuneration. Unless the parties clearly indicated otherwise, the articles may be amended in the normal way, that is by special resolution. If the articles are amended to provide for less remuneration, the director will, from the time of the amendment, be entitled only to the lesser amount.

Activity

The articles of association of Eatwell (Pty) Ltd provide that any director will be paid a salary of R10 000 per month, and that all the directors are appointed for a term of three years. The company has invited Mr Madibe to take up the office of its Director (Financial Services). Mr Madibe is uncertain whether he may, and should, conclude a separate contract with the company. His particular concern is that the company may decrease his salary in the future.

Advise Mr Madibe.

Feedback

No contractual relationship arises between a director and a company merely because of the director's office, nor are the articles of association a contract between the director and the company. A contractual relationship can, however, arise. The director may, for example, conclude a service contract with the company. If no separate contract exists, and the articles contain provisions which regulate the director's office, those provisions bind the director and company. The articles may be amended, and unless there is a clear indication that the parties agreed otherwise, the rights of the director are also amended accordingly. The decision in *Ross v Coleman* [case 146] confirms that any agreement between the company and the director to the effect that the rights set out in the articles should remain undiminished under all circumstances, must very clearly appear.

Mr Madibe should therefore be advised that he can and should conclude an agreement with the company in which they agree that the current conditions of service as stipulated in the articles will apply for the duration of his term of office. Alternatively, he can conclude a separate service contract with the company, in which all his conditions of service are set out.

APPOINTMENT AND TYPES OF DIRECTORS

Corporate Law pars 9.09–9.19

Hahlo text at 240

Companies Act s 214

Re Hydrodam (Corby) Ltd [case 138]

An appointment as director consists of two components, namely an **appointment** to and an **acceptance** of the office. The manner in which directors may be appointed is discussed in paragraph 9.10. **Section 214** provides that notwithstanding any defect that may afterwards be discovered in his or her appointment or qualification, the acts of a director are valid (par 9.18). This section applies only if there has indeed been some form of appointment, and there has not been a fraudulent assumption of power. Moreover, it concerns an act which was performed before the irregularity was discovered.

Alternate directors

It is common practice for the articles to provide for the representation of a director who will be absent from board meetings for a lengthy period by enabling him or her to appoint an "alternate" or "substitute" director (par 9.12). The articles usually then

regulate the alternate director's position, but he or she is subject to all duties and liabilities in respect of honesty, good faith, skill, care and diligence imposed on other directors (see Study unit 3 below).

De facto directors

Two categories of *de facto* directors may be distinguished. In the first instance, there are persons who act as directors without having been appointed as such in the manner prescribed by the articles. The controllers behind nominee directors are included in this category, although internally they are clearly not regarded as directors. They are not, for example, entitled to directors' remuneration and, should the articles permit an ordinary director to convene an extraordinary general meeting, the *de facto* director will not be entitled to do so.

The second category of *de facto* directors concerns persons who are in fact appointed to the office, but where there is some defect in their appointments or qualifications. These persons are legally also not directors, although they are treated as such. Their actions prior to the discovery of the defect in their appointments or qualifications are, nonetheless, valid. See section 214 again in this regard. This category of *de facto* director is described in *Re Hydrodam (Corby) Ltd* [case 138].

Executive and non-executive directors

The distinction between "executive" and "non-executive" directors has been generally accepted for some time, and was recently for the first time also incorporated in the Companies Act in the provisions on disclosure of directors' emoluments (see **Study unit 3** below). As a rule, "non-executive" directors attend and vote at board meetings, but do not work full-time for the company and have no service contract, whereas "executive" directors have a service contract under which they work full-time for the company. The *King Report on Corporate Governance* (see The Institute of Directors in Southern Africa *The King Report on Corporate Governance* (1994) par 4.9) identified four important functions as part of non-executive directors' duties. They are summarised in *Hahlo* at 241:

- “(a) they bring their special expertise and knowledge to bear on the strategy, enterprise, innovative ideas and business planning of the company;
- (b) they can monitor and review the performance of the non-executive management more objectively than the executive directors;
- (c) they can play a role in resolving conflict of interest situations; and
- (d) they can act as a check and balance against the executive directors.”

Activity

Starstruck (Pty) Ltd appointed Mr Botha to its board of directors by means of a special resolution taken at a company meeting. The articles of association authorise any director to buy stationery on the company's behalf. Mr Botha's name is listed as a director of the company on a business letter of Starstruck (Pty) Ltd setting out the items it wants to purchase from Pencils CC. After the contract to purchase the stationery has been concluded, it comes to Mr Botha's attention that the special resolution in terms of which he was appointed as director was mistakenly never lodged with the Registrar and has lapsed. He has accordingly never been validly appointed as a director of Starstruck (Pty) Ltd. Mr Botha is uncertain whether the contract he concluded to purchase stationery from Pencils CC is valid, and is concerned that he or the company may have committed an offence in terms of the Companies Act.

Advise Mr Botha.

Feedback

See paragraphs 9.17 and 9.18. The company and every director or officer commits an offence if the company publishes the name of any person as director when he is not a director or has not been validly appointed as director. Starstruck (Pty) Ltd and its directors have therefore committed an offence by listing Mr Botha's name as director on the company's business letter. Since Mr Botha has not been validly appointed, he is, however, not a director and has not committed an offence.

Section 214 of the Companies Act provides that an act of a director is valid notwithstanding any defect in connection with his appointment or qualification that may afterwards be discovered. The provision only becomes effective if some form of appointment has been made, if there was no fraudulent assumption of power and if it concerns an act which was performed before discovery of the irregularity. It can be argued that Mr Botha's appointment by special resolution complies with the requirement of "some form of appointment", and the other two requirements have clearly been met. The contract to purchase the stationery is therefore valid.

QUALIFICATIONS FOR THE OFFICE OF DIRECTOR

Corporate Law pars 9.20–9.28 excluding pars 9.26–9.27

Hahlo text at 242–243

Companies Act s 218

A director is not necessarily required to hold any qualification shares in the company. If the company wishes to impose such a requirement, it must be clearly stipulated in the

articles. The Companies Act lays down a number of disqualifications for directors (**section 218**). Note that section 218(1)(d) allows the court to authorise the persons mentioned in that subsection to become, or remain, directors. The court will in the exercise of its discretion have regard to both the interests of the shareholders of the companies involved, and the public interest. For example, in *Ex parte Tayob* 1990 (3) SA 715 (T) the appellants were applicants for an order permitting them to remain directors of a group of companies. They had previously been convicted of bribery. The court took into account that it had not been a motive of personal gain that had caused them to make the bribe. (The applicants had offered a police officer a bribe to hand over to them confidential dockets relating to charges pending against their cousins.) The applications were, nonetheless, for other reasons not allowed. According to McLennan (JS McLennan “Disqualification of Company Directors and the Court’s Discretion” (1991) 108 SALJ 4 at 7–8) both the advantages and disadvantages of disqualification should be carefully considered:

“The first appellant was ‘the sole decision-maker and formulator of policy in the group’ ... Since his disqualification the group has had to operate without his experienced management. This, it is said, is prejudicial to the group ... However, the evidence does not go further than to aver that the group has not fared as well as it might have ... But what if the loss of the appellant’s services had spelled disaster to the group in the form of financial collapse and even insolvency? ... [A] wide range of people may be adversely affected: shareholders, creditors, employees, customers, suppliers etc. The collapse of an economic enterprise is obviously never in the public interest. Of course, if the offence or offences giving rise to the disqualification show that the person concerned is a danger to the public, there is simply no alternative to disqualification.”

Section 219 empowers the court to disqualify directors in certain instances. As is stated in paragraph 9.28, this section is in disuse in South Africa. However, in England the corresponding provisions are very effectively used to curb mismanagement in modern company law.

REMOVAL OF DIRECTOR, RESIGNATION, AND RETIREMENT

Corporate Law pars 9.29–9.34

Hahlo text at 254–255

Companies Act s 220

Swerdlow v Cohen [case 151]

Nourse v Farmers’ Co-operative Co Ltd [case 154]

Section 220 enables a company, notwithstanding anything in its memorandum or articles of association or in any agreement between the company and director, to

remove a director from office by ordinary resolution of the general meeting before the expiration of his or her period of office. This does not deprive the director of any existing right (derived, for example, from a service contract) to claim damages.

Activity

The articles of association of Balfour Ltd provide that for as long as two of its directors, Jack Bean and Jim John, are members of the company no resolution taken by the members will be of any effect unless Jack Bean and Jim John have, or whomever of them is at that time a member of the company has, voted in favour of the resolution. At a meeting of the company, Jack Bean is removed as a director by majority vote under section 220 of the Companies Act of 1973. He was present at the meeting, but voted against the resolution.

Jack Bean wants to apply to court for an order setting aside his removal as director and declaring that he is still a director of the company. Advise him in this regard.

Feedback

The facts are similar to those in *Swerdlow v Cohen* [case 151]. Read the extract again. You will see that the court held that a provision in the articles such as the above-mentioned one is not effective to exclude the company's power to pass a resolution under section 220. The removal of Jack Bean is therefore valid. He should be advised that his application to court is unlikely to succeed.

EFFECT ON DIRECTORS OF WINDING-UP

Corporate Law par 9.35

The directors of a company in liquidation are *functus officio*. This means that they are regarded as no longer being in office. However, they retain certain residual powers.

REGISTERS CONCERNING DIRECTORS AND OFFICERS

Corporate Law pars 9.36–9.37

Every company must keep a register of its directors and officers. The Companies Act prescribes the information which must be recorded in the register in respect of every director and officer.

Activity

Mrs Jones has been appointed as company secretary of a company. One of her duties is to see that the register of directors and officers is kept up to date. Provide her with a list of the information that should be entered in the register in respect of each director.

Feedback

(See par 9.37 of your textbook.)

- (a) Full names
- (b) Any former names
- (c) Identity numbers, or if the director has no such number, date(s) of birth
- (d) Nationality, if not South African
- (e) Occupation
- (f) Residential address
- (g) Business address
- (h) Postal address
- (i) Date of appointment
- (j) Name and registration number of every other company of which that person is director
- (k) Any changes in the above-mentioned particulars and the date and nature of such change

SELF-ASSESSMENT

Amy is a director of Supernet (Pty) Ltd. The shareholders wish to remove her from office before the expiry of her term of office. Some of the shareholders have, however, entered into voting agreements whereby they have agreed to vote for Amy's retention as director.

Advise the shareholders on the correct procedure to have Amy removed as director. Also advise them on the effect of the voting agreements.

Feedback

Read paragraphs 9.29–9.33 again. You should have discussed section 220 of the Companies Act, which provides for the removal of a director by ordinary resolution. You should, *inter alia*, have mentioned that an ordinary resolution suffices and that the

provisions of section 220 apply notwithstanding anything to the contrary contained in any separate agreement between Amy and the company, or in the company's constitution. If a separate contract has been concluded between Amy and the company, it is possible that a claim for damages may lie, but she cannot prevent her removal. Section 220(7) expressly provides that removal in terms of the statutory power does not derogate from any other power to remove the director. You should therefore also have considered the possibility that the articles of Supernet (Pty) Ltd may provide for Amy's removal, in which case the procedure laid down in section 220 need not be adhered to. Shareholders are bound by any existing voting agreements not to remove a particular director.



Directors: Rights and duties

The learning outcome of this study unit is that you are able to apply the law relating to the various rights and duties of company directors to factual situations.

In order to achieve this outcome you must know and understand:

- directors' various rights and obligations
- the fiduciary relationship that exists between a director and his or her company
- the various categories of directors' fiduciary duties
- the duty of care and skill.

Prescribed Material

Corporate Law Chapter 10 paragraphs 10.01-10.33

Hahlo text at 270; 272–273; 278–280

Brown v Nanco (Pty) Ltd 1976 (3) SA 832 (W) [case 168]

West Mercia Safetywear Ltd (in liq) v Dodd [1988] BCLC 250 (CA) [case 174]

Regal (Hastings) Ltd v Gulliver [1942] 1 All ER 378; [1967] 2 AC 134 (HL) [case 188]

Cook v Deeks [1916] 1 AC 554 (PC) [case 186]

Robinson v Randfontein Estates Gold Mining Co Ltd 1921 AD 168 [case 187]

Industrial Development Consultants Ltd v Cooley [1972] 1 WLR 443; [1972] 2 All ER 162 [case 189]

Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd 1981 (2) SA 173 (T) [case 193]

Sibex Construction (SA) (Pty) Ltd v Injectaseal CC 1988 (2) SA 54 (T) [case 194]

Fulham Football Club Ltd v Cabra Estates plc [1994] 1 BCLC 363 (Ch and CA) [case 183]

In re City Equitable Fire Insurance Co Ltd [1925] 1 Ch 407 [case 171]

Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd 1980 (4) SA 156 (W) [case 172]

RIGHTS, POWERS AND DUTIES OF DIRECTORS

Corporate Law pars 10.01-10.08

Hahlo text at 272–273; first paragraph of text at 278

***Brown v Nanco (Pty) Ltd* [case 168]**

The board of directors is responsible for the management of the company. Its rights and duties should be set out clearly in the company's articles. The relevant clauses usually start with a general provision to the effect that the business of the company shall be managed by the directors. Thereafter provision is made for any restrictions on this general power, for example that the company in general meeting should consent to transactions exceeding a particular value. The board is also often given the power to delegate certain matters to an individual director, or to a committee of directors.

Directors' **rights** are broadly divided into a possible right to remuneration; the right to access to company records; and the right not to be prevented from properly discharging his or her duties. A director's remuneration is often regulated in a separate service contract concluded with the company. But note that the mere fact that a person is appointed as a director does not entitle him or her to remuneration. Should the articles provide for determination of the remuneration, it is important that it actually be determined. Otherwise a director may find he or she has no claim to remuneration.

No director may be prevented from the proper exercise of his or her office. A director is, moreover, entitled to inspect the books of the company, and to take extracts from company books.

Directors are subject to various **duties**. These obligations can be divided into:

- obligations which arise because of the recognition of the fiduciary nature of their office
- duties of care, diligence and skill
- duties which arise by reason of express provisions derived from the Companies Act and other Acts or the company constitution
- obligations created in separate contracts concluded with the company.

Activities

- 1 Identify the relevant right of the director in *Brown v Nanco (Pty) Ltd* [case 168] and briefly state the legal principle which the court enunciated in respect thereof.
- 2 Mr Osterman is considering taking up an appointment as a director of a private company. He wants to know the various sources of directors' duties so that he can establish what his duties will be.

Advise Mr Osterman.

Feedback

- 1 *Brown v Nanco* [case 168] concerns a director's right to remuneration. The court confirmed that directors may not be paid an amount exceeding their predetermined remuneration unless they have, in addition to their directorships, been appointed in some other position for which they are being recompensed.
- 2 The answer is apparent from paragraph 10.08 of your textbook. Directors' duties may arise from the common law (this is the source of their fiduciary duties and the duties of care, skill and diligence), legislation (the Companies Act of 1973 and some other Acts impose specific obligations on directors), the company constitution, or by virtue of separate contracts concluded with the company.

FIDUCIARY DUTIES

Corporate Law pars 10.09–10.29; 10.33

Hahlo text at 270; text at 278–280

West Mercia Safetywear Ltd (in liq) v Dodd [case 174]

Regal (Hastings) Ltd v Gulliver [case 188]

Cook v Deeks [case 186]

Robinson v Randfontein Estates Gold Mining Co Ltd [case 187]

Industrial Development Consultants Ltd v Cooley [case 189]

Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd [case 193]

Sibex Construction (SA) (Pty) Ltd v Injectaseal CC [case 194]

Fulham Football Club Ltd v Cabra Estates plc [case 183]

In accordance with the common-law principles derived from the English law, it is accepted that directors stand in a fiduciary relationship to the company they serve. A director's position is sometimes compared to that of other types of fiduciaries. The analogies most frequently drawn are between a director and a trustee and between a director and an agent. This can be rather confusing, since legally directors are neither trustees nor agents of the company.

The fiduciary obligations arise by virtue of the holding of the office of director, and not because the directors act as, for example, agents or trustees of the company. This principle is described by McLennan (JS McLennan "Directors' Duties and Misapplication of Company Funds" (1982) 99 SALJ 394 at 403) as follows:

"[I]t is eminently more satisfactory to apply the no power without responsibility principle, and simply to say that if a person is in fact in a position of trust — be he agent, mandatory, director or whatever — he cannot escape the duty that inevitably attaches to the trust."

Similarly, the **cause of action** in instances where directors have breached their fiduciary obligations, is *sui generis* (of its own nature) and is not based on contract or delict.

However, nothing precludes the action, where appropriate, from being based on delict. The company's two primary remedies for breaches of fiduciary duty are, first, a right to claim any benefit or profit acquired by the director as a result of the breach, and in certain circumstances, the right to set aside contracts entered into by the company. Secondly, the company may claim damages in respect of any loss it has suffered as a result of the breach and obtain an interdict to restrain the commission of any threatened breach.

In *Howard v Herrigel* 1991 (2) SA 660 (A) the Appellate Division (now the Supreme Court of Appeal) confirmed that the fact that a particular director may be classified as either executive or non-executive does not necessarily indicate that he or she owes a greater or lesser duty to the company. Goldstone JA regarded such a distinction in respect of directors' duties as unhelpful, and even misleading. The court confirmed that the assessment of a director's compliance with his or her obligations must necessarily depend upon the facts and circumstances of each case. One of these circumstances may be whether the director is in the full-time employ of the company.

The **beneficiary** of the director's fiduciary obligations is the company itself. Although the members collectively will benefit from this, no fiduciary relationship exists between a director and individual members of the company. See paragraph 10.33. Nor is a duty to creditors recognised, although recent decisions in England, Australia and New Zealand seem to favour the proposition that, at least where a company is in financial difficulties, the directors should have a duty to also consider the interests of its creditors. In this regard, see the English case of *West Mercia Safetywear Ltd (in liq) v Dodd* [case 174]. The duty, if one exists at all, has, however, not as yet developed as to allow creditors to take action against the company. In South Africa, no direct duty to creditors is recognised. It seems that creditors' rights are, or could be, adequately protected by other means of imposing personal liability on directors (see **Study unit 4** below).

Because of the common-law nature of directors' fiduciary duties, case law plays a very important role in establishing principles in this area of company law.

A director's **fiduciary obligation** basically entails that he or she should exercise his or her duties **in good faith** and **in the interests of the company**. A number of particular duties arise from this obligation. Various categories of fiduciary duties are often identified. This is sometimes helpful in order to determine whether the basic duty has been complied with. The categories of fiduciary duties are, however, not exhaustive and, to some extent, overlap.

Typical breaches of directors' fiduciary duties are discussed in paragraphs 10.13-10.29 of your textbook.

The decision in *Regal (Hastings) v Gulliver* [case 188] is an application of what is frequently called the "**secret profit rule**" or the "**no profit rule**". The facts of the case are mentioned in the first paragraph of the extract in your casebook. Note that despite the fact that the court accepted that the directors had taken the shares lawfully, in good

faith and in the interests of the company, the House of Lords decided unanimously that the directors should repay Regal Ltd the profit they had made on them. Also note how the different judges differently formulated the test for liability. Lord Porter suggested that the profit should have been acquired by the director on the ground of his **occupation of office**. According to Lord MacMillan and Lord Russell the profit should also have been acquired **in the execution of the director's office**.

In *Cook v Deeks* [case 186] and *Robinson v Randfontein Estates Gold Mining Co Ltd* [case 187] it was clearly the director's duty to obtain the particular asset or opportunity for the company. The fact that the other contracting party preferred to contract with the director in his personal capacity rather than the company did not alter this fact. It can be inferred from the facts in *Robinson* that the defendant (the company's chairman) had at least an implied mandate to purchase the asset on behalf of the company. This decision is another example of the application of the secret profit rule.

Industrial Development Consultants Ltd v Cooley [case 189]; *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd* [case 193] and *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC* [case 194] provide examples of instances where directors, in their private capacities, **compete** with their companies. The decisions confirm that the unauthorised use of confidential information is a breach of the director's fiduciary obligation. Note the difference in opinion expressed in *Atlas* and *Sibex* on whether liability is incurred only when the particular director has acted as an agent of the company. In *Sibex* Goldstone J also indicated that a director remains under a fiduciary obligation even after his or her resignation from office. Do you agree? Can a former director still be regarded as a fiduciary? If not, how can he or she still owe the company a fiduciary duty? Is it perhaps not more accurate to say that the director is released from his or her fiduciary duties when the office of director is terminated, but that accountability may arise because of certain competitive activities which started before the termination of the director's office?

Atlas suggests that the mere incorporation of a competing company on the initiative of the managing director, whilst serving his month's notice, is not a breach of his fiduciary duty. Is this correct? Why should a lesser duty be required from a managing director when he or she is serving a month's notice than at other times?

The decisions illustrate the interesting problems that arise in the application of the legal principles pertaining to directors' fiduciary duties, particularly where they overlap with the law of competition.

Naudé (SJ Naudé "Mededinging deur 'n Direkteur met sy Maatskappy" (1970) 87 *SALJ* 193-203 and "Toestemming deur 'n Maatskappy tot Mededinging deur 'n Direkteur" (1972) 89 *SALJ* 217-228) suggests that liability should be based on a distinction between those directors who are able to perform legal acts on behalf of the company individually, and all other directors. The first category includes the typical managing director (see **Study unit 5** below), but may also include a dominant ordinary director. Any contract concluded by such a director in which the company also has an interest, irrespective of whether or not it involves the use of confidential information, is

at the choice of the company treated by the law as one made in the interests of the company. It is immaterial whether or not the director intended the contract to be in his or her own interests. The director must transfer property acquired in this manner to the company. If the director has sold the property to the company at a profit without disclosure, the profit is recoverable by the company. Consequently, directors who fall under this category, are unable to compete with their companies, even when there are no other competitors. The director will, moreover, not be able to become a managing director of a rival company.

An ordinary director who has no individual powers, but who, together with the other directors, functions as the directorate, falls under the second category suggested by Naudé. This type of director is, provided he or she has not made use of confidential information which was obtained by virtue of the office of director, not prevented from competing with the company. The law gives effect to the intention of such a director to conclude a contract in his or her own name, even if the contract is also in the company's interests. If the property is subsequently sold to the company at a profit, without the required declaration of interest, the contract is voidable, but the director's profit cannot be claimed. The director can also not be compelled to transfer the property to the company. Thus a director who falls in this category is free to transact business on his or her own account even in competition with the company of which he or she is a director and is permitted to be an ordinary director of a rival company. Where a director, who is also the director of another company with an interest in the same transaction, concludes a contract, the contract is, according to Naudé, deemed to have been concluded on behalf of the company in respect of which the director is able to perform legal acts individually (in other words, the company in respect of which the director falls in the first category mentioned above).

Naudé's distinction, based on the level of activity and position of the director in the company, prohibits competition where the director may individually act on behalf of the company, but not otherwise. Do you think this is correct? Consider again that we said above that a director's fiduciary obligations are not based on agency. They are *sui generis*, and are not dependent on the position the director occupies in the company.

A director's duty to **observe any limitation of the powers** of the company, or of the director's own **authority** is discussed in paragraphs 10.21–10.23. We return to the concepts of the capacity of the company and the *Turquand* rule in **Study unit 6** below.

The decision in *Fulham Football Club Ltd v Cabra Estates plc* [case 183] concerns the duty to **act with an unfettered discretion**. Since the basis for this rule is that directors should not be able to limit their ability to act in the company's best interests, directors may contract to vote in a certain way if this is in the interests of the company.

You will see in paragraphs 10.27–10.29 that a director's duty to **exercise his or her powers for the purposes for which they have been conferred** has acquired a specialised meaning.

Activity

Which of the following decisions is the **best authority** for the statement that a director may not make use of information which he has acquired in his capacity as director for personal gain, even after his resignation from the company?

- *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168
- *Fulham Football Club Ltd v Cabra Estates plc* [1994] 1 BCLC 363 (Ch and CA)
- *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC* 1988 (2) SA 54 (T)
- *Howard v Herrigel* 1991 (2) SA 660 (A)

Feedback

The correct answer is *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC* 1988 (2) SA 54 (T). All the cases mentioned deal with aspects related to directors' duties. But in *Sibex* [case 194] the court specifically referred to the fiduciary obligation as continuing beyond the director's resignation from office.

This question is not typical of the type of question you can expect to encounter in the examination. However, it should have enabled you to see whether you can extract the pertinent legal principles from the case extracts.

DUTY TO ACT WITH CARE AND SKILL

Corporate Law pars 10.30-10.32

***In re City Equitable Fire Insurance Co Ltd* [case 171]**

***Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* [case 172]**

Under the common law, directors owe their company a duty to act with the required degree of care, skill and diligence. The rules governing the standard of care required of directors were established in a series of English decisions during the late nineteenth and early twentieth centuries. Havenga (Michele Havenga "The Business Judgment Rule — Should We Follow the Australian Example?" (2000) 12 *SA Merc LJ* 25 at 26) notes that:

"In re City Equitable Fire Insurance Co Ltd [case 171] is often referred to as containing the roots of the common-law duty of care. Romer J found that this duty required directors to use the degree of care which an ordinary man might be expected to take in the circumstances (at 428). Although this might, at first glance, appear to lay down an objective test, his lordship added that a director need not exhibit in the performance of his (or her) duties a greater degree of skill than may reasonably be expected from a person of his (or her)

knowledge and experience (at 428-429). The test thereby becomes subjective, taking into account the particular director's intelligence and experience.

“This lenient approach to directors' duty of care initially stemmed from two factors. First, there was the belief that shareholders should be responsible for the competency of the people appointed by them as managers. An early confirmation of this belief is found in *Turquand v Marshall* (1869) LR 4 CH App 379 where the court declared that as long as directors kept within the powers in their deed, however ridiculous and absurd their conduct might seem, it was the misfortune of the company that they had chosen such unwise directors (at 386. See also *In Re Elgindata Ltd* [1991] BCLC 959 (Ch) where the court held that members of a company have no right to expect a reasonable standard of general management from the company's managing director. It was considered one of the normal risks of investing in a company that its management may turn out not to be of the highest quality.) Also, at the time when the early cases were heard, there were relatively few companies and their boards were largely comprised of part-time, non-executive directors who were regarded as figureheads. They were often appointed because of their title or reputation and not because of their business acumen. An alternative basis for the lenient approach was the assumption that directors were benevolent amateurs, lacking in any specialist or technical talent, who could not be expected to maintain a great involvement in company affairs, much less exercise the skills of a professional . . .

“Common-law courts required gross or culpable negligence before a director would be held to be in breach of his or her duties . . . Moreover, extreme misconduct could still escape being classified as gross negligence (see eg *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425, where directors contracted on behalf of a company to purchase a plantation on the basis of a fraudulent report. Despite the fact that the directors were aware of the discrepancies and exaggerations in the report, their failure to make proper inquiries and to correct the exposed discrepancies did not, in the court's opinion, amount to gross negligence).

“It gradually became apparent that community attitudes and expectations concerning directors' duties generally have changed and that the early English decisions no longer correctly reflect the standard of care expected from directors. In *Norman v Theodore Goddard (a firm)* ([1991] BCLC 1028 (CLD)) Hoffman J was willing to assume that the test of a director's duty of care, in considering what he ought to have known or inferred, empowered the court to consider the knowledge, skill and experience which he actually had, in addition to that which a person carrying out his functions should be expected to have (see also *Bishopsgate Investment Management Ltd v Maxwell (No 2)* [1994] 1 All ER 261 where his lordship also expressed the view that the law was evolving and that a more demanding duty than that previously imposed might now be required). In *Re D'Jan of London Ltd* [1994] 1 BCLC 561 (Ch)

the same judge elevated this assumption to a proposition of law on which he based his decision. Summons had been brought by a liquidator against a former officer of a company under s 212 of the Insolvency Act 1986. As he had done in *Norman v Theodore Goddard*, his lordship based his interpretation of the common-law duty of care on s 214(4) of the Insolvency Act 1986, and described it as the conduct of ‘a reasonably diligent person having both – (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that that director has.’ The court held that the former officer had, on both the objective and the subjective tests, not shown reasonable diligence. His Lordship applied the discretion afforded him under s 727 of the Companies Act 1985 and gave judgment against the director for an amount limited to the sum which he remained entitled to claim as an unsecured creditor of the company. The test applied is a departure from the traditional subjective approach associated with *Re City Equitable Fire Insurance Co Ltd*.”

South African company law recognises that a director must exercise his or her powers and carry out his or her office *bona fide* and for the benefit of the company. In so doing the director must exercise the required degree of care and skill. It is pointed out in *Corporate Law* that the standards according to which the degree of care and skill is to be measured are, however, by no means clear. While it is to a certain extent possible to establish “care” objectively, “skill” varies from person to person. No specific qualification is required to become a company director. Nonetheless, directors are expected to apply such skill as they do possess to the advantage of the company.

In *Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd; Fisheries Development Corporation of SA Ltd v Jorgensen* [case 172] the court summarised the principles governing this duty, drawing on English decisions like *Re City Equitable Fire Insurance Co* [case 171]; *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425 and *Lagunas Nitrate Co v Lagunas Nitrate Syndicate* [1899] 2 Ch 392. Margo J confirmed that the extent of a director’s duty of care depends to a considerable degree on the nature of the company’s business and on any particular obligations assumed by or assigned to the director. The court held that in that regard there is a difference between the full-time or executive director, who participates in the day to day management of the company’s affairs or of a portion thereof, and the non-executive director who has not undertaken any special obligation. The latter is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at any other meetings which may require his attention. He is not, however, bound to attend all such meetings, though he ought to whenever he is reasonably able to do so. A director is not required to have special business acumen or expertise, or singular ability or intelligence, or even experience in the business of the company. He or she is, nevertheless, expected to exercise the care which can reasonably be expected of a person with his or her knowledge and experience. A director is not liable for mere errors of judgment. In respect of all duties that may properly be left to some other official, a director is, in the

absence of grounds for suspicion, justified in trusting that official to perform such duties honestly (that reliance on an apparently trustworthy person may be a good defence is expressly recognised by s 284(4)(b) of the Companies Act of 1973 in connection with the keeping of proper accounting records). A director is entitled to accept and rely on the judgment, information and advice of the management, unless there are proper reasons for querying such. Similarly, a director is not bound to examine entries in the company's books. Obviously, a director exercising reasonable care would not accept information and advice blindly. He or she would accept it, and would be entitled to rely on it, but would give it due consideration and exercise his or her own judgment in the light thereof.

It was mentioned above that the decision in *Howard v Herrigel NNO* (1991 (2) SA 660 (A)) put into perspective the perception that a different degree of care may be expected from a non-executive director than from an executive director. The court regarded it as unhelpful and even misleading to classify company directors in this way for purposes of ascertaining their duties to the company. The legal rules are the same for all directors. In the application of those rules to the facts one should take into account all factors that may be relevant in judging the director's conduct, one of which could be whether the director is engaged full-time in the affairs of the company. This view was also expressed in *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498 (Ch) where it was also held in respect of English law that there was no difference in the duties owed by executive and non-executive directors. The approach followed in *Howard v Herrigel* was approved in *Philotex (Pty) Ltd and Others v Snyman and Others* [case 299]. These two decisions are discussed further in **Study unit 4** below, where the personal liability of directors is considered. In *Philotex* the court found that the test for recklessness is objective insofar as the defendant's actions are measured against the standard of the notional reasonable person and subjective insofar as one has to postulate that notional being as belonging to the same group or class as the defendant, moving in the same spheres and having the same knowledge or means to knowledge. The subjective consideration, found Howie JA in *Philotex*, requires that regard should be had to any additional knowledge, experience or qualification that the evidence reveals the director to possess and which is relevant to the question whether recklessness has been proved (at 148F).

A director who does not observe his or her duties of care and skill towards the company is liable to it in delict for damages. He or she may also be in breach of contract if a contract exists between him or her and the company.

In 1994 the *King Report on Corporate Governance* recommended that our Companies Act be amended to provide for a statutory limitation to the duty of care and skill. It was suggested that directors should not be liable for a breach of the duty of care and skill if they exercised a business judgment in good faith in a matter in which the following criteria are satisfied, namely that the decision is an informed one based on all the facts of the case; that the decision is rational; and that there is no self-interest (see The Institute of Directors in Southern Africa *The King Report on Corporate Governance*

(1994) pars 3.4 and 3.5). It seems, however that there is no need for this legislation since a director would, in those circumstances, have discharged both his or her fiduciary obligations and the duty of care.

Activity

Mr Nell is a director of Jetstar (Pty) Ltd. He has heard that directors owe their company an obligation to act with care, skill and diligence and wants to know more about this duty. Advise him on the origin and basis of this obligation, as well as the strictness with which it is judged.

Feedback

A director's duty of care and skill has its origin in the common law. *In re City Equitable Fire Insurance Co Ltd* [case 171] is often referred to as containing the roots of this obligation. The basis of the duty is generally delictual in nature. It may also be contractual if the director has concluded a contract with the company in which he or she has undertaken any further obligations. Although the duty of care and skill has traditionally been evaluated less strictly than a director's fiduciary obligations, there has in recent times been a tendency to impose a stricter standard. You should refer to the article by Havenga in your answer.

SELF-ASSESSMENT

Mrs Naidu is a director of Earthworks (Pty) Ltd. The company manufactures and sells pottery. Mrs Naidu prefers working for herself and intends resigning from the company to start a similar business. She is unsure whether she may make use of the company's client list compiled over a number of years, to inform potential clients of her new business.

Advise Mrs Naidu.

Feedback

You should have briefly stated what a director's fiduciary obligation generally entails. In this case the duty to avoid a conflict of interests is particularly relevant. You should then have discussed the possibility that the company's client list may constitute confidential information, and should have referred to the decisions in *Industrial Development Consultants Ltd v Cooley* [case 189], *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd* [case 193] and *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC* [case 194], which all concern the use of confidential information. The question whether the fiduciary duty continues beyond the termination of a director's office

should also have been addressed. Since a director's fiduciary obligation towards the company arises by virtue of his or her occupation of the office of director, it is arguable that this obligation cannot continue after resignation. In particular circumstances, such as those in *Sibex*, it may well be argued that the director may be held liable for an action which continued beyond his or her resignation, but which occurred as a result of a breach of the fiduciary obligation which existed prior to the termination of office. This argument would be particularly persuasive if the resignation was influenced by the desire to compete with the company.



Directors: Statutory restrictions and personal liability

The first learning outcome of this study unit is that you are able to apply the common-law and statutory restrictions applicable to directors to a given set of facts.

In order to achieve this outcome you must know and understand:

- the general restrictions on the payment of benefits to directors
- section 228 of the Companies Act
- the prohibition on loans to directors imposed by section 226 of the Companies Act
- the regulation of contracts concluded between directors and their company.

The second learning outcome of this study unit is that you can identify whether directors may incur personal liability in given factual situations.

In order to achieve this outcome you must know and understand:

- in what circumstances directors may be indemnified against liability
- what other relief a court may give a director against whom proceedings are pending in respect of negligence, default, breach of duty or breach of trust
- when a director may incur personal liability under sections 423 and 424 of the Companies Act
- the procedures for the interrogation of directors
- the possible effect of the corporate governance debate on directors' liability.

Prescribed Material

Corporate Law Chapter 10 paragraphs 10.40–10.66

Hahlo text at 279 (only the third paragraph starting with “Unless the ...”); 368; 604–605; notes at 607–609

Companies Act sections 226; 228; 234–241; 247; 248; 295; 296; 417; 418; 423 and 424

Novick v Comair Holdings Ltd 1979 (2) SA 116 (W) [case 216]

Aberdeen Rail Co v Blaikie Bros (1854) 1 Macq 461; 2 Eq Rep 1281 (HL) [case 184]
Barlows Manufacturing Co Ltd v RN Barrie (Pty) Ltd 1990 (4) SA 608 (C)[case 199]
Gordon and Rennie v Standard Merchant Bank 1984 (2) SA 519 (C) [case 219]
Ex parte Lebowa Development Corporation Ltd 1989 (3) SA 71 (T) [case 220]
Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman 1998 (2) SA 138 (SCA) [case 299]

In the previous study unit we concentrated on directors' fiduciary obligations and their duties of care and skill. This unit deals with obligations and restrictions imposed on directors by the Companies Act itself. We also discuss the circumstances under which a director may incur personal liability. In conclusion, we refer briefly to the corporate governance debate.

RESTRICTIONS ON DIRECTORS

Corporate Law pars 10.40–10.45

Companies Act ss 226; 228; 295; 296

***Novick v Comair Holdings Ltd* [case 216]**

The Companies Act imposes various restrictions on **benefits** to directors. These relate to payment for loss of office or on arrangements and takeovers, the issue of shares to directors and their beneficiaries, share option plans, tax free payments and loans to directors. Moreover, the issue of shares, the disposal of the whole or substantially the whole of the company's undertaking or assets and directors' responsibilities in respect of accounting records and disclosure are specifically regulated.

Section 228 determines that, notwithstanding anything contained in its memorandum or articles, the directors of a company shall not have the power, except with the approval of the company in general meeting (an ordinary resolution will therefore suffice), to dispose of the whole or substantially the whole of the undertaking of the company, or of the whole or the greater part of the assets of the company. Any resolution approving such a disposal must authorise or ratify the specific transaction in order to be effective. Note that section 228(3) provides that the requirements of the section are additional to any other requirements that may be imposed by the Securities Regulation Panel. In **Study unit 13** you will see that a disposal as contemplated by section 228 falls under the definition of an "affected transaction" in section 440A of the Act and that it is therefore also regulated by the Securities Regulation Panel. This is aimed at preventing abuse by a single shareholder or by a small group of colluding shareholders.

Directors obviously occupy an influential position in the company. The Act therefore prohibits certain **loans** to directors and managers of certain companies, and requires proper disclosure of those loans which are exempted from the general prohibition.

Section 226 prohibits certain loans. This section is discussed in paragraph 10.42 of the textbook. You will note that it also applies to the directors and managers of a company's holding company. Groups of companies are discussed in **Study unit 11**.

The disclosure in annual financial statements of some of the loans which are exempted from the prohibition in section 226 is regulated in **section 295**. **Section 296** provides for the disclosure in annual financial statements of loans for the benefit of directors and managers prior to their appointment.

Activity

Complete the following sentence:

In *Novick v Comair Holdings Ltd* [case 216] Colman J held that the only test which can reasonably be applied to ascertain whether or not the asset or assets of the company which are sought to be disposed of constitute the greater part of the company's assets in the application of section 228 is the test of ... (one word).

Feedback

The missing word is "**value**". See *Hahlo* 365 (15th line). Colman J indicated that the market value would be the only appropriate test that could reasonably be applied.

CONTRACTS BETWEEN DIRECTORS AND THEIR COMPANY

Corporate Law pars 10.46–10.54

Hahlo text at 279 (only the third paragraph starting with "Unless the ...")

Companies Act ss 234–241

Aberdeen Rail Co v Blaikie Bros [case 184]

The decision in *Aberdeen Rail Co v Blaikie Bros* [case 184] confirms a director's common-law fiduciary obligation not to allow his or her interests to conflict with those of the company. It follows from this duty that a contract concluded between the director and the company may, in appropriate circumstances, be voidable at the option of the company. Voidability may, however, be excluded by an **exclusion clause** in the articles of association. Typically, an exclusion clause authorises directors to enter into contracts with their company under certain circumstances. In *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589 (PC) the court confirmed that nothing precludes a director from voting at a general meeting in her capacity as

shareholder on a contract in which she is interested. **Sections 234–241** of the Companies Act are aimed at preventing too generous relief in terms of exclusion clauses. These sections are discussed in paragraphs 10.46–10.54 of the textbook.

Activity

The articles of association of Feelgood (Pty) Ltd authorise the directors to conclude contracts with the company, provided that the general meeting has given prior approval to all contracts exceeding the value of R1 million. The board of directors has authorised its managing director, Mrs Satekge, to purchase a car for the company for use as a delivery vehicle. Mrs Satekge owns a suitable car herself and wants to know whether she has to comply with any requirements before she may sell it to the company for R40 000.

Advise Mrs Satekge.

Feedback

Your answer should be based on sections 234–241 of the Companies Act and paragraphs 10.46–10.54 in the textbook. Since the company's articles of association contain an exclusion clause, the issue of voidability of the contract under the common law will not arise. The next question to be decided, is whether the provisions of sections 234–241 of the Companies Act are applicable. It may be assumed that the proposed purchase of the delivery vehicle is of importance to the company's business. The given facts also indicate that Mrs Satekge has been authorised by a resolution of the board of directors to enter into the contract. The sections are therefore applicable (see par 10.49 of the textbook) and Mrs Satekge must disclose full particulars of the contract of sale that she intends to conclude with the company. You should advise her on the duty to disclose, the consequences if she fails to do so, when disclosure should be made and in what way, and also that the disclosure should be recorded.

INDEMNITY OF DIRECTORS AND RELIEF BY THE COURT

Corporate Law pars 10.55–10.59

Companies Act ss 247; 248

Barlows Manufacturing Co Ltd v RN Barrie (Pty) Ltd [case 199]

A company may indemnify any director (or officer or auditor) against any liability incurred in successfully defending any proceedings brought against him. However, it is not possible, in the articles of association or by contract, to exempt directors from personal liability for negligence, default, breach of duty or breach of trust: **section**

247(1). In this regard, McLennan (JS McLennan “No Contracting out of Fiduciary Duty” (1991) 3 SA Merc LJ 86) discusses the decisions in *Barlows Manufacturing Co* [case 199] and an English decision on the same point, *John Crowther Group plc v Carpets International plc & Others* [1990] BCLC 460. In respect of *Barlows Manufacturing Co Ltd v RN Barrie (Pty) Ltd* [case 199], he notes (at 86–87) that the case:

“concerned the validity of an agreement entered into between two companies, the second applicant and the first respondent. The contract involved the sale of a certain business together with ‘tangible assets’ to the respondent. In terms of this contract the applicant was given the right to appoint, in certain circumstances, a manager to run the business sold. The powers so conferred on the manager were so extensive that, as Conradie J observed, the directors of the respondent company ‘purported to relinquish all effective control, at any rate, over that part of the first respondent’s affairs which concerns the business’ (at 611D–E). The applicant retained, for instance, the sole discretion to appoint or remove a manager and it was further stipulated that the manager was ‘absolved from liability for any omissions or for any act done properly pursuant to the powers in the clause’ (at 610A). In discharging a rule nisi that the applicants had obtained for an order of specific performance, the court held that the agreement was not enforceable.

...

“Counsel for the applicants contended that certain clauses in the company’s articles of association empowered the directors to delegate their authority in the manner they had done. Whilst it was true that these articles contained wide powers of delegation, Conradie J held that they could not be construed as permitting the board to divest itself of its control of the company.

“ ‘[I]t stretches any commercially acceptable construction of the articles to say that the directors are given authority, not only to choose someone else to do the work for them, but also to choose someone else to choose someone else to do the work for them’ (at 613D).”

In respect of *John Crowther Group plc v Carpets International plc & Others* [1990] BCLC 460, McLennan states (at 87–88) that:

“[t]he factual circumstances ... were very different. The dispute centered around a proposed acquisition by C Co of the shares of U Co. The latter company was a subsidiary of I Co. An agreement was entered into whereby I Co sold its shares in U Co, to C Co for a certain consideration. Since the sale ‘affected a substantial part of the business of [I Co] ... under Stock Exchange requirements, it had to be made conditional on approval of the shareholders of [that company]’ (at 461i). This meant that the take-over was conditional upon the passing of a resolution in a general meeting of members of I Co approving the transaction. The directors who represented the company in the

contract undertook (purportedly on its behalf) to 'use all reasonable endeavours to procure the satisfaction of the conditions' (at 462a–b). There was a rival bidder, P Co, in the offing and it transpired that the directors had already undertaken to cease all negotiations with P Co pending the holding of the general meeting of shareholders of I Co. Shortly thereafter, P Co announced an offer for the shares that was considerably more attractive than that made by C Co. The directors of I Co sent out a circular to the shareholders recommending approval of the new offer. C Co maintained that this constituted breach of contract.

...

“Vinelott J had little difficulty rejecting this contention:

‘At this point the argument becomes, to my mind, somewhat fanciful. It is for the directors to decide themselves what they consider to be in the interests of the company and to take whatever steps they think appropriate to advance the interests of the company. It is also for the directors to decide what steps they should take to discharge their duty to ensure that proper disclosure is made to the shareholders. If they act honestly in the belief and on advice that acceptance of a higher offer would not give rise to any claim for damages, then I do not see it would be right for the court to compel them to put out some circular or press release explaining that such a claim has been made’ (at 465g–h).

“In such circumstances it is submitted that there could *never* be any question of breach of contract.”

McLennan concludes (at 88):

“It is a well-established principle that directors cannot fetter their discretion by agreeing to act in accordance with the directions of others even if such directions happen to be in the best interests of the company Thus, the law does not recognize ‘nominee’ or ‘stooge’ directors. If the law will not tolerate this, then a fortiori it cannot countenance an undertaking by a director to abandon his right and duty to act in his company’s best interests. The principle, therefore, is a very simple one. A company is at all times entitled to the free, objective, and unbiased discretion of its directors to further its interests. Any agreement or undertaking that purports to subvert this principle must be void and of no effect: public policy can demand nothing less. Which brings me to my last point. It was, as we have seen, unsuccessfully contended in the *Barlows Manufacturing* case that certain clauses in the articles of association authorised the directors to delegate their powers to the extent that they could effectively ‘abdicate’. This argument carried, it is submitted, the seeds of its own destruction. The reason is that it is trite law that articles must be lawful. ‘Articles may not contravene the Companies Act or any other imperative statutory or common-law rule’ (Hahlo *op cit* 110). So even if the

relevant articles could have been construed in the manner contended for, they would have been unlawful and of no effect. No article can validly relieve a director of his fiduciary duty.”

Note that in terms of the proviso to it, section 247(1) does not apply to insurance taken out and kept by the company as indemnification against any liability of any director or officer towards the company in respect of any negligence, default, breach of duty or breach of trust.

A court may, in terms of **section 248**, relieve from liability in whole or in part a director who has acted honestly and reasonably from liability on such terms as the court deems fit. The court must be satisfied that the special circumstances provided for in the section apply before it will absolve the director. It should also be noted that the general meeting may always condone a breach of directors’ fiduciary duties which was committed in good faith. Breaches committed in bad faith cannot be condoned.

Activity

Mr Moore is a director of Tennis SA (Pty) Ltd. The articles of association of the company contain a provision that reads “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 concluding such transactions”.

Advise Mr Moore whether this provision is valid.

Feedback

Section 247 makes it impossible to exempt directors from personal liability for negligence, default, breach of duty or breach of trust. You should have referred to the decisions in *Barlows Manufacturing Co* [case 199] and *John Crowther Group plc v Carpets International plc & Others* [1990] BCLC 460, as well as the article by McLennan in which they are discussed. The articles may not contravene any statutory rule. Mr Moore should therefore be advised that the provision purporting to exempt him from liability in all instances except where he has acted with gross negligence is invalid.

PERSONAL LIABILITY TOWARDS OTHERS

Corporate Law pars 10.60–10.64

Hahlo text at 368; 604–605; notes at 607–609

Companies Act ss 417; 418; 423 and 424

***Gordon and Rennie v Standard Merchant Bank* [case 219]
Ex parte Lebowa Development Corporation Ltd [case 220]
Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman [case 299]**

Despite the fact that a company is a separate legal entity, a director may incur personal liability in several circumstances, listed in *Hahlo* at 368.

Section 423 permits the court when, in the course of the winding-up or judicial management of a company, it appears that any person who has taken part in the formation or promotion of the company, or any present or past director or officer of the company has misapplied or retained or become liable or accountable for any money or property of the company, or has been guilty of any breach of faith or breach of trust in relation to the company, to enquire into the conduct of such person and to order that person to repay or restore the property or any part thereof, or to contribute such sum to the assets of the company by way of compensation. The application to court must be brought by the Master, or the liquidator, or any creditor, member or contributory of the company.

Section 424 imposes personal liability on any person (not only a director) who was knowingly a party to the reckless or fraudulent carrying on of the business of a company. The court may declare such a person to be personally liable, without any limitation of liability, for all or any debts or liabilities of the company. Unlike section 423, the application need not be brought only in respect of a company that is in liquidation or is being wound up.

Havenga (see Michele Havenga “Directors’ Personal Liability for Reckless Trading” (1998) 61 *THRHR* 719) notes that (at 719):

“[C]ommentators have in the past questioned the effectiveness of section 424 ..., especially since recent decisions in the Appellate Division, now the Supreme Court of Appeal (*Howard v Herrigel* 1991 2 SA 660 (A); *Ozinsky NO v Lloyd* 1995 2 SA 915 (A)), refused the applicants’ claim to hold directors personally liable. However, the decision by the Supreme Court of Appeal in *Philotex (Pty) Ltd v JR Snyman* 1998 2 SA 138 (SCA) indicates that our courts are indeed prepared to use section 424 as an effective measure to control directors’ actions.”

The relevant facts in *Philotex* [case 299] and the court’s interpretation of section 424 appear from the extract in *Hahlo*. The defendant directors in this case were also directors of the holding companies, which had continued to provide financial assistance to their financially ailing subsidiary. Havenga (*supra*) further remarks (at 721) that:

“[T]he decision in *Philotex* has far-reaching implications, especially for directors in a group structure. As the trial court observed, the Wolnit directorate was really just an extension of the controlling group (179G). The

Supreme Court of Appeal opined that had there been an arm's length relationship between Wolnit and its financial supporter, the respondents might have understood their responsibilities better (179H). None the less, the respondents were not only directors of the holding company, but also of Wolnit. They and their fellow Wolnit directors should have applied reasonable standards in their conduct of the company's affairs and in observing their duty to members. Also, in the court's view, they were required to have reasonable regard for the interests of trade creditors once it was manifest, as it must have been to them, that only sufficient holding company support could keep Wolnit from commercial insolvency and liquidation (179I). In the circumstances the directors should have obtained a commitment from the group as to what financial support was available and for how long. Instead of doing that, the respondents and their colleagues on the Wolnit board left those questions both unresolved and unasked, with the result that culpably inadequate attention was given to ascertaining what support Wolnit could rely on.

“The court gave a clear indication that if the directors of Rentbel and Rentmeester [the two holding companies] had in fact held a negative view of Wolnit's prospects, it would have amounted to irresponsible and unreasonable behavior towards their own companies to inject further operating capital into Wolnit (178H). This also opens the door to action by the holding companies against the directors concerned.”

On company groups, see also **Study unit 11**.

The protection afforded by section 424 is supplementary to other common-law remedies which may be available to the plaintiff. You will note from the prescribed case extracts that the intention of the Legislature was clearly to make section 424 a meaningful remedy. The view that courts should be prepared to take a firm stance against directors' abuse of their power and position in the company has been endorsed by the Constitutional Court. In *Bernstein v Bester* (1996) 2 SA 751 (CC), for example, Ackermann J held (at 796):

“The establishment of a company as a vehicle for conducting business on the basis of limited liability is not a private matter. It draws on a legal framework endorsed by the community and operates through the mobilization of funds belonging to members of that community. Any person engaging in these activities should expect that the benefits inherent in this creature of statute will have concomitant responsibilities.”

The remedy provided by this section can also be effectively used by **creditors** of a company against defaulting directors. South African company law does not, however, at this stage recognise a duty owed directly by directors to company creditors. See paragraphs 10.62–10.63 of your textbook in this regard. See also **Study unit 3** above. What do you think? Does section 424 provide enough relief to creditors, or should the fiduciary obligation of directors be extended? Commentators like Sealy (LS Sealy

“Directors’ ‘Wider’ Responsibilities — Problems Conceptual, Practical and Procedural” (1987) 13 *Monash University LR* 164 at 176 suggest that creditors should not complain that insolvency has caused them loss because they have contracted to bear that risk, and have built compensation for bearing it into the cost of the credit (by, for example, charging interest for the services they render). On the other hand, it has been suggested (see AC MacKenzie “Directors’ Liability — In Which Direction is South Africa Heading?” 1997 *TSAR* 370 at 371) that:

“The principle of legal corporate identity and the ensuing limited liability, while encouraging entrepreneurship, can result in the creditors of the corporation bearing an unacceptable level of risk. Limited liability may fail to discourage directors from continuing to trade in technically insolvent circumstances as, in these circumstances, the major risk passes from the shareholders, whom the directors represent, to the creditors of the corporation.”

Consider also the problematic issue of enforcement. If a duty owed directly to creditors, and possibly also to other stakeholders like employees, is recognised, a member of that group should be able to enforce it. Note that in *Philotex* [case 299] the court ordered the relief to be paid directly to the appellants who were former creditors of the company. It therefore seems that South African law does afford a direct remedy to creditors through section 424.

Note also that the decision in *McLelland v Hulett* 1992 (1) SA 456 (D) (see paragraph 10.64 of your textbook) allows **shareholders**, after the dissolution of the company, to institute a delictual action against directors for an omission causing pure economic loss. This decision is important in respect of shareholders’ rights against directors.

Sections 414 and 415 provide for the holding of meetings when a company is being wound up. The purpose of these meetings is to ascertain the wishes of the creditors, members or contributories. Directors and officers must attend the first and second meetings of creditors unless their absence has been authorised by the Master, and may be interrogated at such meetings if the Master considers that they may be able to give material information regarding the company or its affairs.

Sections 417 and 418 provide for the examination of persons by the Master or a commissioner in connection with the winding-up of a company. Note that the Constitutional Court has invalidated section 417(2)(b) to the extent that it requires the person who is interrogated to answer incriminating questions.

Activity

Mrs Wood has been appointed as a director of Footwear Ltd. She is under the impression that because a company enjoys limited liability, she cannot incur personal liability in her capacity as director. Briefly explain to her the circumstances under which a director may incur personal liability.

Feedback

See *Hahlo* 368 for a list of the various circumstances in which a director may incur personal liability. You should also explain to Mrs Wood that our courts have, in decisions like *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman* [case 299] and *Bernstein v Bester* (1996) 2 SA 751 (CC), given a clear indication that directors who abuse their position will be held personally accountable.

CORPORATE GOVERNANCE AND DIRECTORS' DUTIES

Corporate Law pars 10.65–10.66

“Corporate governance” is a very wide concept and, generally, refers to all aspects of the control and management of companies. It therefore includes matters like directors’ duties, financial accounting, the duties of the company secretary and the protection of the interests of various stakeholders. In the past decade, comprehensive reports on corporate governance have been published in many jurisdictions. In England, for example, the Cadbury, Greenbury and Hampel Reports have been published. In South Africa, the *King Report on Corporate Governance* which was published under the auspices of the Institute of Directors in 1994, has led to several amendments of the Companies Act. A second *King Report* was published in 2002. Enforcement of the recommendations of the *King Report* is driven mainly by the JSE Securities Exchange South Africa, except when recommendations are incorporated into the Companies Act (as has happened, for example, in respect of the company secretary).

It is inevitable that the corporate governance debate will be influential in the future development of the law relating to company directors.

SELF-ASSESSMENT

Stonemix (Pty) has been in serious financial difficulties for the past few years. Mrs Tayob is a director of the company. The other directors wish to incur considerable expense on the purchase of very costly equipment for the company, which they hope will enable it to make its business more profitable and help it out of its financial trouble. Mrs Tayob is worried about this, because there is no proof that the new equipment will have the desired effect. She is concerned that she may incur personal liability if the company is unable to meet its future debts.

Advise Mrs Tayob.

Feedback

You should advise Mrs Tayob that she could indeed incur personal liability under section 424 of the Companies Act. Explain to her the gist of the section and discuss, specifically, the possibility that the purchase of expensive equipment in circumstances when the company is already experiencing financial difficulties could amount to reckless trading. Your answer should contain brief discussions of the relevant case law, and especially of our courts' interpretation of "reckless" in this context. Also mention that our courts have indicated that they are prepared to take a tough stance against directors in appropriate circumstances. Remember that your arguments should be properly motivated and substantiated by reference to authorities. If you were required to answer a similar question in an examination, you would be credited even if your eventual conclusion differed from that of the lecturer or fellow students, provided that your arguments and discussion of the applicable law were feasible and properly motivated.



Other office-bearers of a company

The learning outcome of this study unit is that you are able to apply the law applicable to office-bearers of a company to given sets of facts.

In order to achieve this outcome you must know and understand:

- the legal position of employees of a company
- the role and functions of the company secretary
- the legal position of managers, managing directors and chairpersons of boards of directors.

Prescribed Material

Corporate Law Chapter 11

Hahlo text at 264

Companies Act sections 1 (only definition of “officer”); 218; 268A–268I

In re Maidstone Buildings Provisions Ltd [1971] 1 WLR 1085 (Ch) [case 161]

Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd [1971] 2 QB 711; [1971] 3 All ER 16 (CA) [case 213]

Moresby White v Rangeland Ltd 1952 (4) SA 285 (SR) [case 159]

Nelson v James Nelson & Sons Ltd [1914] 2 KB 770 (CA) [case 157]

INTRODUCTION

An office-bearer of a company is not necessarily an employee of the company. An office-bearer of a company is simply one who occupies the office of, for example, a manager or director or secretary of the company.

EMPLOYEES

A company may, and normally will, employ many persons for a variety of reasons. The nature of the relationship a particular person has with the company must be ascertained from the agreement between that person and the company.

Directors are not necessarily also employees of the company. But nothing precludes a director from entering into a service relationship with the company. Employees who are also appointed as directors are generally known as executive directors (see also **Study unit 2** above).

Note that it is an offence to publish the name of a person as a director if he has not actually been appointed as such (see also **Study unit 2** above). Note too that under South African company law employees have no formal say in the management of the company in contrast with, for example, German company law.

Activity

Mr Bloch has been employed as an administrative assistant of Pointsettia (Pty) Ltd for a number of years. The company now wishes to appoint him as one of its directors. Mr Bloch likes his current position and also has very favourable conditions of service. He is unsure whether he will be able to continue as the administrative assistant of the company if he accepts the appointment as director.

Advise Mr Bloch.

Feedback

Mr Bloch should be advised that he may be a director as well as an employee (in this case an administrative assistant) of the company. See paragraph 11.03 of your textbook.

THE COMPANY SECRETARY

Corporate Law pars 11.06–11.13

Hahlo text at 264 (second and third paragraphs)

Companies Act ss 218; 268A–268I

***In re Maidstone Buildings Provisions Ltd* [case 161]**

***Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd* [case 213]**

The company secretary is usually the chief administrative officer of his or her company and therefore obviously has a key role in the proper functioning of the enterprise. The secretary is, however, not charged with any managerial powers. See *In re Maidstone Buildings Provisions Ltd* [case 161] in this regard.

Sections 268A–268I of the Companies Act contain provisions pertaining to the company secretary. These sections were added to the Companies Act following the Report by the *King Committee on Corporate Governance* in 1994, which made various

recommendations in respect of the office of company secretary. The King Committee made the following comments (see Institute of Directors of Southern Africa *Report by the King Committee on Corporate Governance* (1994) 66–67) about this office:

- “1 The company secretary has a key role to play in ensuring that board procedures are both followed and regularly reviewed.
- 2 The chair and the board will look to the company secretary for guidance on what their responsibilities are under the rules and regulations to which they are subject and on how those responsibilities should be discharged.
- 3 All directors should have access to the advice and services of the company secretary and should recognize that the chair is entitled to the strong and positive support of the company secretary in ensuring the effective functioning of the board.
- 4 It should be standard practice for the company secretary to administer, attend and prepare minutes of board proceedings.
- 5 The responsibility for ensuring that the secretary remains capable, and any question of the secretary’s removal, should be a matter for the board as a whole.
- 6 The company secretary should be the source of advice to the chair and to the board on the implementation of the Code of Corporate Practices and Conduct.
- 7 There is no requirement in the Companies Act for the board to appoint a company secretary. This anomaly should be corrected.”

The last matter was addressed by **section 268A** of the Companies Act, which now makes it compulsory for all directors of a **public company** with a share capital to appoint a company secretary. The secretary will clearly have a vital role in corporate governance and is required, in the opinion of the directors, to have the requisite knowledge and experience to carry out the duties of a secretary of a public company.

As the **chief administrative officer** of the company, the secretary exercises considerable discretion and undertakes various responsibilities. Her specific duties will, however, vary in scope and nature according to the size of her company, the nature of its activities and the function assigned to the secretary by the directors.

Section 268G sets out certain duties of the company secretary of a public company. The section makes it clear that the secretary’s duties are not restricted to those mentioned in the Act.

Note that the name of the secretary must be stated on every trade catalogue, trade circular and business letter of a public company (s 268H). The same rules applicable to directors apply in respect of the disqualification of company secretaries, except that a

body corporate may act as company secretary, provided that at least one person in the employment of that body corporate (or partnership) complies with the requirements set out in **section 268A**. See **sections 218; 268D** and **268F**.

It is stated in paragraph 11.09 of the textbook that a company secretary owes fiduciary duties to the company. Fiduciary duties are discussed in **Study unit 3**, where we deal with directors' duties. Normally a person stands in a fiduciary position towards another (the beneficiary of the duty) when he or she is able to unilaterally exercise some discretion or power affecting the beneficiary's interests. Note too that the secretary stands in the position of an employee of the company.

The view taken by English courts is that because of their more prominent role in present-day companies, company secretaries should be deemed to be authorised to conclude contracts on behalf of the company with regard to administrative matters. See *Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd* [case 213] in this regard. Dealings with outsiders on behalf of the company are discussed in more detail in **Study unit 6** below.

Activity

Mrs Ram-Prasad is a director of Judram Ltd. She has heard that all companies now have to have company secretaries and wants to know from you if this is true. She also wants to know what the duties of a company secretary are, and by whom this company officer should be appointed.

Feedback

You should have advised Mrs Ram-Prasad that only public companies with a share capital (excluding share block companies) are obliged under **section 268A** of the Companies Act of 1973 to appoint company secretaries. Since it is apparent from its name that Judram Ltd is a public company, a secretary must be appointed.

The duties set out in **section 268G** should be explained to Mrs Ram-Prasad, and it should also be explained that this list is not comprehensive. The secretary is usually the chief administrative officer of the company, but is not involved with the management of the company. Her specific duties will vary in scope and nature according to the size of her 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 (**s 268A**). The first secretary (ie of a new company) should be appointed by a majority of the subscribers or the directors (**s 268B**).

MANAGERS AND MANAGING DIRECTOR

Corporate Law pars 11.14-11.27

Hahlo text at 264 (only the first paragraph)

***Moresby White v Rangeland Ltd* [case 159]**

***Nelson v James Nelson & Sons Ltd* [case 157]**

In terms of the definitions in **section 1** of the Companies Act, the term “**manager**” includes any person who is a principal executive officer of the company for the time being, by whatever name he may be designated and whether or not he is a director. The King Committee describes a manager as someone in control of the carrying on of the business of the enterprise.

A **managing director** is usually entrusted with the power to transact the whole, or a material part, of the company’s affairs and to do everything that is necessary for that purpose. In this regard, see *Moresby White v Rangeland Ltd* [case 159].

The articles must provide for the appointment of a managing director before such an appointment can be made. See paragraph 11.23 of the textbook and *Nelson v James Nelson & Sons Ltd* [case 157]. This is usually the case. Articles 61 of Table A and 62 of Table B empower the directors from time to time to appoint one or more of their body to the office of managing director for such term and at such remuneration as they may think fit, and to revoke such appointment subject to the provisions of any agreement they may have entered into.

Since a company cannot perform juristic acts on its own behalf, it requires a natural person or natural persons collectively to perform such acts. No person can bind a company if he or she is not **authorised** to do so. The important topic of authority is discussed in more detail in **Study unit 6**. In normal circumstances, the managing director has more extensive powers than an ordinary director. An outsider contracting with the managing director (who purports to act on behalf of the company) may therefore assume that he or she has all the powers apparently associated with the office of managing director.

Activity

Mr Proudfoot is considering applying for the position of Services Manager of a large private company. He wants to know from you whether he could incur liability under the Companies Act of 1973 if he should be appointed to this position.

Advise Mr Proudfoot. (It is not necessary to discuss any provisions that may provide for liability.)

Feedback

The first aspect on which to advise Mr Proudfoot is that the term “manager” includes any person who is a principal executive officer of the company for the time being, by whatever name he may be designated and whether or not he is a director (s 1 of the Companies Act of 1973). The designation as Services Manager does not necessarily imply that Mr Proudfoot will be a manager of the company. However, if his duties are to include being in control of the business of the company, or being a principal executive officer, then he will be regarded as a manager of the company for purposes of the Companies Act. The term “officer” in the Companies Act includes any manager, secretary or managing director. If Mr Proudfoot’s position is to be that of a principal executive officer, then he will be a manager, and therefore an officer, in terms of the Companies Act. Consequently all the provisions of the Act under which personal liability can be imposed on directors or officers of the company (and there are several), will apply to him.

THE CHAIRPERSON OF THE BOARD OF DIRECTORS

Corporate Law pars 11.28-11.30

The articles of association usually provide that the board of directors may elect a chairman for a specified term. The chairman does not normally have any additional powers merely by virtue of her position as chairman of the board. She may, however, be given a specific mandate or be authorised to perform certain acts. Note that an outsider who deals with the chairperson should not assume that she has the necessary authority to bind the company. See also Study unit 6 below.

Unless the articles prohibit it, the managing director and chairperson of the board may be the same person.

SELF-ASSESSMENT

Mr Levick has been approached by the directors of Mediserve Ltd to become the company’s secretary. He has heard that the office of company secretary is regulated in the Companies Act of 1973 and is concerned that he may be subject to onerous duties.

Advise Mr Levick on the office and duties of a company secretary.

Feedback

You should have advised Mr Levick that the Companies Act includes provisions which regulate the office of company secretary. You should have briefly discussed these sections, in particular **section 268G** which sets out some, but not all, of the duties of the secretary. You should also have referred to the general comments made in the Report of the King Committee in respect of the office of this company officer. Finally, you should have mentioned that the company secretary is regarded as an officer of the company, and that as all the provisions in the Companies Act which provide for potential liability for directors and other officers also apply to the secretary.



Capacity and representation of the company

The learning outcome of this study unit is that you are able to apply the legal principles relating to the capacity of a company and the authority of those who represent it in dealings with outsiders to a given set of facts in order to decide whether the company is bound by specific contracts.

In order to achieve this outcome you must know and understand:

- the general requirements for binding a company
- the concept of the capacity of a company
- the *ultra vires* doctrine
- the operation of section 36 of the Companies Act and its effect on *ultra vires* transactions
- the doctrines of disclosure and constructive notice
- the *Turquand* rule
- the effect of the doctrine of estoppel on transactions concluded on behalf of a company
- general considerations relating to the law of agency with regard to contracts concluded on behalf of companies.

Prescribed Material

Corporate Law Chapter 12

Companies Act sections 33; 34; 36

Hahlo text at 60–61; 346; notes at 63–66; 360–363 (starting with “The *Turquand* rule” at the bottom of page 360)

Attorney-General v Mersey Railway Co [1907] 1 Ch 81 (HL) [case 28]

Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd [1964] 2 QB 480; [1964] 1 All ER 630 (CA) [case 206]

Royal British Bank v Turquand (1856) 6 E & B 327; 119 ER 886 [case 207]

Bygerstaff v Rowatt’s Wharf Ltd [1896] 2 Ch 93 [case 208]

Paddon & Brock Ltd v Nathan 1906 TS 158 [case 209]

Wolpert v Uitzigt Properties (Pty) Ltd 1961 (2) SA 257 (W) [case 211]

Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd [1964] 2 QB 480; [1964] 1 All ER 630 (CA) [case 212]

Panarama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd [1971] 2 QB 711; [1971] 3 All ER 16 (CA) [case 213]

Tuckers Land and Development Corporation (Pty) Ltd v Perpellief 1978 (2) SA 11 (T) [case 214]

INTRODUCTION

Corporate Law pars 12.01–12.03

In this study unit we are concerned with the **capacity** of a company to conclude transactions, and with the **authority** of persons who purport to act on behalf of the company in its dealings with outsiders.

Since the principles of agency, the *ultra vires* doctrine, section 36 of the Companies Act, the doctrine of constructive notice and the *Turquand* rule may interact, you will need a very clear idea of what is said in the unit as a whole before attempting to study it in detail. We therefore recommend that you read through this study unit once before you actually commence your study of the material under the specific headings.

Paragraphs 12.01-12.03 of the textbook concern the **general principles of agency**. Note that, as a general rule, a principal will **not be bound** by the **unauthorised acts** of an agent. This a general principle of the law of agency.

THE CAPACITY OF THE COMPANY — THE ULTRA VIRES DOCTRINE AND THE STATUTORY ARRANGEMENT

Corporate Law pars 12.04-12.18

Hahlo text at 60–61; notes at 63–66

Companies Act ss 33; 34; 36

***Attorney-General v Mersey Railway Co* [case 28]**

The common-law *ultra vires doctrine* is discussed in paragraphs 12.05-12.06 of the textbook. Because of its operation any act which fell beyond the capacity of the company as stated in the objects clause of its memorandum of association was (before section 36 was inserted in the Companies Act of 1973) previously **void**. The extract from *Attorney-General v Mersey Railway Co* [case 28] provides a good example of how this doctrine worked at common law, and also of how to determine whether or not a particular act falls within the capacity of a company. The *ultra vires* doctrine was based on the understanding that a company existed in law only for the purpose for which it was incorporated. Thus if the company acted outside its capacity it was as if the

company did not exist in law. If the company exceeded its capacity, the company was not bound. Furthermore, the directors could not have had authority to perform that act on behalf of the company because the company did not exist to give them the necessary authority to perform that act. The company was thus not bound for two reasons:

- because in law it did not exist, and
- therefore the directors did not have the authority to bind the company.

Commentators argued that the *ultra vires* doctrine afforded too much protection to companies. Cassim (FHI Cassim “The Rise, Fall, and Reform of the *Ultra Vires* Doctrine” (1998) 10 *SA Merc LJ* 293 at 294) points out that:

“The ultra vires doctrine has been severely criticized in every jurisdiction that adopted it. In the United States of America, the doctrine was condemned on the ground that it gave ‘the benefit to the corporation of the protection of the disabilities of a minor, or of a person non compos mentis, while it is well known that corporations are guided by the best of legal skill much more able to understand and interpret the provisions of their charters than the untrained and unsuspecting public.’”

The effect of the *ultra vires* doctrine was neutralised to a considerable extent by specific provisions of the Companies Act of 1973. See paragraph 12.07 for a concise summary of the **statutory dispensation** provided for in this Act. A company’s capacity is determined by its **main object** as stated in the memorandum of association. In addition, **unlimited ancillary objects for the purpose of achieving this object** are deemed to be included in the company’s capacity. Moreover, every company has **plenary powers to enable it to realise its main and ancillary objects**. Study sections 33 and 34 in this regard. Note that it is possible for a company’s main business and main object to be changed.

Now read **section 36** and paragraph 12.14 of your textbook very carefully. Section 36 of the Companies Act reads as follows:

“No act of a company shall be void by reason only of the fact that a company was without capacity or power so to act or because the directors had no authority to perform that act on behalf of the company by reason only of the said fact and except as between the company and its members or directors, or as between its members and its directors, neither the company nor any other person may in any legal proceedings assert or rely upon any such lack of capacity or power or authority.”

Acts beyond the objects of a company are still *ultra vires*, or outside its capacity. But section 36 provides that no such act of a company shall be void merely because of the fact that the company lacked the power or capacity so to act. Also, in as far as section 36 is concerned, the doctrine of constructive notice has become irrelevant. In other

words, it does not matter whether or not an outsider who contracts with the company is aware of the fact that the particular transaction is *ultra vires*. (The doctrine of constructive notice is discussed below.)

You should note that the directors may lack authority to act on behalf of the company for a reason **other than** the company's lack of capacity, for example if it appears from the articles that they do not have the authority to bind the company.

Let us consider the following **example**: the main object of Cycles (Pty) Ltd is to manufacture bicycles. The directors enter into a contract on behalf of the company for the purchase of a yacht. In terms of the common law (that is, the position prior to the enactment of section 36) the company would not have been bound by the contract for two reasons: (1) the company did not exist in law, and (2) therefore the directors, who would normally collectively have the authority to act on behalf of the company, did not have any authority to bind the company. However, section 36 now provides that a contract which is beyond the capacity of the company and outside the authority of the directors **only because it was beyond the capacity of the company** is no longer void. The company is thus **bound** by the contract.

Remember, however, that there may be **another reason** why the directors do not have the authority to enter into a specific contract. Say, for example, the articles of Cycles (Pty) Ltd provide that a certain director may never enter into any contract exceeding the value of R100 000. The director enters into a contract for the purchase of a yacht for R150 000. Here the company will not be bound. This is so because it appears from the articles that the director does not have the authority to bind the company to a contract which exceeds R100 000. **Section 36 would not make the contract valid** in such a situation because the director's lack of authority was not by reason only of the fact that the company lacked the necessary capacity.

Section 36 also provides that **except as** between the company and its members or directors, or as between its members and its directors, no person nor the company may rely on the lack of the company's capacity. This implies that there are some instances where the company's lack of capacity may be relied on — **not to invalidate the transaction**, because the first part of section 36 clearly provides that no act of the company shall be void — but to obtain **some other relief**. A member may, for example, rely on the company's lack of capacity to obtain an interdict to prevent the company from acting in contravention of its contractual obligations. The lack of capacity may also form the basis of an action against defaulting directors for breach of their fiduciary obligation to the company if they acted beyond their authority. Study paragraphs 12.15 and 12.16 in this regard. Also see **Study unit 3** again, where we discussed directors' fiduciary duties to the company. One of these duties is that a director must observe any limitations of the powers of the company or of her own authority.

Naudé (S) Naudé "Company Contracts: The Effect of Section 36 of the New Act" (1974) 91 *SALJ* 315) provides a good summary of the effect of section 36 (at 335). Study the extract of his article in *Hahlo* at 64.

McLennan (JS McLennan "Time for the Final Abolition of the Ultra Vires and Constructive Notice Doctrines In Company Law" (1997) 9 *SA Merc LJ* 333 comments as follows on section 36 (at 334):

"This rather clumsily worded enactment attracted criticism ... For present purposes, it will suffice to mention only one of ... [Naudé's] reservations: whilst the section may have reduced the operation of the doctrine of constructive notice to the memorandum, the doctrine 'still applies with all its vigour to the articles and hence to the whole arrangement of directors' powers contained in them'".

In respect of sections 33 and 34, McLennan further states (at 334):

"Instead of requiring the memorandum to state the company's objects, as in the past, the new [1973] Act introduced the concepts of 'main object' and 'main business'. In terms of s 33 the capacity of a company is governed by its main object:

'(1) Any company ... shall have the capacity determined by the main object stated in its memorandum and there shall be included in its capacity unlimited objects ancillary to the said main object except such specific ancillary objects as are expressly excluded in its memorandum.

(2) If the main business actually carried on at any time by a company ... falls within the capacity of the company by virtue only of an object ancillary to the main object ... such main business shall be deemed to be the main object of that company ...'

"Section 34 deals specifically with the powers of a company:

'Subject to any limitation imposed by this Act, every company shall have plenary powers, including the common powers stated in Schedule 2 to this Act, to enable it to realise its main and ancillary powers, except such specific powers as are expressly excluded or qualified in its memorandum.'

"The overriding impression of both these sections is one of vagueness. 'Main object' and 'main business' are imprecise expressions. It is by no means clear what 'ancillary objects' are. 'Plenary powers' would seemingly allow a company to do anything it liked. The effect of s 33(2) is that the main object — and hence the capacity — of a company can shift and change informally and that the actual capacity of a company could be something quite different from its stated main object! Whilst this is absurd, it is probably safe to assume that it is also harmless. But, in any event, the question arises: what is the point of having a main object?"

McLennan then makes out a strong case for amending sections 33 and 34 (at 334–335):

“The advantage of the vagueness of ss 33 and 34 is that it would be very difficult for a company or anyone else to establish that any particular act fell outside the capacity or powers of the company. And, even if one can clear this hurdle, the uncertainties of s 36 still have to be faced. All this may well explain why there has apparently been no litigation on the subject since the Act was passed. The sections may be inept and badly drafted, but it would appear as if they have had the desired effect. So, is that not a good reason to leave them alone? Well, I am not so sure. Sections 33(1) and 34 make provision for the express exclusion of specific ancillary objects and powers. I would imagine that very few companies provide for such exclusions, but it is not clear what the position would be if a company acted in contravention of such an exclusion. Far more important is the point made above regarding constructive notice and the articles. Suppose it is provided in a company’s articles that a certain contract or type of contract must be signed by at least two directors. In the event it is signed by only one director. The contract is not binding on the company even if that person is the managing director, acting with the authority of the board. The article effectively prohibits a director from representing the company on his own. Constructive notice will defeat the other party’s case. The *Turquand* rule does not help him in these circumstances: if he had read the article, he would have seen that a contravention was actually taking place.

“The framers of the Close Corporations Act 69 of 1984 [close corporations are discussed later in the guide] made sure not to bedevil the statute with these nineteenth-century doctrines, which, as we have all learned, were misconceived in the first place. The relevant provisions of that Act could, it seems to me, be adapted quite simply to the Companies Act with minimal consequential amendments. I would propose the repeal of ss 33, 34, 36 and Schedule 2 of the Companies Act and the enactment of the following two new sections (or subsections) —

(1) Capacity and powers of companies

‘There shall be no limit to the capacity and powers of a company other than such capacity and powers as are impossible for a juristic person to possess or to exercise.’

(2) No constructive notice of company documents

‘No person shall be deemed to have knowledge of any particulars merely because such particulars are stated, or referred to, in any document regarding a company registered by the Registrar or lodged with him, or which is kept at the registered office of a company in accordance with the provisions of this Act.’

“It will be observed that (1) is an adaptation of s 2(4) of the Close Corporations Act. In (2) I have used the exact wording of s 17, save that I have omitted the reference to the founding statement.

...

“It is submitted that such changes would provide a much more satisfactory and comprehensible framework, similar to that which exists in the Close Corporations Act. In particular, our company law would be rid finally of the pernicious doctrine of constructive notice and, as a further consequence, the problematic *Turquand* rule would also become legal history.”

Cassim (FHI Cassim “The Rise, Fall, and Reform of the Ultra Vires Doctrine” (1998) 10 *SA Merc LJ* 293 at 311) agrees that there is no need for the provisions contained in sections 33 and 34:

“It really is questionable whether it makes sense for the Companies Act to require a company to have an objects clause, since these clauses are not informative but serve only to deceive and obscure the true business activity of the company. An objects clause is not a suitable vehicle for protecting the interests of the shareholders and creditors. I believe that companies should be allowed to carry on any type of business they wish, subject to restrictions imposed by the articles of association of the company. These restrictions should operate only between the company, the directors, and its shareholders, and should have no effect on third parties or outsiders.”

However, Cassim (*op cit* at 315) is of the opinion that section 36:

“... is not too badly out of step with modern trends and developments.

“Section 36 abolishes the ultra vires doctrine externally. But it is badly drafted. It has to be redrafted to eradicate its defects, uncertainties, and shortcomings.

...

“The reform of the ultra vires doctrine is not simply a matter of giving a company the capacity of a natural person, as has been done with close corporations. The problem is far more complex. For example, the Companies Act does not adequately deal with the problem of the authority of the directors to enter into an ultra vires contract. Perhaps the time is ripe to also take the opportunity to simplify this complex area of company law, by introducing statutory provisions on presumptions similar to those that apply in New Zealand or Australian company law, which would make it unnecessary for bona fide third parties to enquire into the scope of the authority of the directors of a company.”

When you have studied the discussion below on the doctrine of constructive notice and the *Turquand* rule, consider whether you agree with the suggestions made by McLennan and/or Cassim.

Activity

The main objects clause as set out in the memorandum of association of Leroy Brown (Pty) Ltd provides that the company is to be involved in all aspects of the manufacture and sale of cast-iron garden furniture. The board of directors concludes a contract with Mrs Lewis in terms of which the company agrees to purchase pre-fabricated huts from her for resale by the company.

Discuss whether the company is bound by the contract concluded with Mrs Lewis.

Feedback

The capacity of the company is apparent from its main objects clause. It is to be involved in the manufacture and sale of cast-iron garden furniture. The purchase of pre-fabricated huts has nothing to do with the company's capacity. This transaction is therefore *ultra vires*.

It is therefore necessary to consider the effect of section 36 of the Companies Act of 1973. You should briefly, **and in your own words**, have stated what section 36 provides. Your conclusion should have been that the contract is valid, despite the fact that it is beyond the capacity of the company. It would make no difference even if Mrs Lewis knew of the lack of the company's capacity.

Note that the board of directors is generally authorised to conclude transactions on behalf of the company and, in the absence of any indication to the contrary, it can be assumed that they have such authority. It is therefore not necessary to discuss the directors' authority.

REPRESENTATION OF THE COMPANY, THE DOCTRINE OF DISCLOSURE, THE DOCTRINE OF CONSTRUCTIVE NOTICE, THE *TURQUAND* RULE AND ESTOPPEL

Corporate Law pars 12.19-12.39

Hahlo text at 346; notes at 360–363 (starting with “*The Turquand rule*” at the bottom of page 360)

Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd [case 206]

Royal British Bank v Turquand [case 207]

Bygerstaff v Rowatt's Wharf Ltd [case 208]

Paddon & Brock Ltd v Nathan [case 209]

Wolpert v Uitzigt Properties (Pty) Ltd [case 211]

***Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [case 212]**
***Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd* [case 213]**
***Tuckers Land and Development Corporation (Pty) Ltd v Perpellief* [case 214]**

A transaction concluded by the board of directors, acting within the powers conferred upon it by the company's constitution, is binding on a company. So is any contract concluded by a director, manager, or officer of the company if that person acts within his or her actual authority. On actual authority, see *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [case 206]. (The other extract from the same decision [case 212] is referred to below, where we discuss estoppel.)

The **doctrine of disclosure** is discussed in paragraphs 12.21-12.25 of your textbook. In paragraphs 12.26-12.28 you will find a discussion of the **doctrine of constructive notice**. The authority to act on behalf of a company is usually regulated in the company's articles. Ever since the old English decision in *Ernest v Nicholls* (1875) 6 HL Cas 401 it has been accepted that anyone dealing with a company is deemed to be fully acquainted with the **public documents** of that company, which include its **memorandum** and **articles** of association, as well as any **special resolutions**. These documents are all lodged with the Registrar of Companies and are therefore available for public inspection. This doctrine is known as the doctrine of constructive notice. It follows that where Summit Ltd's articles authorise directors Smith and Jones to conclude contracts on its behalf and a third party concludes a "contract" with Ntuli who purports to represent Summit Ltd, the company would not be bound by the contract since the third party is deemed to know that Smith and Jones have the authority to bind the company, but would not know whether Ntuli was authorised.

The doctrine of constructive notice also operates where someone who is authorised to represent the company, acts beyond the scope of his authority. For example, let us assume the company's articles authorise Andrew to act on its behalf, but limit his authority to contracts which do not exceed R50 000. The company would not be bound by a contract entered into by Andrew on behalf of his company for the purchase of equipment worth R100 000. The other contracting party is deemed to know the limitations on Andrew's authority.

Note that the doctrine of constructive notice applies to information that **actually appears** from the public documents. If, for example, the articles provide that Mr Ramongana **may not** contract on behalf of the company, an outsider cannot conclude a contract with the company by transacting with Mr Ramongana. This would be the case even if Mr Ramongana is the managing director of the company (see also the extract from McLennan's article which is quoted above in this regard). If, however, the articles provide that Mr Mpise **may be** authorised by the company in general meeting to conclude contracts exceeding the value of R20 000, then the outsider is only deemed to know that the **possibility** exists that Mr Mpise **could be** authorised to conclude such a contract. The outsider will not, by virtue of the doctrine of constructive notice, be able to assume that Mr Mpise **has been** authorised. The *Turquand* rule may, however, assist the outsider (see below).

Interestingly, the doctrine of constructive notice has been abolished in its jurisdiction of origin, England, and also in Australia, New Zealand and Canada. Cassim (FHI Cassim “The Rise, Fall, and Reform of the Ultra Vires Doctrine” (1998) 10 *SA Merc LJ* 293 at 311) remarks:

“Furthermore, the English doctrine of constructive notice, as laid down in *Ernst v Nicholls*, has now been abolished in English law. I believe that South African company law should follow suit.

...

So South African law is conspicuously out of step with other similar jurisdictions in preserving this troublesome and archaic doctrine.”

This is also the view of other commentators including, as we saw above, McLennan. There appears to be general agreement that the doctrine of constructive notice should no longer be retained in our company law.

The *Turquand* rule applies to **internal requirements**. An example of an “internal requirement” is where the company has to approve something in general meeting. Let us again use the example of the articles providing that Mr Mpise may be authorised by the company in general meeting to conclude contracts exceeding the value of R20 000. It appears from the articles only **that** a general meeting **should** be held at which the approval must be obtained, but **not whether** that meeting has in fact **been** held and the approval obtained. This is where the outsider may rely on the *Turquand* rule — to assume that the approval from the company in general meeting has been obtained. In paragraph 12.30 of your textbook you will find a discussion of the application of the *Turquand* rule. Note the **exceptions** to the rule which are discussed in paragraph 12.31. Study the decision in *Paddon & Brock Ltd v Nathan* [case 209]. It provides an example of a case in which the circumstances surrounding the transaction were suspicious and the outsider was precluded from relying on the *Turquand* rule. You should also remember that senior officials in the company structure, for example, the board of directors or the managing director, usually possess express authority to act on behalf of the company. Study the rules in this regard which are set out in the judgment of Claassen J in *Wolpert v Uitzigt Properties (Pty) Ltd* [case 211]. It is clear from this decision that an outsider who deals with an ordinary director may not assume that a particular (ordinary) director has the necessary authority to contract on behalf of the company. This is so even if the articles provide that **an** ordinary director **may be authorised** to conclude the particular transaction, without specifically mentioning a **particular** director. The outsider may not assume on the basis of the *Turquand* rule that the director with whom he or she is contracting is the particular director who has been authorised. The decision in *Tuckers Land and Development Corporation (Pty) Ltd v Perpellief* [case 214] is an example of where the individual who purported to act on behalf of the company did not have the necessary authority to do so.

Estoppel as a basis for binding the company is discussed in paragraphs 12.33-12.36. Estoppel only comes into play when the agent did not have actual (express or implied) authority to bind the company. Take particular note of the fact that the

misrepresentation that the agent had the necessary authority must have been made by the **company** as principal. It is not sufficient for the agent to have made the misrepresentation. This rule is logical: if Peter were to tell you that he is the authorised agent of a particular company and it transpires that the company has never even heard of him, the company will not be bound to any contract concluded by him on their behalf even on the basis of estoppel. But if Peter has regularly been concluding contracts on behalf of the company without being authorised thereto and the company has regularly and without objection been meeting its “obligations” under these contracts, a good case can be made out that the company should be estopped from denying liability under a similar contract concluded by Peter. There must of course also be compliance with the other requirements for estoppel before the company will be bound. Clearly therefore, estoppel will only be relevant in **exceptional circumstances**, when there is also a clear indication that all the requirements of this doctrine are met.

The decision in *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [case 212] is discussed in paragraphs 12.34 and 12.35 of your textbook. You must also study the extract from the judgment of Diplock LJ in *Hahlo*.

Now study the **general considerations** summarized in paragraphs 12.37–12.39 of your textbook. Also bear in mind that the **managing director** and the **board of directors** (that is, the directors acting together) are generally entrusted with the management of the company (see **Study units 2 and 5** above) and may, unless there are indications to the contrary, be assumed to have authority to act on behalf of the company. Remember too, that the company **secretary** is the chief administrative officer of the company. In view of the recent developments and increased importance of this company officer’s role in the company (see **Study unit 5** above), it may be assumed that the secretary may conclude contracts related to the company’s **administration** on its behalf. See *Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd* [case 213] in this regard.

Activities

- 1 The memorandum of association of Protea (Pty) Ltd provides that the main object of the company is the manufacture of a tar mixture for the construction of roads. The company’s articles of association provide that only the board of directors, or any person appointed by the board, is entitled to conclude contracts on behalf of the company. The articles further provide that any contract which involves the expenditure of more than R100 000 must first be authorised by the company in general meeting. The board of directors of the company concludes a contract for the purchase of equipment that will be used in the process of manufacturing the tar mixture. The contract price is R200 000. The contract was concluded without the necessary authorization by the general meeting.

Consider whether Protea (Pty) Ltd is bound by the contract.

- 2 The articles of association of Wildwest (Pty) Ltd provide that its main object is to do

business as a furniture removal and storage company. The articles further provide that the management of the company is vested in the board of directors and that any contract for the purchase of immovable property by the company which exceeds the value of R500 000, requires the prior approval of the company in general meeting by ordinary resolution, while any such a contract exceeding R1 million in value, requires prior approval by special resolution.

The board of directors concludes a contract to purchase an immovable property which the company requires for storage space. The approval of the general meeting has not been obtained for the particular contract.

Consider whether the company would be bound by the contract if the purchase price is R750 000. Would your answer differ if the purchase price is R1,25 million?

Feedback

- 1 The contract clearly falls within the capacity of Protea (Pty) Ltd and section 36 of the Companies Act of 1973 is therefore not applicable. The contract concluded by the board exceeds the limit of R100 000 which was stipulated in the articles and the authority of the board is subject to the internal formality that the prior authorisation by the company in general meeting should first be obtained. The seller of the equipment is, by virtue of the doctrine of constructive notice, deemed to know that this internal formality must be complied with. But the seller will not know from the public documents of the company whether the internal formality has been complied with (that is, whether the authorization has been given by the company in general meeting). He or she may rely on the *Turquand* rule to assume that the internal formality has been complied with. You should briefly have described what the *Turquand* rule states, and should have referred to *Royal British Bank v Turquand* [case 207]. The stated facts do not indicate that any of the exceptions to the *Turquand* rule apply. Based on this rule, Protea (Pty) Ltd is bound by the contract.

Note that since the facts give no indication of the presence of the requirements of estoppel, it is unnecessary to discuss this aspect.

- 2 The contract is clearly within the capacity of the company and section 36 need not be discussed. The board of directors may, in terms of the articles, conclude contracts on behalf of the company. There is no problem in respect of their authority in this regard. But the directors require the consent of the general meeting in respect of transactions for the purchase of immovable property which exceed the value of R500 000. Where the purchase price is R750 000, the consent of the general meeting by **ordinary resolution** is required. The outsider (the seller) would be able to rely on the *Turquand* rule, because it will be apparent from the articles only that such consent is required, but not whether it has actually been obtained. The company would be bound by the contract. But where the purchase price is R1,25 million, the outsider will not be able to rely on the *Turquand* rule. The seller

would have been able to ascertain that the required consent had not been obtained, because **special resolutions** are public documents that have to be registered with the Registrar of Companies (see s 200 of the Companies Act of 1973). The requirement that the general meeting has to consent by special resolution can therefore not be regarded as an internal formality to which the *Turquand* rule would apply and the contract would not bind the company.



In conclusion, remember the following as a general guideline:

When you are confronted with a problem relating to the **capacity** of a company, section 36 will apply. When the **authority** of persons acting on behalf of the company is concerned, and the lack of authority is the result of something else (ie a provision in the articles) and not a consequence of the company's lack of capacity, you will have to consider whether the *Turquand* rule is applicable. If a particular transaction is clearly within the capacity of the company, it is obviously not necessary to discuss section 36.

In order to ensure that you have fully grasped the various rules and doctrines explained in this study unit, we strongly recommend that you attempt to answer the self-assessment question below. Do not look at the feedback to it before you have attempted to formulate your own answer.

SELF-ASSESSMENT

Rugbymania (Pty) Ltd sells sports gear. The articles of association of the company provide that the management and control of the company are vested in the board of directors which has the power to delegate its authority to an ordinary director. The articles further provide that any contract concluded by a director which exceeds the value of R100 000 requires the prior approval of the company in general meeting.

- 1 The board of directors concludes a contract to purchase a house on the Kwazulu-Natal North Coast from Wise. Wise had previously dealt with the company and is aware that its main business is the sale of sports gear. Ramon, a member of Rugbymania (Pty) Ltd, wants to know whether the company is bound by the contract. Advise Ramon.
- 2 The board of directors of Rugbymania (Pty) Ltd delegates its authority to Sally, an ordinary director of the company. Sally concludes a contract to the value of R150 000 for the purchase of imported soccer boots on behalf of the company without obtaining the prior approval of the company in general meeting. Consider whether the contract is binding on the company. Also consider if your answer would differ if the same contract had been concluded by Lisa, another ordinary director of the company, who had not had any authority delegated to her by the board of directors.

Feedback

The question involves the application of the legal principles relating to the capacity of a company and the authority of the persons who represent it in transactions with outsiders, to a given set of facts in order to decide whether the company is bound by a contract. Remember that in a question of this nature you should incorporate as many of the **relevant** prescribed cases and articles as possible, even though your discussion may be **brief** (eg where a particular case merely substantiates a point that you have made).

- 1 The contract concluded by the board of directors falls outside the capacity of Rugbymania (Pty) Ltd. Prior to the coming into operation of section 36 of the Companies Act of 1973 the contract would have been void as a result of the *ultra vires* doctrine. You should **briefly** have discussed the operation of this doctrine and the applicable cases.

Section 36 now provides that no act of a company shall be void (in other words, the contract is valid) merely because the company was without the capacity or authority to act, or because the director who concluded the transaction had no authority because of the company's lack of capacity. Thus the company would be bound by the contract even though Wise knew that the act was outside the capacity of the company. The only remedy the company would have at this stage (it is too late to obtain an interdict against the board to prevent the conclusion of the contract) is to claim damages from the directors who concluded the contract on the basis that they have breached their fiduciary duty (to act within their powers) to the company.

Depending on the marks allocated for this type of question, a good answer would also have included references to the articles by Naudé and McLennan, as set out above.

- 2 Here the contract is clearly within the capacity of the company and section 36 need not be discussed. The board has delegated its powers to Sally. Although she is an ordinary director, she has been authorised to conclude contracts on behalf of the company. The problem revolves around the fact that Sally did not obtain the required consent of the general meeting for the contract exceeding R100 000 as stipulated in the articles. The doctrine of constructive notice assumes that everyone dealing with the company is fully acquainted with the contents of the public documents of the company. You should have **briefly** discussed the origin and content of this doctrine. The seller of the soccer boots is therefore presumed to have known that the prior approval of the company was needed and cannot deny that he or she was unaware of the limitations on Sally's authority.

The seller is, however, protected by the *Turquand* rule even if he or she has never read the articles. You should have explained the operation of this rule. The seller is entitled to assume that internal requirements have been complied with. The seller may therefore assume that Sally obtained the prior approval of the company in

general meeting. The contract will bind Rugbymania (Pty) Ltd unless the seller was in bad faith and knew that Sally's mandate was defective, or if he or she (the seller) should have been on his or her guard in this respect. There is, however, no indication of this in the given facts.

Had Lisa concluded the contract, the answer would be different. An ordinary director is not usually authorised to conclude contracts on behalf of the company. Although the seller would have been entitled to assume that someone could have had authority delegated to him or her, the seller would not be entitled to rely on the *Turquand* rule to assume that Lisa is that person. This is apparent from the decisions in *Wolpert v Uitzicht Properties* [case 211] and *Tuckers Land and Development Corporation (Pty) Ltd v Perpellief* [case 214]. The contract would therefore not bind the company.



Capital structure

The learning outcome of this study unit is that you are able to apply the basic principles of corporate finance in deciding how a company should structure its capital.

In order to achieve this outcome you should know and understand:

- the distinction between share capital and loan capital
- the distinction between authorised and issued share capital
- the distinction between par value and no par value shares
- the characteristics of the main classes of shares
- when redeemable preference shares may be redeemed
- the distinction between debentures and other forms of loan capital
- how the authorised share capital of a company may be varied
- the principles regarding the share premium account and the capital redemption reserve fund.

Prescribed Material

Corporate Law Chapter 14 **excluding** paragraphs 14.29–14.34; Chapter 20 paragraphs 20.37–20.42

Companies Act sections 52(2); 74–76; 98

Utopia Vakansie-Oorde Bpk v Du Plessis 1974 (3) SA 148 (A) [case 84]

SHARE CAPITAL AND LOAN CAPITAL

***Corporate Law* pars 14.01; 14.41**

One of the main advantages of companies, particularly public companies, is that they make it easier for an enterprise to raise large amounts of capital from investors. The need for large amounts of capital played an important role in the early development of company law during the Industrial Revolution. However, the ability to obtain a large

capital is not important in every enterprise and many companies operate successfully with very little capital. The capital of a company usually consists of two kinds of capital, namely share capital (or equity) and loan capital (or debt).

Share capital is the fund which reflects the consideration that the company receives when it issues shares to its shareholders. The issued share capital is thus the company's own funds and is reflected in the balance sheet as owner's interest or equity. Although the textbook states that share capital is the primary source of capital of a company, this does not mean that it is necessarily the largest source of the company's capital. It is regarded as primary because a company **must** have a share capital (unless of course it is a company limited by guarantee). In its memorandum of association a company with a share capital has to state its maximum authorised share capital. The authorised share capital is just a figure and a company need not issue all its shares. When we refer to share capital as a source of capital for a company we mean the issued (or paid-up) share capital and not the authorised share capital. (Since stamp duty is payable on the maximum authorised share capital, companies usually choose an authorised share capital close to the amount of the shares they intend issuing.) As you will see later in this study unit, a company may at any stage vary its authorised or even its issued share capital.

The second source of capital is loan capital, reflected in the balance sheet as external interests. The company obtains this by issuing debentures or by taking up other loans.

The providers of share capital are the members or "owners" of the company while the providers of loan capital are creditors. Creditors receive interest while shareholders receive dividends. If the company is liquidated and it is insolvent, the creditors are entitled to be paid back first. If a balance remains, it will be distributed among the shareholders. The shareholders thus bear a greater risk of losing their investment than the creditors do. This theoretical distinction explains why shareholders have a say in the company affairs through their voting rights and other membership rights while creditors do not. The same person can be both a shareholder and a creditor of a company.

Various factors, such as interest rates, the availability of security and the tax treatment of interest and dividends can influence a company's decision on the ratio between equity and debt financing. The debt/equity ratio of a company reflects the extent to which it uses each of the two kinds of capital. A debt/equity ratio of 1:1 means that half of the company's capital is derived from each source, while a ratio of 2:1 means that for every one rand of share capital the company uses two rands of loan capital. In our law there are no rules prescribing a maximum debt/equity ratio for companies.

The concept of "gearing" or "leveraging" is important in this regard. If a company has a high percentage of debt financing, we say that it is leveraged or geared. This means that the potential return for the shareholders is increased. An example can explain this better:

Zeno Ltd needs capital of R500 000 for the business it is starting. If it uses only equity finance, ie issues shares for the full R500 000, and makes a profit of R100 000, each shareholder will receive a return of 20% if the whole profit is distributed to the shareholders. Let us now assume that Zeno Ltd has issued R200 000 worth of shares and taken up loans for the balance at an interest rate of 15%. (Zeno Ltd thus has a debt/equity ratio of 3:2.) The first R45 000 of the R100 000 return would have to be applied to pay the fixed interest on the loans (15% on R300 000). This would leave a balance of R55 000 to be distributed to the shareholders, ie a return of 27,5%. If the gearing is further increased, the return to the shareholders will increase even further. Let us assume that Zeno Ltd issues only R100 000 of shares. (Its debt/equity ratio will thus be 4:1.) Once the 15% interest on the R400 000 loan is paid, the shareholders will be left with R40 000, representing a return to them of 40%.

Obviously there are risks involved in excessive gearing and, depending on the interest rates and the actual return or profit, the shareholders may get much less than they had anticipated. If a company becomes too highly geared even the creditors are placed at risk. If, in our example, Zeno Ltd were to make a profit of only R50 000, the creditors in our last instance would not receive the fixed interest they are entitled to.

Activity

Theo wants to invest in a company. He has heard that the company is issuing both shares and debentures. He asks you for advice on the difference between these two forms of investment.

Feedback

You should explain the difference between share capital and loan capital of a company. If Theo invests in shares, he will be a shareholder. As debenture holder he will be a creditor of the company. Basically, the difference between the two forms of investment is:

- Shareholders, the providers of share capital, are entitled to dividends while debenture holders, who provide loan capital, are entitled to interest. The interest on debentures is usually fixed and has to be paid before shareholders can receive dividends.
- Upon liquidation the creditors have to be paid before the shareholders are entitled to share in the distribution.
- Shareholders are members of the company and have a say in the affairs of the company through their membership rights. Debenture holders are not members of the company.

With this information in mind, Theo should be able to make an informed decision depending on the degree of risk he is willing to take and his perception of the prospects of the company.

TYPES OF SHARES

Corporate Law pars 14.03–14.09

Companies Act ss 52(2); 74

The Companies Act requires a company having a share capital to state in its memorandum its authorised share capital (s 52(2)). Where the company has **par value shares** it must state the amount of the share capital with which it is proposed to be registered, and the division thereof into shares of a fixed amount. The provision in the memorandum may look like this: “The capital of the company is R1 000 divided into 1 000 shares of R1 each”. Where the company has **no par value shares** it must state the number of shares, so the memorandum could provide “The share capital of the company is 1 000 shares of no par value”.

The par value or nominal value of a share very rarely reflects its actual or market value, and may be regarded as a purely arbitrary figure. Nevertheless, the par value has legal implications, for example the rule that a par value share may generally not be issued for less than its nominal value. The market value of all shares fluctuates — par value and no par value alike — depending on different factors such as the financial position of the company and the earning capacity of its shares. In the case of no par value shares, the potentially misleading concept of nominal value is absent. Also, certain rules do not apply, or apply less rigorously, to no par value shares.

Activity

The share capital of Handson Ltd consists of 2 000 ordinary no par value shares. The company needs further capital and intends issuing redeemable preference shares for this purpose. What type of shares should the new shares be?

Feedback

The redeemable preference shares can be either no par value or par value shares. A company may issue both types of shares, provided that all the ordinary shares must be of one type (ie either par value or no par value) and all the preference shares must be of one type, which may either be the same type as the ordinary shares or a different type (s 74). However, once it has decided on the type of preference shares it wants to issue, Handson Ltd will have to use that type (ie either par value or no par value) for all preference shares it wants to issue in the future. Although no par value shares are not widely used, they have certain advantages over par value shares, such as the fact that it is fairly easy to issue them at a higher or lower price than their first issue price.

THE CLASSIFICATION OF SHARES

Corporate Law pars 14.10–14.28

***Utopia Vakansie-Oorde Bpk v Du Plessis* [case 84]**

Although the Companies Act does not define the term “share”, it is clear that a share:

- is a form of **property** (it can be bought, sold, used as security, etc)
- denotes a **financial stake** in the company (entitling its holder to dividends and to participate in a distribution on liquidation)
- entitles its holder to **membership rights** (such as voting rights).

Shares in a company need not all be of equal value. Nor is it necessary that equal rights and privileges should be attached to all shares: some may have preferential rights, either to **capital**, **dividend**, or **both**. They may even, subject to the provisions of sections 193–198, have peculiar privileges in the matter of voting or in other respects. Thus, the division of shares into various classes is based on the nature of the rights afforded by them in regard to dividends and participation in a distribution on liquidation. The differing degrees of risk assumed by the various classes of shareholders are very often also reflected in their voting rights.

The preferential dividend position enjoyed by the holders of preference shares is offset by the fact that their voting rights are usually curtailed by the articles of the company (see **pars 14.22** and **8.43** of your textbook). The general rule, set out in the Companies Act, is that every member of a company must have the right to vote at meetings of that company in respect of each share held by him or her. However, section 194 permits the articles of a company to provide that its preference shares will not confer the right to vote at meetings, except in the following circumstances:

- during any period for which any redemption or dividend payment on such shares remains in arrears and unpaid
- in regard to any resolution proposed which directly affects any of the rights attaching to such shares or the interests of their holders, including a resolution for the winding-up of the company, or for the reduction of its capital.

In *Utopia Vakansie-Oorde Bpk v Du Plessis* [case 84] the question arose whether — since shareholders have the right to a dividend only once it has been declared — the dividend on preference shares could be said to remain “in arrears and unpaid” if no dividend had been declared by the company. The court said that in the context of section 194, these words were wide enough to include the situation where the fixed dividend on preference shares had not been declared. The court also pointed out that the “interests” of preference shareholders were to be interpreted widely, because the concept of **interests** was much broader than that of **rights**.

When you read paragraph 14.25 for purposes of the current heading, you need only study the first two sentences. Study the rest of the paragraph when you get to the redemption of preference shares later in this study unit.

One of the reasons a company would issue redeemable preference shares is that it may need a part of its capital for a fixed period only. A company may also convert existing shares into redeemable preference shares (s 75). Such conversion and redemption can, as stated in the textbook, be used to effect alterations of control. The conversion and redemption will alter the balance of the voting rights in the company.

In practical terms redeemable preference shares are difficult to distinguish from debentures, since both these securities entitle their holders to a fixed return and the investment in both can be returned to the holders. As stated in your textbook, however, the legal distinction between shareholder and creditor remains. Debenture holders are thus entitled to payment before holders of redeemable preference shares.

A company can have different classes of ordinary shares and of preference shares, in which case it is customary to use a letter of the alphabet to distinguish between them. For example, if a company has two classes of ordinary shares they may be called class A and class B ordinary shares. The nominal value or issue price of the two classes could differ, as could the voting rights attached to them. In the case of preference shares, the percentage of the fixed dividend of the classes could differ, or some classes may be participating preference shares while others are not. Different classes of preference shares are usually distinguished by reference to the amount or percentage of the fixed dividend as well as the order in which it is payable. For example, if a company has two classes of preference shares they may be called 6% first preference shares and 8% second preference shares. In the case of par value preference shares the percentage refers to the nominal value, and in the case of no par value preference shares, to the issue price.

Activity

Jane has inherited shares from her uncle. They are described in the will as “class A ordinary shares” and “class B preference shares”. She wants to know what the distinction between ordinary and preference shares is and how she can determine exactly what rights the shares will confer on her. Advise her.

Feedback

The difference between ordinary shares and preference shares is that preference shares have some preferential rights to dividends and/or repayment of capital upon liquidation when compared to ordinary shares. The rights attaching to a particular class of shares are set out in the conditions of issue of those shares. The conditions of issue may be found in the memorandum or articles of the company or in the resolution which created that class of shares. Jane can thus determine her rights by consulting the conditions of issue of the shares she inherited.

THE REDEMPTION OF REDEEMABLE PREFERENCE SHARES

Corporate Law par 14.25

Companies Act ss 75(1)(e), (g), (i); 98–99

When a company redeems a share, it refunds to the shareholder his or her contribution to the capital of the company and cancels the share. While the articles of a company may prescribe the terms and manner of redemption, section 98 of the Companies Act provides that the redemption may be funded only out of two possible sources. The purpose of the provision is to ensure the integrity of the company's share capital. In **Study unit 10** you will see that a company may also acquire its own shares (which has the same effect as redemption) in terms of section 85, in which case it does not have to maintain its share capital. It is perhaps anomalous that redeemable preference shares are treated differently from other shares. However, a company with redeemable preference shares may convert those shares into shares of another class and then repurchase them in terms of section 85. Section 75(1)(i), which allows a company to convert any of its shares into shares of another class, is discussed later in this study unit.

Activity

Topfin (Pty) Ltd intends converting all its class B ordinary shares into redeemable preference shares. It then wants to issue a new class of ordinary shares, class C ordinary shares, and use the proceeds to redeem the converted redeemable preference shares. Explain whether this is possible.

Feedback

Section 75(1)(i) states that a company may convert any class of shares into shares of another class. Section 99 states that when shares have been converted into redeemable preference shares, the provisions of section 98 regarding redemption will apply to those shares. The articles of Topfin (Pty) Ltd will have to authorise the existence of redeemable preference shares. The redemption can be funded either out of profits available for dividend or out of the proceeds of a fresh issue of shares made for the purposes of the redemption. The intended redemption is thus lawful. It will not affect the total issued capital of Topfin (Pty) Ltd because the new shares will replace the redeemed shares.

SHARE PREMIUM ACCOUNT AND CAPITAL REDEMPTION RESERVE FUND

Corporate Law pars 20.37–20.40

Companies Act ss 76; 98

The Companies Act specifies the purposes for which each of these two non-distributable reserves may be applied. When they are not being applied for one of these purposes set out in sections 76(3) and 98(4), they are treated like share capital (see s 76(1) and s 98(1)(b)). The purposes for which each of these reserves may be applied according to sections 76(3) and 98(1) are couched in permissive terms — both these provisions state that the particular reserve **may** be applied for the purposes listed **notwithstanding** the fact that it is regarded as share capital. In the past this meant that, except under a formal reduction of capital, they had to be maintained and could only be applied for these limited purposes. However, the relaxation of the capital maintenance rule (see **Study unit 10**) has the effect that the possibilities for applying the statutory non-distributable reserves have also been extended. It also appears that when the reserves are being applied for the stated purposes, the provisions of sections 85 and 90 need not be complied with. Although paragraph 20.39 of your textbook correctly states that the repayment in general of the share premium account would be subject to section 90, paragraph 20.40 creates the impression (which is contradicted by footnote 88) that the capital redemption reserve fund may be applied only to provide for capitalisation shares. This is wrong, and for two reasons. First, section 98(4) provides that the capital redemption reserve fund may be applied to provide for a premium when the company acquires its own shares under section 85. Secondly, it should also be possible to make payments to members out of this reserve in terms of section 90.

Activity

Because Cyclepower (Pty) Ltd recently used all its divisible profits to redeem preference shares, it does not have distributable funds available from which to declare a dividend. In an effort to keep its shareholders satisfied, it intends to pay up and issue some of its unissued shares to the shareholders as fully paid up capitalisation shares. Explain whether Cyclepower (Pty) Ltd can proceed with its plan.

Feedback

When Cyclepower (Pty) Ltd redeemed the preference shares out of divisible profits, it had to create a capital redemption reserve fund. It may use this statutory non-distributable reserve to pay up the unissued shares that will be issued to its members as capitalisation shares. (The transaction will not affect the authorised capital of the company, because the amount of capital represented by the newly issued capitalisation

shares will replace the amount applied out of the capital redemption reserve fund.) If Cyclepower (Pty) Ltd happens to have a share premium account, it may also apply this reserve to provide for the capitalisation shares.

THE VARIATION OF SHARE CAPITAL

Corporate Law pars 20.41–20.42
Companies Act s 75

As you will see from the textbook the variation of share capital relates to the authorised share capital of a company and does not influence the issued share capital. These variations in the share capital are achieved by special resolution and amount to alterations of the company's memorandum. The conversion of issued shares into stock does not influence the authorised capital of a company.

Activity

Variations Ltd has 2 000 unissued no par value shares and 500 unissued par value shares which it no longer intends issuing. It wants to cancel these shares. Explain what requirements have to be met.

Feedback

Section 75 of the Companies Act allows a company to alter its authorised capital in various ways, one of which is the cancellation of unissued par value or no par value shares. Such an alteration may be made only if it is authorised by the articles and if it has been approved by a special resolution. (Remember that the articles may be amended by a special resolution and that the special resolution amending the articles and the special resolution approving of the variation of the authorised capital may be taken at the same meeting — see **study unit 1**.) In the case of the par value shares, Variations Ltd will have to reduce the amount of its authorised share capital by the nominal amount of the cancelled shares. In the case of the no par value shares the number of authorised no par value shares reflected in the memorandum will have to be reduced.

DEBENTURES AND OTHER LOAN FUNDS

Corporate Law pars 14.35–14.44

We have already considered the difference between shares and debentures. We now have to distinguish between debentures and other loans. The difference is basically

that a debenture is a security, that is, it is an investment in a company that can be transferred like a share. The word debenture refers to the document which is issued by the company as proof of the right to reclaim a loan — it is an acknowledgement of debt. Debentures are often not paid back during the existence of the company — a debenture holder who wants to get his investment back will sell the debenture to someone else who will then become the debenture holder. An ordinary loan usually has to be repaid within a fixed period. Although a loan can be ceded to someone else, it is not as easily transferable as a debenture.

A company can have different classes of debentures, issued for different periods and at different rates of interest. The main distinction is between secured and unsecured debentures. In the case of default by the company, the holders of secured debentures have a right to be paid out of the proceeds of the specific property used as security.

Although debenture holders are creditors of a company and are therefore not entitled to attend meetings and to vote, shares and debentures are treated as similar for certain purposes. For example, the same rules apply when shares and debentures are offered to the public.

Other loans to the company can, just as in the case of debentures, be either secured or unsecured. We can also distinguish between long-term loans (regarded as fixed capital) and short-term loans (operating capital), although their legal nature is the same. A specific kind of loan often encountered in company finance is the “loan account”. Very often the major shareholders, especially of small private companies, will lend money to the company rather than contribute everything in the form of share capital. Such loans are usually repayable on demand and the idea is that the company will use it as capital for as long as required. Again, there is no legal distinction between such loans and loans in general.

Activity

Thandiwe has invested in 12% secured debentures (secured by a mortgage bond over the property of the company) issued by a public company. She wants to know why debentures are referred to as securities and what the relevance of this term is. Her friend Jason says it is because they are secured by the mortgage bond, while Izzy says it is because they bear a fixed interest rate. Explain whether they are right and briefly discuss the significance of classifying a debenture as a security.

Feedback

Although Thandiwe’s debentures are secured and bear a fixed interest rate, the reasons advanced by her friends are not accurate. The term “security” denotes an easily transferable investment in a company. The significance of classifying a debenture as a

security is that the rules regarding offering and issuing them to the public correspond with that of shares and that the same transfer rules apply to both shares and debentures.

SELF-ASSESSMENT

Manyshares Ltd has issued the following securities:

- 1 000 ordinary par value shares with a nominal value of R1 each, issued at a premium of 10% (class A ordinary shares)
- 500 ordinary par value shares with a nominal value of R5 each, issued at par (class B ordinary shares)
- 200 no par value 8% cumulative preference shares
- 50 no par value 4% participating preference shares
- 100 no par value 6% preference shares, redeemable at the option of the company
- 50 deferred shares with a par value of R200 each
- 200 secured debentures of R40 each bearing interest at 10% per year
- 200 convertible debentures of R10 each bearing interest at 9% per year

The stated capital of Manyshares Ltd is R6 400.

- 1 What is the amount of Manyshares Ltd's issued share capital (share capital account)?
- 2 What is the debt/equity ratio of Manyshares Ltd?
- 3 Explain whether Manyshares Ltd should be regarded as a geared or leveraged company.
- 4 Briefly explain the difference between the different classes of preference shares issued by Manyshares Ltd.
- 5 Can Manyshares Ltd convert its 4% participating preference shares into par value shares?
- 6 Can Manyshares Ltd use the proceeds of any of the shares it has issued to redeem the redeemable preference shares?
- 7 What is the earliest stage at which the debentures could have been issued?

Feedback

- 1 The issued capital, as reflected in the share capital account, is the aggregate nominal value of the issued **par value** shares. (Note that the no par value shares are reflected in the stated capital account.) To calculate this figure you will have to

identify all the par value shares. They are the class A ordinary shares ($1000 \times R1$); class B ordinary shares ($500 \times R5$) and the deferred shares ($50 \times R200$). The issued capital is thus R13 500.

- 2 To determine the debt/equity ratio, the total equity and the total debt must be known. The total equity is R20 000, made up of:
 - (a) the R13 500 in the share capital account (see 1 above)
 - (b) the R100 in the share premium account (the premium of 10% paid on the 1 000 class A ordinary shares amounts to 10c per share and has to be transferred to a share premium account in accordance with s 76(1))
 - (c) the R6 400 in the stated capital account.

The debentures total R10 000 ($200 \times R40$ plus $200 \times R10$). (The facts do not mention any further debts.) Based on this information, the ratio of debt to equity is thus 1:2.

- 3 Manyshares Ltd has twice as much equity as debt. It is thus not geared or leveraged.
- 4 The difference between the different classes of preference shares relate to their right to share in the distributions beyond their fixed percentage, the right to receive dividends in respect of years where no dividend has been declared and, in the case of the redeemable preference shares, the fact that the shares may be redeemed by the company. These classes are described in the textbook (see pars 14.18–14.19; 14.24).
- 5 According to section 75, a company can convert no par value shares into par value shares and *vice versa*. However, all the preference shares or all the ordinary shares must consist of either par value or no par value shares (s 74). The conversion can thus be made only if the other classes of preference shares are also converted into par value shares.
- 6 Redeemable preference shares may be redeemed only out of the proceeds of a fresh issue of shares, issued for the purpose of the redemption, or out of divisible profits (s 98(1)(a)). In the given facts there is no indication that any of the shares have been freshly issued for the purpose of the redemption. However, if the preference shares are to be redeemed at a premium, Manyshares Ltd can apply either profits or its share premium account to provide for the premium (s 98(1)(c)).
- 7 A company may issue debentures only once a certificate to commence business has been issued.

Membership of a company and the transfer of shares

The first learning outcome of this study unit is that you are able to apply the legal principles relating to membership of a company to a practical situation.

In order to achieve this outcome you must know and understand:

- what membership of a company means
- how membership is acquired and terminated
- what a register of members is
- the difference between a beneficial owner of shares and a nominee shareholder
- the difference between certificated and uncertificated securities
- the difference between a share certificate and a share warrant.

The second learning outcome of this study unit is that you are able to apply the legal principles relating to the transfer of shares and the giving of security by means of shares to a practical situation.

In order to achieve this outcome you must know and understand:

- the difference between the transfer of shares and the issue and allotment of shares
- how certificated and uncertificated securities are transferred
- the special rules applicable to the transfer of listed shares
- the dividend rights on the purchase of shares
- the different ways in which shares can serve as security for debts.

Prescribed Material

Corporate Law Chapter 15 **excluding** paragraph 15.48; Chapter 18 **excluding** paragraphs 18.10–18.14

Hahlo notes at 201–202; 204–206

Companies Act sections 32; 66; 91–97; 101; 103–115; 133; 139–140A; 221–222

Standard Bank of SA Ltd v Ocean Commodities Inc 1980 (2) SA 175 (T) [case 106]

Botha v Fick 1995 (2) SA 750 (A) [case 107]

United South African Association Ltd v Cohn 1904 TS 733 [case 109]

Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd 1976 (1) SA 441 (A) [case 110]

MEMBERSHIP OF A COMPANY

Corporate Law pars 15.01–15.16

Companies Act ss 32; 66; 103–104; 140A

Although the terms “member” and “shareholder” often refer to the same person, there are two instances where the terms have to be distinguished:

- some companies, such as companies limited by guarantee, do not issue shares and therefore have members but not shareholders. (Note however that in the case of a company with a share capital, the same person will usually be both a shareholder and a member of the company.
- the (registered) member of a company with a share capital could be holding the shares on behalf of another person, the shareholder. In this case the member is known as the nominee or the registered nominal owner, while the shareholder is called the beneficial owner.

Various problems may arise when shares are being held by a nominee, and your prescribed case *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* [case 110], which you will be studying later in this study unit, is an example in point. Although it was not the main point to be decided, it is clear from this case that a nominee does not have the power to transfer the shares he or she holds without being instructed to do so by the beneficial holder.

When you study section 140A and paragraph 15.14–15.16 of the textbook, note that the disclosure requirements in respect of beneficial interests apply only to securities listed on the JSE Securities Exchange South Africa.

Activity

When Google Ltd was incorporated, it had 7 members, but one of the members subsequently sold all his shares to another member. Sally, one of the remaining six members now wants to sell her shares to a partnership of which Peter and Themba are the only partners. The partners are concerned about the fact that Google Ltd has only six shareholders. They also need your advice on whether the partnership can become a member of Google Ltd. Advise Peter and Themba.

Feedback

A public company such as Google Ltd has to have at least seven members at incorporation (s 32). If the membership falls to below seven and the company has carried on business for more than six months while the number of members has been so reduced, every member who is aware of this fact shall be personally liable for debts contracted by the company once the six month period has expired (s 66). The company could also be wound up by the court on the ground that its membership has fallen below seven (s 344(d)). The facts do not state how long Google Ltd has been doing business with only six members and it may be that it has not yet exceeded the six month grace period. Nevertheless, Themba and Peter must be informed that the partnership as such cannot become a member of Google Ltd because a partnership is not a juristic person. Both Themba and Peter will thus be registered as members and Google Ltd will once again have seven members. Peter and Themba need therefore not be concerned about incurring personal liability in terms of section 66.

(Note, however, that for purposes of the limitation on the maximum membership of a private company (s 20(1)(b)) co-owners of a share or shares are regarded as a single member (s 20(2)).)

REGISTER OF MEMBERS: FORMAL REQUIREMENTS

Corporate Law pars 15.17–15.27

Companies Act ss 91; 91A, subsections (1), (3), (6), (8); 105–115

***Standard Bank of SA Ltd v Ocean Commodities Inc* [case 106]**

In *Standard Bank of SA Ltd v Ocean Commodities Inc* [case 106], the court explained an important legal difference between the registration of immovable and movable property. In regard to immovable property, registration is conclusive proof of ownership. In respect of registered shares a court can look behind the register to ascertain the identity of the true owner because shares are movable property (see s 91). The register of members that a company has to keep in terms of section 105 is *prima facie* evidence of the matters stated therein.

When shares have been dematerialised in terms of section 91A, they are held by a CSD (central securities depository) participant and the company would not know who the members are. The company has to enter in its register of members the total number of shares of every class that are held in uncertificated form. The participant is responsible for entering the information which would usually have to be contained in the register of members (see ss 105 and 133) in an electronic subregister (s 91A(3)(c)) and for supplying the shareholder/member with regular statements reflecting the shares held on her behalf (s 91A(3)(f)). The subregister is deemed to form part of the company's register of members (s 91A(3)(b)). A participant can be required to furnish the

company with the information in the subregister kept by it (s 91A(3)(d)) and the company can in turn be required to prepare a subregister which can be inspected by members or any other persons (s 91A(3)(e)). Where the participant holds the uncertificated shares as nominee for the beneficial owner, the name of the participant will be reflected in the subregister.

Activity

Kevin is interested in knowing who the members of Roadsafe (Pty) Ltd are. Explain to him how he can satisfy his curiosity.

Feedback

Section 113 of the Companies Act provides that any person may inspect the register of members of a company. While a member or his agent may do so free of charge, any other person has to pay the prescribed fee of 25 cents per inspection or such lesser amount as the company may determine. Kevin is apparently not a member and will have to pay a fee. He can either visit the registered office (or other place where the register may be kept in terms of s 110) of Roadsafe (Pty) Ltd during business hours and inspect the register during the times that may be fixed in accordance with section 113(1), or he may request a copy or extract of the register. Kevin should bear in mind, though, that some of the members may actually be holding shares as nominees for the real owners of the shares.

ALLOTMENT AND ISSUE OF SHARES

Corporate Law pars 15.28–15.43

Companies Act ss 92–93; 97; 221–222

When you study these sections and paragraphs consider the different stakeholders who are protected by the rules regarding issue and allotment. They are the company and its existing shareholders (ss 221–222), the new shareholders (s 97) and creditors (s 92). The special rules protecting persons who subscribe for shares following an offer to the public (ss 164–169; see par 15.34 of the textbook) are discussed further in **Study unit 9**.

Activity

Ochre (Pty) Ltd has issued 3 000 par value ordinary shares with a nominal value of R1 each at a premium of 10 cents per share. The board of directors, acting in terms of a specific authority given by the general meeting, adopted a resolution allotting these shares to Lerato. It now appears that Lerato accidentally made out the cheque for

R2 300 instead of R3 300 and that Ochre (Pty) Ltd has received payment of only this lower amount. Lerato is willing to pay the outstanding R1 000 immediately. Explain whether the allotment to Lerato was valid or could be validated.

Feedback

In terms of section 92 of the Companies Act shares may be allotted only if the full issue price (including any premium) has been paid to and received by the company. The allotment to Lerato is thus not valid. However, section 97 provides that a court may, on application, validate an allotment of shares if it was invalid by virtue of any provision of the Act (or of any other law or of the memorandum and articles). Thus, despite the fact that section 92 has not been complied with, a court may possibly validate the allotment by Ochre (Pty) Ltd. The court may impose conditions and in this case it could possibly make the validation conditional upon receipt of the outstanding R1 000 from Lerato.

SHARE CERTIFICATES, SHARE WARRANTS AND UNCERTIFICATED SECURITIES

Corporate Law pars 15.44–15.47

Hahlo notes at 201–202

Companies Act ss 91A subsections (7), (10); 94–96; 101; 140

United South African Association Ltd v Cohn [case 109]

Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd [case 110]

Certificated securities

The Companies Act prescribes the issuing of a share certificate to a member within two months after allotment (s 96(1)) or within six weeks after an instrument of transfer has been lodged (s 140(1)). In the case of default, the company and every director or officer who is knowingly a party thereto shall be guilty of an offence (s 96(3)). The duty to provide share certificates can be enforced by the court (s 96(2)).

The share certificate or share warrant is *prima facie* evidence of the title of the member to such shares (s 94(1)). It thus evidences the legal relationship which exists between the company and the shareholder and is not a negotiable instrument. You should note that the register of members also provides *prima facie* evidence of the same information (see s 109), but that the certificate is the only evidence which the member has in his possession. The certificate usually forms the basis of a transaction whereby a purchaser will rely exclusively on the possession of the certificate as evidence of title to the shares which are described therein. Hence a conflict may develop as to which one of two or more unregistered shareholders (who all claim to be *bona fide* purchasers for value) may claim the shares. Such a situation would arise

where the registered shareholder sold or mortgaged the same shares to more than one claimant by showing them the share certificates. This does not mean that an owner who has lost possession of a share certificate has lost his shareholding. The share certificate is subordinate to the right which it evidences and may in certain circumstances be replaced or cancelled.

Share certificates have to be distinguished from share warrants which are negotiable instruments and which entitle the bearer thereof to the shares therein specified (s 101). A company can issue share warrants if it is authorised to do so by its articles. The bearer of a share warrant who acquired possession in good faith is entitled to the shares mentioned in the warrant.

Where a person entrusts a certificate with a blank transfer form to another (eg as a pledge), he may be estopped from claiming the shares from a third party who has acquired them *bona fide* and for value from that other person. See in this regard *United South African Association Ltd v Cohn* [case 109] and *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* [case 110]. When you read the latter case, note that the last sentence of the introductory summary refers to the plaintiff and defendant as they were in the court *a quo*. It thus means that the appellant's appeal was dismissed. You will see that the term "scrip" is used in *United South African Association Ltd v Cohn* [case 109]. The term refers to documents evidencing title to shares and is often used to denote share certificates which are accompanied by signed share transfer forms.

Uncertificated shares

When a share has been dematerialised, it is no longer evidenced by a share certificate but only by a computer record. The phrase "uncertificated securities" is defined in section 91A(1) as "securities as defined in section 1 of the Stock Exchanges Control Act ... which are by virtue of this section transferable without a written instrument and are not evidenced by a certificate". In addition to shares, the term "securities" includes debentures and certain other financial instruments. For present purposes we will restrict our discussion to shares. It is important to note that only listed shares are regarded as securities in terms of the definition. Section 91A(7) provides that a company may not issue a share certificate in respect of a dematerialised share except where the shares are to be withdrawn from the CSD upon the request of the shareholder. A person who subscribes to new shares in a company may choose whether the shares must be issued to him in certificated or uncertificated form (s 91A(10)). However, shares held in certificated form will have to be dematerialised before they can be sold on the JSE Securities Exchange South Africa.

Paragraph 15.48 of your textbook does not correctly reflect the law. It is no longer possible to deposit share certificates (or certificates evidencing title to any other equity security) with a depository institution. A central securities depository (CSD) participant may hold securities only in dematerialised form.

Activity

Jeff owns unlisted shares in Toyworld Ltd. He has pledged the shares to Funds Bank Ltd and has delivered the share certificates to Funds Bank Ltd together with transfer forms which he signed in blank. An employee of Funds Bank Ltd steals the certificates and transfer forms and sells the shares to Anna, who has acted in good faith. Toyworld Ltd registers the transfer and issues Anna with share certificates in respect of the shares she bought. Jeff wants to recover the shares from Anna, but she is relying on the share certificates issued to her. Explain whether Jeff can recover the shares from Anna.

Feedback

Share certificates, as well as the register of members of a company, are only *prima facie* evidence of the title of the member (ss 94 and 109). This means that someone can prove that he, and not the person to whom the share certificate has been issued, is entitled to the shares. The law protects the true owner of the shares and Jeff may thus in principle vindicate his shares. However, Anna can raise the defence of estoppel against Jeff to stop him from asserting his title to the shares. In order to do this, she will have to prove the four elements set out in *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* [case 110]. You will have to list the elements in your answer. In *United South African Association Ltd v Cohn* [case 109] the court held that where a person signed scrip in blank and then entrusted it to someone else, he or she represented that the holder of the scrip was authorised to transfer the shares. In such a case the owner will be estopped from relying on the absence of authority of the transferor. Anna will be able to prove the elements of estoppel and Jeff will thus not be entitled to recover his shares from Anna, the *bona fide* purchaser. He will, however, be able to institute action against the employee who stole the certificates and transfer forms.

TRANSFER OF SHARES

Corporate Law pars 18.01–18.09; 18.15–18.19

Companies Act ss 91A subsections (4), (5), (9), (12); 92; 133; 139

The general rule is that shares are freely transferable in the manner provided for by the Companies Act and the articles of the company. However, the shares of private companies are not as freely transferable as shares in public companies, because private companies must impose some form of restriction on the free transferability of their shares (s 20(1)(a). If you are interested in knowing more about the various ways in which private companies can restrict the transfer of their shares, see *Hahlo* notes at 187–189. This aspect is, however, not prescribed.). Although shares in public companies are generally freely transferable, the ease with which they can be transferred depends on whether they are evidenced by share certificates, share

warrants and, most importantly, whether they are listed on a stock exchange. You will note that paragraphs 18.10–18.14 of the textbook are not prescribed. The procedure discussed in them no longer applies to equity securities (shares).

Section 91A regulates the transfer of uncertificated shares (which are also listed shares) and provides that uncertificated shares may be transferred only by a participant (s 91A(5)(a)) who has to debit the account in the subregister from which the transfer is effected and credit the account in the subregister to which the transfer is made (s 91A(4)(a)). The transfer may be made only on receipt of an instruction to transfer sent and authenticated under the rules of the CSD (s 91A(5)(b)). When the transferee's name is entered in the subregister, he becomes a member and the company cannot refuse to recognise him as such. A transfer of uncertificated shares is final and will generally not be affected by illegality or fraud (s 91A(4)(c)). We recommend that you refresh your memory at this stage by revising the discussion of the STRATE system of the JSE Securities Exchange South Africa in the second paragraph of *Hahlo* notes on page 201.

Activity

Michelle holds uncertificated shares in Trueworld Ltd, a public company listed on the main board of the JSE Securities Exchange South Africa. Her estranged husband Gavin gives an instruction for the transfer of her shares. The instruction is sent and authenticated under the rules of the CSD and the transfer is registered. Michelle wants to know whether she will be able to recover the shares from the transferee. Advise her.

Feedback

Section 91A(4) of the Companies Act regulates the transfer of uncertificated shares. The transferee becomes owner of the shares and member of the company when the entries in the subregisters are made. Section 91A(4)(c) provides that transfer of ownership will occur despite any fraud or illegality which may have resulted in the transfer being effected. The transferee will thus obtain final and irrevocable title to the shares. However, if the transferee was a party to the fraud or had notice of it, he or she will not obtain a valid title and in such a case, Michelle will be able to recover her shares and claim rectification of the register of members. The facts do not indicate that the transferee was involved in the fraud. In transactions on a stock exchange it will usually be very difficult to prove such involvement.

Michelle is not left without remedy, however. She may institute a claim against the STRATE Dispossessed Members' Fund or take action against Gavin or the participant who effected the transfer.

SECURITY BY MEANS OF SHARES

Corporate Law pars 18.20–18.27

Hahlo notes at 204–206

Botha v Fick [case 107]

In South Africa the transfer and settlement processes associated with share transactions were until recently essentially paper based. The share certificate thus played an important role in the securing of debts by means of shares, namely pledge and cession *in securitatem debiti*. However, it was finally settled in *Botha v Fick* [case 107] that delivery of the share certificate was not a prerequisite of a valid cession of shares.

As explained in paragraph 18.26 of your textbook, uncertificated shares may be pledged or ceded as security under the rules of the CSD.

Activity

Thomas owes Lindiwe R10 000 and has agreed to cede some shares he has in Orbis (Pty) Ltd to Lindiwe as security for the debt. The articles of association of Orbis (Pty) Ltd provide that the company will have a lien on a shareholder's shares for any amounts the shareholder may owe the company. Advise Lindiwe on the risks involved in accepting this form of security.

Feedback

As cessionary, Lindiwe faces three real risks. If Thomas is also indebted to Orbis (Pty) Ltd, the company will have a lien on his shares which could rank in priority to Lindiwe's rights. Secondly, if Thomas does not pay and Lindiwe becomes entitled to transfer of the shares, Orbis (Pty) Ltd may refuse to register Lindiwe as a member, especially as it is a private company. Lindiwe will then have to depend on Thomas for the exercise of membership rights. The last risk is that Thomas could obtain duplicate share certificates from Orbis (Pty) Ltd and use these to transfer the shares to someone else.

SELF-ASSESSMENT

Eletek (Pty) Ltd purchased 500 shares in Formco Ltd from Galant CC. Galant CC agreed to hold the shares as nominee for Eletek (Pty) Ltd. Eletek (Pty) Ltd has now discovered that Galant CC subsequently sold and transferred the same 500 shares to Phindi. Advise Eletek (Pty) Ltd whether it can hold Formco Ltd liable for allowing the transfer of the shares to Phindi. Also explain whether Eletek (Pty) Ltd would be able to recover the shares from Phindi.

Feedback

This question deals with three aspects:

- whether a nominee has the power to transfer the shares without the authority of the beneficial owner
- whether a company has to recognise the beneficial owner of its shares
- whether shares transferred without the consent of the beneficial owner can be recovered from a third party who acquired them in good faith and for value.

As regards the first aspect, a nominee does not have the power to transfer shares without reference to the beneficial owner. This was confirmed in *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* [case 110]. Galant CC did not have the right to transfer the 500 shares to Phindi unless Eletek (Pty) Ltd instructed it to do so.

A company need only recognise the registered holder of shares. Section 104 expressly states that a company shall not be bound to see to the execution of any trust in respect of any share. The concept “trust” has to be interpreted widely and includes the holding of shares as nominee. Formco Ltd can thus not be held liable for registering the transfer of the shares.

Regarding the final aspect, the general rule is that the owner of a share may vindicate (claim back) his shares, even from someone who acted in good faith and paid for them. However, the owner may sometimes be estopped from asserting his ownership of the shares. This will be the case where the owner has made a negligent representation that the transferor (the nominee in this case) was the owner of the shares or had authority to dispose of the shares and the purchaser relied on this representation and as a result of this acted to his detriment. It is unlikely that Phindi will be able to prove the defence of estoppel, because it has been held in *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* [case 110] that the mere fact that an owner entrusts shares to a nominee does not amount to a representation that the nominee has the power to transfer the shares without reference to the owner. However, in that case the name of the nominee indicated that it was a nominee company and a court may perhaps find that Eletek (Pty) Ltd did, in fact, make a false representation regarding Galant CC’s power to give transfer. The defence of estoppel in the context of unauthorised transfer of shares succeeded in *United South African Association Ltd v Cohn* [case 109], but in that case the shareholder had signed blank transfer documents.

The offer of shares to the public

The learning outcome of this study unit is that you are able to apply the statutory provisions regulating the offer and allotment of shares to the public in a practical situation.

In order to achieve this outcome you must know and understand:

- the different ways in which shares may be offered to the public on the primary and secondary market
- the disclosure requirements applicable to each kind of public offer
- the meaning of “public” in the various provisions
- what a prospectus is, how its availability is ensured and when liability will arise for untruths in a prospectus
- how acceptance of applications and allotment of shares pursuant to a public offer have to take place
- the concept of underwriting of shares
- the requirements for listing shares on the main board of the JSE Securities Exchange South Africa.

Prescribed Material

Corporate Law Chapters 16 and 17 **excluding** paragraphs 17.08–17.21

Hahlo text at 85–87; 98

Companies Act sections 92; 141–147; 157; 160–161; 164–169

S v Rossouw 1971 (3) SA 222 (T) [case 47]

DISCLOSURE AS THE BASIS OF REGULATION

Corporate Law pars 16.01–16.02

The doctrine of disclosure plays an important role in connection with the offering of shares in a company, whether for subscription by the company or for sale by its shareholders. The principle entails that every potential investor should have sufficient material information at his or her disposal on which he or she can rely to make an

objective assessment of the merits of the investment he or she wants to make. The doctrine of disclosure underlies the provisions of the Act which require that information relating to the issue of shares be given to investors in certain instances.

There are a number of factors which play a role in raising the share capital a company needs to conduct its business. Of particular importance is whether it is a private or public company and, if public, whether it is listed or not. It is also important whether the attempt to raise capital is the company's initial effort or a subsequent attempt to procure additional capital.

KINDS OF PUBLIC OFFERS

Corporate Law par 16.03

Hahlo text at 85–87; 98

In order to understand the different kinds of public offers you have to be able to distinguish between:

- an offer for subscription and an offer for sale
- the primary and secondary market for shares

An **offer for subscription** is a method of raising finances for the company as the company receives the issue price of the shares which it offers for subscription. In other words, the public subscribes for previously unissued shares. In a **public offer for subscription**, a prospectus is usually required.

However, when a company makes an offer to its existing shareholders to subscribe for further shares which will be listed on the JSE Securities Exchange South Africa, this is known as a **rights offer**. Rights offers are regulated differently from other offers for subscription in that a prospectus is not required (see s 146A).

An **offer for sale** is an offer in respect of existing (previously issued) shares. An offer for sale in the general sense is not a method of raising money for the company, as it is merely a sale of shares by a shareholder, who receives the entire proceeds of that sale. In other words, a sale of shares relates to shares which have been previously issued to, and are held by, a shareholder. The company is not involved in their sale and the seller, if they are on offer to the **public**, has to issue a written statement containing the information required by section 141. We refer to these kinds of offers in which the company is not involved as offers for sale in the general sense, or offers regulated by section 141. They are offers on the secondary market.

However, when new shares are issued by a company to an intermediary so that the intermediary can offer them to the public for sale, or when shares are being offered to the public for sale but it has been announced that those shares will be listed on an exchange, the situation is similar to an offer for subscription and therefore a prospectus

will usually be required. This situation is regulated by section 146 of the Companies Act. The offer is made on the primary market and is referred to as an **offer for sale in terms of section 146**.

The distinction between the primary and secondary markets is explained in paragraph 16.03 of your textbook. The following diagrammatic overview of the regulation of public offers should assist you in studying this work.

Primary market		Secondary market	
Kind of offer	Form of disclosure	Kind of offer	Form of disclosure
public offer for subscription (s 145)	prospectus	(general) offer for sale (s 141)	written statement
public offer for sale (s 146)	prospectus		
rights offer (s 146A)	letter of allocation		

OFFERS ON THE PRIMARY MARKET

Offers on the primary market are discussed under the following headings:

- The meaning of “offer to the public”
- Disclosure requirements for public offers — the prospectus and liability for untruths
- Allotment and acceptance pursuant to a public offer
- Regulation of rights offers
- Underwriting of shares

THE MEANING OF “OFFER TO THE PUBLIC”

Corporate Law pars 16.04–16.11

Companies Act ss 1 definition of “share”; 142 definitions of “offer” and “offer to the public”; 144–144A

Offers for sale or subscription on the primary market are regulated by Chapter VI (ss 142–169) of the Companies Act 61 of 1973. The concepts “offer” and “offer to the public” are defined (for purposes of Chapter VI) in section 142. “Share” is defined in

section 1 of the Act. The wide general meaning of an offer for sale is limited for purposes of Chapter VI to offers for the sale of shares within the categories described in section 146(1) namely:

- newly issued shares issued for the purpose of offering them to the public
- shares which are proposed to be listed on a stock exchange.

Certain offers for subscription or sale are specifically excluded from being regarded as offers to the public. They are listed in section 144 and discussed in paragraph 16.11 of your textbook.

Activity

Expand-a-Bit Ltd needs more capital and intends issuing additional shares. You have been approached to advise the company as to whether it will be regarded as an offer to the public if the shares are offered for subscription to the existing shareholders. If possible, Expand-a-Bit Ltd would like to avoid having to comply with the disclosure requirements of Chapter VI of the Companies Act of 1973. Advise the company.

Feedback

Expand-a-Bit Ltd intends offering previously unissued shares for subscription and thus has to consider the provisions of Chapter VI of the Companies Act. The meaning of “offer to the public” is defined in section 142 and includes the existing members of a company. Expand-a-Bit Ltd will thus be making a public offer unless the offer qualifies as an exception in terms of section 144. There are two exceptions relating specifically to offers made to existing members. The first is an offer for subscription which is not renounceable in favour of persons who are not shareholders or debenture-holders (s 144(d)). The second is a rights offer (s 144(e)). If Expand-a-Bit Ltd thus wants to escape the regulation in respect of public offers, it will have to structure the offer as one of these two exceptions. The facts do not state whether or not Expand-a-Bit Ltd is already a listed company or intends applying for a listing. Unless this is the case, the exception in respect of rights offers is not applicable. The only way in which to structure the offer as a non-public offer would be to make use of a non-renounceable offer to the existing shareholders of Expand-a-Bit Ltd.

DISCLOSURE REQUIREMENTS FOR PUBLIC OFFERS — THE PROSPECTUS AND LIABILITY FOR UNTRUTHS

Corporate Law pars 17.01–17.07; 17.22–17.30

Companies Act ss 142 definitions of “expert”, “promoter” and “untrue statement”; 143; 145; 146; 147; 157; 160–161

Section 145 of the Companies Act contains two prohibitions:

- No public offer for subscription of shares may be made unless it is accompanied by a properly registered prospectus.
- No prospectus may be issued unless it has been registered in the Companies Registration Office.

Section 146 contains the same prohibitions in respect of the offers for sale to which it applies.

The Companies Act prescribes the minimum information which must be contained in a prospectus. These contents do not form part of the course material, but if you are interested you may glance through sections 148–153 or paragraphs 17.08ff of the textbook to get an idea of the kind of information which can be found in a prospectus.

Apart from the basic requirement that a prospectus must be issued, the protection of investors is enhanced by:

- provisions ensuring the availability of the prospectus (see pars 17.03–17.05)
- the wide definition of “prospectus”
- criminal and civil liability for untruths in a prospectus
- restrictions on the allotment and issue of shares pursuant to a public offer (discussed later in this study unit).

Paragraph 17.07 states that the meaning of “prospectus” is extended by the presumption in section 157(1) of the Companies Act which provides that every newspaper or other advertisement **offering** the **shares** of a company to the **public** shall be deemed to be a prospectus issued by the person, unless it contains no more information than that listed in paragraphs (a)–(g) of subsection (1).

A prospectus is normally issued when a company wishes to acquire additional capital, and if the need is for loan capital it will seek subscribers for its debentures. From the definition of a “share” in section 1(1) of the Companies Act it follows that the provisions of the Act in relation to an offer of shares for subscription or sale have been greatly extended. It refers not only to shares, but also to debentures. Any reference to a “share” relating to offers must be understood in the extended sense (see par 16.09 again).

Because the protection of investors depends on the accuracy of the information disclosed in the prospectus, the Companies Act provides for liability of promoters, directors and others for untrue statements in a prospectus. The concept “untrue statement” is defined in section 142 to include misleading statements and omissions calculated to mislead. The statutory civil and criminal liability for untruths does not replace the possible common law liability, which is discussed in paragraph 17.23 of your textbook. However, holding someone liable at common law would in most instances require proof of fault. For the statutory civil liability fault is not a requirement (see par 17.24). The requirement for statutory criminal liability (see par 17.30) is that the accused must **knowingly be a party** to the contravention.

Activity

Thandi has recently been appointed as a director of Get-a-Lot Ltd. When she joined the company it was in the process of offering additional shares to the public for subscription. The prospectus was issued two weeks after she became a director and she consented to its issue. Three weeks later she realised that the prospectus omitted important information and could possibly mislead investors. Advise her whether she could be held liable for untruths in the prospectus under section 160 of the Companies Act of 1973 and whether she could take steps to avoid liability.

Feedback

In your answer you should set out the requirements for liability under section 160, and explain the extended meaning of “untrue statement” (s 142). You should then explain whether Thandi is a person who may be held liable under the provision, and whether there are any possible defences she could rely on.

Regarding the requirements for liability, you should point out that the subscriber or purchaser has to prove the following elements, viz that he or she acquired shares in reliance on the prospectus, that he or she suffered a loss, and that this loss was caused by an untrue statement in the prospectus.

The meaning of “untrue statement” has been extended to include an omission which is calculated to mislead and the omission Thandi has discovered may very well qualify as an untrue statement in a prospectus.

As a director of the company issuing shares for sale, Thandi qualifies as a person who may be held liable (s 160(2) read with s 160(1)).

The possible defences can be classified in two groups, namely those relating to the person’s belief in the untrue statement as such (s 160(3)(a)–(c)) and those relating to the person’s involvement in the distribution of the prospectus (s 160(3)(i)–(iii)). Thandi clearly does not believe that the prospectus correctly reflects the position of the company, so the first category of defences would not apply. She knew that the

prospectus was being issued and consented to it. The only possible defence open to her is the one contained in section 160(3)(iii), namely that upon becoming aware of the untrue statement, she withdrew her consent and gave reasonable public notice of the withdrawal of her consent and the reasons therefor.

Thandi is thus advised to give public notice of the fact that she is withdrawing her consent and to state the reasons therefor. She has to do this before the company has accepted any offers for its shares.

ALLOTMENT AND ACCEPTANCE PURSUANT TO A PUBLIC OFFER

Corporate Law pars 17.31–17.38
Companies Act ss 92; 164–169

The words “issued” and “allotted” are often used interchangeably, although the main provisions dealing with share capital refer to allotment. **Allotment** takes place when a person acquires the unconditional right to be included in the company’s register of members in respect of the shares, and allotted or issued capital is the amount actually issued as opposed to nominal or authorised capital. An issue of shares must always be very carefully considered and executed, not only because it is generally the most expensive form of capital, but also because it involves very important communication with the “owners” of the company (shareholders) and must comply with detailed, strict regulations. This task requires a degree of forward planning so that authority to issue is put in place at the previous annual general meeting, wherever possible. The procedure to be followed when dealing with applications for, and allotment of, shares will depend upon a number of factors, such as the size of the company, whether or not the services of an issuing house will be utilised, and whether or not the shares will be listed on the JSE Securities Exchange South Africa.

Under English law, issued shares may be fully or partly paid-up. Prior to the South African Companies Act of 1973, it was possible for a company to issue shares payable partly on application, and the balance in agreed instalments or when “calls” were made by the directors. The Act now provides that only fully paid up shares may be allotted or issued (s 92(1)), unless they are allotted with a view to their being offered to the public in terms of an offer for sale within not more than one month from the date of allotment. In such a case the offer must be completely taken up, and shares fully paid for, within two months from the date of the original allotment (s 92(2)(b)).

Activity

Sam subscribed for shares which were being offered to the public. He saw a prospectus and application form in his colleague’s office and made a photocopy of the application

form. He then submitted his photocopied application form without sending any money to the company, because he was concerned that he might lose his money if the minimum subscription was not made up. He attached a letter from his bank to his application form in which the bank guaranteed payment should shares be allotted to him. Explain to Sam why the company would not allot any shares to him.

Feedback

There are various reasons why shares could not be allotted to Sam. The allotment of shares pursuant to a public offer is regulated by sections 164–169 of the Companies Act. The first problem is that Sam used a photocopy. A company may not allot shares unless the subscription was made on an application form which has been attached to or accompanied by a prospectus or unless it is shown that the applicant was in possession of a prospectus or aware of its contents when making the application (s 166). The company would not know whether Sam had access to a prospectus. For all the company knows, Sam could have received a photocopy without having seen the prospectus. The second problem is that Sam did not include payment for the shares. Section 92 provides that the full issue price has to be paid to and received by the company before it may issue a share. The bank guarantee is thus not sufficient. Sam need not be concerned about losing his money if the minimum subscription is not made up, since section 165(4) provides that the payments must be deposited in a separate fund and may not be used until the minimum subscription has been made up. If the minimum subscription is not reached within a prescribed period, the payments must be repaid to the applicants failing which the directors will be personally liable for repayment (s 165(5)(a)).

REGULATION OF RIGHTS OFFERS

Corporate Law pars 17.39–17.42

Companies Act ss 142 definition of “rights offer”; 145A; 146A

By far the most common method by which successful companies raise additional capital on the primary market is not an issue to the public at large, but a rights issue.

A rights offer or rights issue may take a variety of forms. Basically, such an issue or offer involves the delivery by the company to each of its existing members (or debenture holders) of a letter of allocation (“letter of right”), conferring on him or her the right to subscribe within a specified period for shares (or debentures) in the new issue in proportion to his or her existing holding. The price is usually below the current market price of the shares (or debentures) to encourage the shareholders (or debenture holders) to take up the offer. The letter of allocation may or may not be renounceable (ie can be declined in favour of someone else — usually against payment). Where the letter is renounceable it is usually accompanied by a form of renunciation. The shares are allotted (or issued) by the company to the holder of the letter (either the original

recipient or renounee if it has been renounced in his or her favour), who applies therefor and pays the price. Sometimes the letter of allocation takes the form of a provisional letter of allotment. A rights offer/issue need not necessarily be one to subscribe for shares in proportion to the recipient's existing holding — it may be to subscribe for any number of shares in the new issue. An offer to existing shareholders which is not renounceable, is not regarded as a public offer (see s 144(d)). Renounceable offers are public offers because they can be renounced in favour of members of the public at large. However, if an offer qualifies as a rights offer in terms of section 142, it is also not regarded as a public offer (see s 144(e)).

For a rights offer to be one as defined in section 142 of the Companies Act, 1973, and therefore outside the category of offers to the public in terms of section 144(e):

- the letter of allocation must be **renounceable** and
- the shares to which the offer pertains must be ones for which the JSE Securities Exchange South Africa has **granted or has agreed to grant a listing**.

A rights offer is not to be construed as an offer to the public (s 144(e), notwithstanding that it carries with it a right to renounce in favour of others. Thus, sections 145 and 147, as well as 148, do not apply to a rights offer. The provisions in the Companies Act controlling rights offers are sections 145A and 146A. The letters of allocation must be approved by the stock exchange which has listed or agreed to list the shares and the stock exchange may prescribe further disclosure. In terms of section 146A(5) certain provisions relating to a prospectus, including sections 160–163 which regulate the liability for untruths in a prospectus, apply *mutatis mutandis* to a rights offer and all documents issued in connection with it.

If the company has no unissued capital, a general meeting will have to be convened to pass a special resolution increasing the authorised capital. At this meeting the members will also grant the directors their approval (an ordinary resolution will be sufficient) of the issue of the new shares in terms of section 221 of the Companies Act. The dates for the offer may be fixed at this general meeting, or the board may be authorised to make this decision, provided that the offer is made not later than the next annual general meeting. If the company's shares are listed on the JSE Securities Exchange South Africa, all the offer documents and the timetable must first be approved by the JSE Securities Exchange South Africa before shareholders are notified. In particular, the date for closing the transfer register must be agreed upon. This is an important date, since it pinpoints the time for the determination of the shareholders qualified to receive the "rights".

Activity

Needmore Ltd is a public listed company in need of more capital. It intends making an offer to its existing shareholders to subscribe for the new shares it will be issuing. The JSE Securities Exchange South Africa has agreed to grant a listing for the new shares. Advise Needmore Ltd of the best way to structure the offer.

Feedback

Needmore Ltd should structure the offer as a rights offer as defined in section 142. It will then not be regarded as an offer to the public (s 144(e)), but will have to comply with sections 145A and 146A. The essential elements are that the letter of allocation must be renounceable and the shares to which the offer pertains must be ones for which the JSE Securities Exchange South Africa has granted or has agreed to grant a listing. Needmore Ltd has already obtained approval for the listing of the shares on the JSE Securities Exchange South Africa. It must send a renounceable letter of allocation to each shareholder. The letter of allocation must be approved by the JSE Securities Exchange South Africa (s 145A) and registered with the Registrar together with any documents prescribed by the JSE Securities Exchange South Africa (s 146A).

UNDERWRITING OF SHARES

Corporate Law par 17.43

The relevance of this paragraph which explains what underwriting involves, is that other sections of the Companies Act refer to underwriting contracts and underwriter's commission. They are section 80, which regulates the payment of underwriter's commission and section 153, which provides that where a prospectus refers to an underwriting contract, a copy of the contract must be lodged with the Registrar together with a declaration that the underwriter will be in a position to take up all the shares. However, you need not study these sections of the Act.

OFFERS ON THE SECONDARY MARKET

Corporate Law pars 16.12–16.18

Companies Act s 141

S v Rossouw [case 47]

When someone wishes to dispose of her shares in a company by selling them to the "public", the sale must be effected in accordance with section 141 of the Companies Act. In this instance, the party offering the shares for sale to the public acts independently of the company and is thus not in a position to meet the requirements for the issue of a prospectus (see pars 17.01–17.07 on the prospectus). Where a shareholder holds such a large amount of shares that he cannot effectively dispose of it by private negotiation, he will have to resort to a public offer. Section 141 requires a written statement setting out certain minimum information.

Activity

On 7 August 1996 Mr Mokaba travelled on the same aircraft as the respondent (and accused), Mr Letlaka. During the flight Mr Mokaba and Mr Letlaka engaged in conversation, in the course of which Mr Letlaka told Mr Mokaba that a private company which was developing a diamond mine, would become a public company in February 1998. Mr Letlaka offered to sell his shares in the company to Mr Mokaba. The latter agreed to buy 1 000 shares in the company for R10 000, which he then paid to Mr Letlaka. Mr Letlaka is now being accused of contravening section 141 of the Companies Act by making an offer to sell shares to the public without the prescribed written statement. Explain whether Mr Letlaka has contravened section 141 of the Companies Act.

Feedback

The question concerns a secondary offer of shares. Your answer should consider the following aspects: Did Mr Letlaka offer his shares for sale or invite an offer from the public? Is section 141 of the Companies Act applicable? Is Mr Mokaba a member of the “public” within the meaning of the provision?

When the party offering shares for sale to the public acts independently of the company, he is not in a position to meet the requirements for the issue of a prospectus. When the shareholding of the offeror is so large that he cannot effectively dispose of it by private negotiation he will have to make a public offer. He will then have to make use of the written statement in terms of section 141 of the Companies Act.

Section 141 provides that no person may either verbally or in writing (including a newspaper advertisement), directly or indirectly, offer shares for sale to the public, or invite offers from the public to purchase any shares, unless the offer or invitation is accompanied by a written statement containing prescribed information.

Prior to 1973 the corresponding provision referred to “the public or any member of the public” which is obviously a much wider concept than the now more limited phrase “to the public”. An example of a case where the offeror would not be a member of the “public” is a member of the immediate family of the offeror. But, the question can only be answered with reference to the circumstances of the particular case.

The facts of the question are based on your prescribed case *S v Rossouw* [case 47]. This case was decided under the previous Companies Act which also regulated an offer to a “member of the public”. In this case the regional magistrate acquitted the accused, holding that there had been no offer to the public. On appeal, the Transvaal Court reversed the decision and held that there were no circumstances which would justify the conclusion that the offeree was in relation to the company or to the respondent, anything other than a member of the public. However, the current position (s 141) is

formulated more narrowly and refers only to “the public”. It is thus possible that a court will now decide that Mr Letlaka, unlike the accused in *S v Rossouw*, did not commit an offence.

SELF-ASSESSMENT

Goldco (Pty) Ltd holds 30% of the ordinary shares in Zeno Ltd, but wants to sell these shares. Goldco (Pty) Ltd intends offering these shares to the other 400 shareholders of Zeno Ltd. Explain what form of disclosure, if any, is required.

Feedback

Goldco (Pty) Ltd will be offering the shares in Zeno Ltd for sale (it is not an offer for subscription). If disclosure is required, it will thus be in the form of a written statement under section 141 and not in the form of a prospectus. Whether such a statement is indeed required in this instance depends on whether or not the offer for sale is made to the public. For purposes of section 141, “public” is not defined, but the mere fact that an offer is made to a shareholder will not exclude it from being an offer to the public (s 141(10)). The word “public” has to be given its ordinary meaning. An offer will be regarded as being made to the public if it goes further than negotiating the sale of the shares on an individual basis in a closed circle of parties. In this instance, where there are 400 other shareholders, Goldco (Pty) Ltd will probably be regarded as offering the shares to the public (it is unlikely that individual negotiation will take place) and will have to issue a written statement in terms of section 141.

STUDY UNIT 10

Share capital rules and payments to shareholders

The learning outcome of this study unit is that you are able to apply the rules on share capital and payments to shareholders in a practical situation.

In order to achieve this outcome you must know and understand:

- the concept of maintenance of share capital
- how the common-law capital maintenance rules have been changed through legislation
- the requirements for the acquisition by a company of its own shares
- when shares may be issued at a discount
- when financial assistance for the acquisition of a company's shares is prohibited
- the rules regarding dividends and other payments to members by reason of their membership.

Prescribed Material

Corporate Law Chapter 20; Chapter 21, paragraphs 21.30–21.36 **only**

Hahlo notes on 136–137

Companies Act sections 38; 79; 81–82; 85–88; 90

Trevor v Whitworth (1887) 12 App Cas 409 [case 60]

Gradwell (Pty) Ltd v Rostra Printers Ltd 1959 (4) SA 419 (A) [case 61]

Jacobson v Liquidator of M Bulkin & Co Ltd 1976 (3) SA 781 (T) [case 62]

Lipschitz v U D C Bank Ltd 1979 (1) SA 789 (A) [case 63]

Fidelity Bank Ltd v Three Women (Pty) Ltd [1996] 4 All SA 368 (W) [case 64]

CAPITAL MAINTENANCE AS A CONCEPT

Corporate Law pars 20.01–20.05

***Trevor v Whitworth* [case 60]**

The concept of the maintenance of share capital entails that the issued share capital of a company may not be directly or indirectly returned to the shareholders except through some statutory procedure providing for proper safeguards for creditors and others who might be prejudiced by the diminution of the company's assets. The fact that the liability of shareholders is limited to their contributions to the company, which is reflected in the capital fund, has led to the idea that creditors have the right to insist that the capital fund must not be reduced, except through normal business risks. When the doctrine was initially developed in England in the 19th century, the *ultra vires* rule played an important role, as you will see from the reasoning in *Trevor v Whitworth* [case 60].

However, companies are often formed with a share capital of R100 or less. It is clear that maintaining share capital as such does not necessarily protect creditors. The Companies Amendment Act of 1999 has thus relaxed the traditional capital maintenance rule and allows certain returns of capital to shareholders subject to the company's solvency and liquidity.

The common law had three fundamental capital maintenance rules, namely:

- **A company may not purchase its own shares.**
- **Shares may not be issued at a discount.**
- **Dividends may not be paid out of share capital.**

To these rules, statute law added a fourth fundamental rule (contained in s 38 of the Companies Act), namely:

- **A company may not give financial assistance for the purchase of or subscription for its own shares.**

The present state of our law is that the second and fourth rules still apply, but the first and third rules have been changed so that distributions to shareholders may, in fact, be made out of share capital, subject to certain safeguards of which the solvency and liquidity requirements are the most important.

Activity

The members of Streetsure CC are contemplating converting their close corporation into a private company so that it can have more than its present 10 members. In the past, Streetsure CC has on occasion purchased member's interests of members who wanted to withdraw from the corporation and provided financial assistance to new members to purchase member's interests. They have heard a rumour that the capital

maintenance rule applies to companies and that after the intended conversion Streetsure (Pty) Ltd will not be able to purchase back its own shares or give financial assistance to new members who purchase shares in it. Advise them.

Feedback

You should have explained that the capital maintenance rule, which prohibited companies from acquiring their own shares and giving financial assistance for the purchase of their shares, has been radically changed by amendments in 1999. Companies are now allowed to acquire their own shares, subject to certain safeguards (similar to those applicable to close corporations). However, the prohibition against a company giving financial assistance for the purchase of its shares has been retained and the rumour they have heard is thus partially true. Streetsure (Pty) Ltd will not be able to give financial assistance to new members to enable them to acquire shares. With this information at their disposal, the members of Streetsure CC should be better able to decide whether to proceed with a conversion or not.

ACQUISITION OF OWN SHARES

Corporate Law pars 20.06–20.18
Companies Act ss 85–88

When a company buys back its own shares, it in effect returns the purchase price for the shares concerned to the shareholder and thus reduces its share capital. It was for this reason that the common law prohibited a company from acquiring its own shares.

There are a number of advantages in allowing companies to purchase their own shares. First, if a company has the power to buy its own shares, it can protect itself against manipulative speculation in its shares on the financial markets and stabilise the price of its shares. Secondly, it can facilitate the transfer of shares in companies when a shareholder who wants to withdraw from the company is unable to find a willing purchaser for his shares, as is often the case in small private companies. A third advantage is in relation to employee shareholder schemes where the company can acquire the shares of an employee leaving its service.

With these advantages in mind, the Companies Act was amended in 1999 to allow companies to acquire their own shares subject to certain safeguards such as the solvency and liquidity requirements and the personal liability of directors and shareholders. Sections 85 to 88 contain the relevant provisions.

When you study section 85 and paragraph 20.06, take note that if the articles do not allow the company to acquire its own shares, they may be altered by special resolution (s 62). Also note that in terms of section 201 the special resolution for the alteration of

the articles and the special resolution allowing the company to proceed with the purchase of its own shares may be passed at the same general meeting. (Meetings and resolutions are discussed in **Study unit 1.**)

Although most acquisitions under section 85 would be (re)purchases, the section is wide enough to include other ways of acquisition, whether for a consideration or not.

Paragraph 20.07 explains how the share capital accounts of the company have to be adjusted. The purpose of the adjustment is that creditors should not be misled into believing that the issued or paid-up capital is higher than it actually is. The shares must be restored to the status of authorised, but unissued, shares. This means that when the company needs further capital it can offer the cancelled shares for subscription and issue them like new shares.

The purpose of the requirement discussed in 20.08 is to ensure that a company cannot acquire all its shares or be in a position where it can convert or redeem all its remaining issued shares so that it no longer has any shareholder(s). If a company could acquire all its shares it would be able to wind up its affairs informally without complying with the proper procedures laid down in the Companies Act.

In order to protect creditors of companies that acquire their own shares, section 86 provides for personal liability of the directors and shareholders if the solvency and liquidity requirements have not been satisfied. The reference in the text of paragraph 20.11 to section 84(5) is incorrect — it should read 85(4). If any other requirements have not been complied with, liability will not be determined under section 86 but under the other provisions of the Companies Act and the common law.

In paragraph 20.10 of the textbook it is stated that a creditor may apply to court for an order against a shareholder or former shareholder whose shares have been acquired. The information in paragraph 20.10 of the textbook is not sufficiently detailed for the purposes of this module and we wish to add some remarks. It is required that the creditor must have been a creditor at the time of the acquisition or that the cause of debt must have arisen before the acquisition (s 86(3)). A person who becomes a creditor after the acquisition and discovers that section 85(4) has been contravened cannot apply. An application may also be made by a shareholder, including a shareholder who became a shareholder after the acquisition. The court may order that the shareholder or former shareholder return to the company the consideration received for the acquisition of the shares. It may also order the company to issue to the shareholder or former shareholder an equivalent number of shares or make any other order as it thinks fit.

Section 87 prescribes the procedure for the acquisition by a company of its own shares (see pars 20.06 and 20.13–20.15). In paragraph 20.15 the statement is made that an offering circular is not required if the special resolution in terms of section 85(3) has dispensed with this. Following a legislative amendment in December 2001 the position is that such a circular is required only where the special resolution gives a general approval. If the company acquires the shares through transactions on the JSE

Securities Exchange South Africa, the only further requirement is that it must inform the Registrar. The company will also have to comply with any further requirements that may be set by the JSE Securities Exchange South Africa (see par 20.15 fn 26).

Activity

Natalie, one of the shareholders and directors of Auditland Inc, a firm of accountants incorporated as a section 53(b) company, wants to retire and sell her shares in the company. The remaining shareholders do not have the funds to acquire the shares and no suitable purchaser can be found. Can you propose a solution to this problem?

Feedback

Auditland Inc could solve this problem by acquiring Natalie's shares in terms of sections 85 to 88 of the Companies Act. You should be able to briefly outline the requirements and procedure which should be followed. In this regard, the articles should allow such a repurchase and Auditland Inc should be able to comply with the solvency and liquidity requirements of section 85(4). It is most likely that the special resolution approving the acquisition will take the form of a specific approval for the particular transaction (see par 20.06). (The fact that Auditland Inc is a section 53(b) company is not material to the answer. However, we would like you to keep in mind that there are different types of companies and that, as we explain in the **General Introduction to Company Law**, you should be familiar with them. Types of companies are discussed in chapter 3 of the textbook and s 53(b) companies in par 3.08.)

REPURCHASE OF SHARES

Corporate Law pars 20.19–20.20

In your textbook a distinction is made between the acquisition of shares under section 85 and other repurchases of shares (see par 20.06 and the heading to pars 20.19–20.20). Apart from section 85, the Companies Act contains two other provisions allowing a company to purchase its own shares, viz sections 98 (redemption of redeemable preference shares) and 252 (court order to purchase shares).

Redemption of redeemable preference shares

The redemption of redeemable preference shares was originally designed as an exception to the rule prohibiting a company from purchasing its own shares. Contributed capital is maintained in this case by the requirement (in s 98) that the shares may be redeemed only out of the proceeds of shares which have been issued for the purpose of the redemption or out of divisible profits. If divisible profits are used, a

capital redemption reserve fund must be created to substitute the redeemed shares. Thus the underlying principle, that the company's capital should be maintained, is upheld.

The requirements for the redemption of redeemable preference shares are much stricter than those for the acquisition of shares in terms of section 85. We think that section 98 should be deleted from the Companies Act and that the same rules should apply to acquisitions and redemptions. The redemption of redeemable preference shares is discussed in paragraphs 14.24–14.25 of the textbook and referred to in **Study unit 7**. We suggest you study these paragraphs again at this stage.

Court order to purchase shares

When a company is ordered by a court to purchase the shares of a member in terms of section 252, this also constitutes an exception to the common law rule (see par 20.20). Such purchases are also expressly excluded from the ambit of section 85, so that solvency and liquidity are not required. Section 252 provides a remedy for a shareholder who is being oppressed or prejudiced by the conduct of the company. This topic is discussed in paragraphs 19.40–19.53 of the textbook, but does not form part of the course material. (The reference in par 20.20 to the purchase by a company of its own shares as part of a scheme to reduce its capital, appears to be a mistake. Section 83, which previously provided for the reduction of capital of a company, has been deleted from the Act. Unfortunately s 252 itself also still refers to a “reduction of the capital of a company under section 83”.)

Note

There is no activity about repurchase of shares in this study unit. The redemption of redeemable preference shares is discussed in more detail in **Study unit 7**, and an activity has been included there. Section 252 and court orders for the repurchase by a company of its own shares do not form part of the course material. You only need to know that these two kinds of repurchases are not covered by sections 85–88 of the Companies Act.

THE ISSUE OF SHARES AT A DISCOUNT

Corporate Law pars 20.21–20.24
Companies Act ss 81–82

The common-law rule prohibiting the issue of shares at a discount is aimed at ensuring the initial integrity of the issued share capital. If the company does not receive the full consideration for the shares issued by it, the guarantee fund to which the creditors may look for payment has a value lower than that of the shares it represents. For example, a

company issues 10 000 shares with a nominal value of R1 each at 80 cents each (ie at a discount of 20 cents per share). Although the issued share capital of the company is R10 000, the company receives only R8 000 as consideration for the shares. Apart from protecting the creditors, the discount rule also has the effect of protecting the shareholders by ensuring that they all give the same consideration for the same rights.

Because the nominal value of a share does not necessarily correspond with its real or market value, it can happen that the shares of a financially troubled company are traded at a price lower than their nominal value. If the company then tries to obtain further share capital by issuing more of those shares, it will encounter problems in getting investors to subscribe to the (overpriced) new shares because prospective investors can purchase shares from existing shareholders at a lower price. Practical considerations such as these thus necessitated relaxation of the rule prohibiting issue at a discount. Section 81 provides that in certain circumstances shares may be issued at a discount. You will note that the requirements are designed to protect both creditors and shareholders.

In its pure form, the discount rule can apply only to par value shares. Since no par value shares do not have a nominal value, they can theoretically not be issued at a discount. However, our Companies Act also regulates the issue of no par value shares at a price below the average issue price (s 82). The statutory rule on no par value shares is not aimed at the maintenance of share capital, but at the fair treatment of shareholders. For this reason, the only requirement is a special resolution. Since the stated capital account will reflect the actual issue price of the shares (as explained in **Study unit 7**), there is no danger that creditors may be misled.

Activity

The authorised capital of Woodfun (Pty) Ltd consists of 100 000 ordinary shares with a nominal value of R1 each as well as 500 no par value preference shares. When Woodfun (Pty) Ltd commenced its business three years ago, it issued 80 000 of the ordinary shares and 250 of the preference shares. The stated capital account reflects an amount of R25 000. Woodfun (Pty) Ltd now needs more capital to exploit a new business opportunity. Because of the urgency of the matter it wishes to issue the remaining ordinary shares at a discount of 5% (ie for 95c each) and the preference shares at a price of R90 each. Explain what requirements apply to the intended issue prices.

Feedback

The intended issue of the par value shares at a discount of 5% has to comply with the requirements of section 81. A special resolution is required and should specify the maximum rate of discount (5% in our case). Since the previous shares were issued three years ago when the company commenced its business, the requirement that at least one year should have lapsed since the company became entitled to commence its

business or since it first issued shares of that class, has been satisfied. The issue must be sanctioned by the court and the shares must be issued within one month after such sanctioning. Section 82 applies in respect of the issue of the no par value preference shares at a price lower than the average issue price of R100 (stated capital account of R25 000 divided by number of shares issued). A special resolution is required.

PROHIBITED FINANCIAL ASSISTANCE FOR THE PURCHASE OF OR SUBSCRIPTION FOR OWN SHARES

Corporate Law pars 20.25–20.36

Hahlo notes on 136–137

Companies Act s 38

***Gradwell (Pty) Ltd v Rostra Printers Ltd* [case 61]**

***Jacobson v Liquidator of M Bulkin & Co Ltd* [case 62]**

***Lipschitz v U D C Bank Ltd* [case 63]**

***Fidelity Bank Ltd v Three Women (Pty) Ltd* [case 64]**

The purpose of section 38

As explained in paragraph 20.27, the scope of section 38 is wider than an ordinary capital maintenance rule. This explains why the prohibition has been retained despite the relaxation of other capital rules.

You will note that the ambit of section 38 is very broad, extending to both direct and indirect assistance and including any type of assistance for the purpose of or in connection with either the purchase of or subscription for shares. Financial assistance is not confined to assistance to the purchaser but to financial assistance to whomsoever given. Note too, that the prohibition is aimed only at **financial** assistance. Other assistance, for example assistance which involves the restructuring of the board of directors, making information available or entering into *bona fide* service agreements, is not prohibited by section 38.

Exceptions

Certain transactions are expressly **exempted** from the prohibition against financial assistance. They are listed in paragraph 20.28. The last exception (s 38(2)(d)), which was added in 1999, has been described as a curious one (see fn 52 on p 330 of your textbook). However, if one bears in mind that the prohibition in section 38(1) also extends to financial assistance given by a subsidiary for the purpose of the acquisition of shares in its holding company, this exception, correctly interpreted, indeed makes sense.

You will perhaps be better able to understand the ambit of the exception if we reformulate it by breaking it up into the two alternatives it contains.

Section 38(2)(d), together with its introductory sentence, reads:

The provisions of section 38(1) shall not be construed as prohibiting the provision of financial assistance for **the acquisition of shares in a company by the company or its subsidiary** in accordance with the provisions of section 85 for the acquisition of such shares.

The alternative phrases “by the company” and “or its subsidiary” belong to “the acquisition of shares in a company” and not to “the provision of financial assistance”. Split up into the two alternatives, the exception would thus read:

- The provisions of section 38(1) shall not be construed as prohibiting the provision of financial assistance for **the acquisition of shares in a company by the company** in accordance with the provisions of section 85 for the acquisition of such shares.
- The provisions of section 38(1) shall not be construed as prohibiting the provision of financial assistance for **the acquisition of shares in a company by its subsidiary** in accordance with the provisions of section 85 for the acquisition of such shares.

According to our reading of the section 38(2)(d), it thus contains two exceptions, relating to two different situations. The **first exception** applies to “the acquisition of shares in a company by the company”, that is, where a company acquires its own shares. Section 38(1) in effect contains two prohibitions which could possibly apply to this situation, namely

- the company whose shares are being acquired may not give financial assistance to anyone in connection with the acquisition
- a subsidiary of the company whose shares are being acquired may not give assistance to anyone in connection with the acquisition.

Applied to the situation where a company is acquiring its own shares, it is obviously not possible for the company to give assistance to itself. But the function of this first exception is to allow a subsidiary to give financial assistance to its holding company when the holding company is acquiring its own shares in terms of section 85. (It is important to note that the provisions of s 37 regarding loans made or security given by a subsidiary to its holding company would apply to this situation. This is discussed in **Study unit 11.**)

The **second exception** applies where a subsidiary is acquiring shares in its holding company. Before we consider the effect of the prohibition on this situation, it is interesting to note that section 38(2)(d) refers to the acquisition by a subsidiary of shares in its holding company “in accordance with section 85”. The power of a subsidiary to acquire shares in its holding company is conferred by section 89. However, section 89 expressly states that the subsidiary may acquire the shares

“*mutatis mutandis* in accordance with section 85”. Perhaps section 38(2)(d) should have referred to the acquisition by a subsidiary of shares in its holding company in accordance with section 89. What do you think?

Returning to the effect of section 38(1) on the situation where a subsidiary is acquiring shares in its holding company, two prohibitions apply to this situation:

- the holding company (being the company whose shares are being acquired) may not give assistance because a company may not give assistance to anyone in connection with the purchase of or subscription for its shares
- a subsidiary may not give assistance to anyone in connection with the acquisition of shares in its holding company.

The first function of the second exception is thus to allow a holding company to give assistance for the purpose of or in connection with an acquisition of its own shares by its subsidiary. The assistance may be given either to the subsidiary itself, or to any other person, as long as it is given for the purpose of or in connection with the acquisition by the subsidiary of shares in its holding company. The second function of this second exception is to enable the co-subidiaries of the subsidiary that is acquiring shares in the holding company, to render assistance to the acquiring subsidiary or to anyone else in connection with the acquisition by the subsidiary (the subsidiary acquiring the shares can obviously not render assistance to itself).

In summary then, the exception in section 38(2)(d) allows the following:

- The giving of financial assistance by a subsidiary in connection with the acquisition by the holding company of its (the holding company’s) own shares. (The provisions of s 37 would apply here.)
- The giving of financial assistance by a holding company in connection with the acquisition by its subsidiary of shares in the holding company.
- The giving of financial assistance by a co-subidiary in connection with the acquisition of shares by a subsidiary in the holding company.

The giving of financial assistance

Following the case of *Gradwell (Pty) Ltd v Rostra Printers Ltd* [case 61] the courts tended to use the “impoverishment test” to determine whether financial assistance had been given. This test involved asking if the company had become poorer as a result of what was done for the purpose of, or in connection with, the purchase of or subscription for the company’s shares. However, while serving as a useful tool, this is not the only or necessarily the decisive test, as was clearly stated by the Appellate Division in *Lipschitz v UDC Bank Ltd* [case 63]. Where the company gives security or otherwise exposes its funds to risk, the impoverishment test is not useful. The section is aimed not only at preventing actual loss of company funds, but also at the **exposure** of company funds to possible risk. Whether financial assistance has been given or not

should also not depend on the likelihood of a loan becoming irrecoverable or of a security being enforced due to the default of the principal debtor, an argument which was rejected in *Jacobson v Liquidator of M Bulkin & Co Ltd* [case 62].

The purpose of the assistance

As was stated in the *Lipschitz* case section 38 comprises two elements, namely the **giving of financial assistance** and the **purpose** for which the assistance is given. As regards the requirement that the assistance must be **for the purpose of or in connection with** the purchase of shares, the *Lipschitz* decision makes it clear that section 38 is only contravened if assistance was at least **contemplated** at the time of the transaction. The phrase “in connection with” is intended to close loopholes and not to substantially extend the meaning of “for the purpose of”. In deciding whether financial assistance was for the “purpose of” the purchase of or subscription for the company’s shares, a distinction must be drawn between the ultimate goal and the direct object of the transaction. If the direct object is to perform a perfectly normal business transaction (eg to pay off an existing debt), there can be no objection against the assistance, even though the ultimate goal of the transaction was to facilitate the purchase of shares in the company.

For a contravention to have taken place, financial assistance must have been given for the purpose of or in connection with the purchase of the **company’s shares**. If financial assistance is given for some other purpose, section 38 is not contravened. The Appellate Division in the *Lipschitz* case thus found that where a company passed a mortgage bond over its fixed property in favour of a bank in order to secure payment of a loan account, the financial assistance related to the loan account and not to the purchase of shares. (A loan account reflects the amount of money owed to a creditor, who is often also a shareholder of the company.) Although securing the loan account facilitated a transaction which included the purchase of the same company’s shares, it did not constitute a contravention of section 38.

As regards the purpose of a transaction, the court in *Fidelity Bank Ltd v Three Women (Pty) Ltd* [case 64] used the fact that a particular transaction which facilitated the purchase of shares did not serve any **legitimate commercial interest** of the company as a basis for concluding that its purpose was indeed to give assistance for the purchase of shares.

It is possible to deduce certain guidelines from judgments handed down by the courts. In paragraph 20.32 various examples of the application of the impoverishment test are discussed. However, the impoverishment test is not conclusive and it is better to use the approach followed in the *Lipschitz* case. Nevertheless, the result would be the same in the examples used. The notes in *Hahlo* on pages 136–137 also discuss circumstances from decided cases in which section 38 was either held to have been contravened or not. If you are confronted with a set of facts, you should be able to identify which circumstances apply, apply the test and, accordingly, conclude whether or not the section has been contravened.

In practice the prohibition against financial assistance is sometimes avoided by converting a company into a close corporation. The close corporation then gives financial assistance in connection with the acquisition of the member's interest. (See **Study unit 17**.) This can obviously be done only if the requirements for a conversion can be satisfied (see s 27 of the Close Corporations Act of 1984) as well as the requirements for financial assistance (see s 40 of the Close Corporations Act of 1984). Provided the transaction is structured correctly, this practice is unobjectionable, as was recently confirmed by the Supreme Court of Appeal in *Peters NO and Others v Schoeman and Others* 2001 (1) SA 872 (SCA), which is not one of your prescribed cases.

Activity

Sipho wants to buy shares in Zet (Pty) Ltd. He intends to pay for the shares by selling his truck to Zet (Pty) Ltd for R100 000, which is a fair price. Discuss fully whether the proposed transaction constitutes a contravention of section 38 of the Companies Act of 1973, which prohibits the giving of financial assistance by a company for the purpose of purchasing its own shares.

Feedback

You should discuss section 38 of the Companies Act briefly. The wider test used in the *Lipschitz* case should be applied to establish whether the particular transaction has exposed the company's funds to a possible risk. Section 38 comprises two elements, namely the giving of financial assistance, and the purpose for which it was given. Whether there is financial assistance in contravention of section 38 when the company purchases an asset from the share purchaser will depend upon the circumstances. For example, if an inflated price is paid for the asset, this is indicative that the company is in fact rendering financial assistance. Also, if the company purchases an asset which it does not actually require, financial assistance is rendered. The fact that a fair price is paid for an asset is not conclusive. The purchase should also be one which the company might in any event reasonably have made in the ordinary course of its business, to advance this business.

These principles should be applied to the given facts. Although it is clearly stated in the facts that a fair price was paid for the truck, this will not necessarily avoid a contravention of section 38. If the purchase of the truck is not a purchase which Zet (Pty) Ltd might in any event have made in the ordinary course of business, then the purchase will indeed be a contravention of section 38.

On the other hand, if the transaction is in fact genuinely entered into by the company in its own commercial interests and not merely as a means of providing financial assistance to buy shares in the company, then the fact that it does so partly with the object of putting the vendor in funds to buy its shares, might not involve a contravention of section 38.

With the help of the guidelines referred to in the discussion of section 38 in this study unit, you should be able to apply the legal principles to a given set of facts and to reach a conclusion whether any particular transaction constitutes a contravention of the section. Even if, in answering an examination question similar to this, your conclusion is incorrect, you will be credited for a correct exposition of the relevant legal principles (ie the provisions of section 38 and the tests used by our courts).

DIVIDENDS AND OTHER PAYMENTS TO MEMBERS BY REASON OF MEMBERSHIP

***Corporate Law* pars 21.30–21.36**

Companies Act s 79; 90

Because the capital maintenance doctrine entails that share capital may not be returned to shareholders, it also means that dividends may not be paid out of share capital. The positive rule that evolved from this prohibition is that dividends may be paid only out of profits. The common-law rules that were used to determine which profits are available for dividends are explained in paragraphs 21.11–21.29, which do not form part of the prescribed material for this course. These common-law rules have been affected by the amended section 90 of the Companies Act, which came into effect on 30 June 1999. If authorised thereto by its articles, a company may make payments to its shareholders subject to the requirements of the section. Creditors are protected by solvency and liquidity requirements.

‘Payment’ is defined as including any direct or indirect payment or transfer of money or other property to a shareholder **by virtue of the shareholder’s shareholding** in the company. This clearly includes dividends. Certain payments are specifically excluded from the ambit of the section because they are provided for under other sections of the Act. They are mentioned in paragraph 21.32. Payments to shareholders in their capacity as creditors or employees are not regulated by section 90.

Shareholders will be liable to the company for any payments received contrary to the solvency and liquidity requirements.

It can be assumed that the articles of many companies still provide that dividends may be paid only out of profits. This is what the model articles contained in Schedule 1 to the Companies Act still provide (see article 86 of Table A and article 85 of Table B). Companies wishing to make payments in terms of section 90 may thus have to amend their articles.

Interest on share capital

The consistent application of the common-law rule means that interest on shares may

also not be paid out of share capital. This is not always desirable for the company as it could discourage investment. Section 79 of the Companies Act thus makes another statutory exception to the common-law rule. This exception, which is discussed in paragraphs 21.35–21.36 of the textbook, is much older than the one provided for in section 90 and of more limited scope. It allows the payment of interest out of capital subject to the approval of the Minister of Trade and Industry. Although the minister may theoretically approve of such payment even if the solvency and liquidity requirements are not met, it is unlikely that such approval will be given unless the financial health of the company is above suspicion.

The payment of interest on shares is a payment by virtue of a shareholder's shareholding and is thus also a payment for purposes of section 90. Unlike other payments specifically regulated by other sections of the Companies Act, payment of interest on shares has not been excluded from the definition of "payment" for purposes of section 90. It is to be expected that companies wishing to pay interest on shares will, in future, rather make use of the provisions of section 90 than comply with the much more cumbersome procedure of section 79.

Activity

The articles of association of Funworld (Pty) Ltd provide that dividends may be paid only out of profits. The company has not yet made any profits, but has realised that it does not need all its capital. It wishes to return 5% of its issued capital to shareholders by way of a special dividend. Explain how this can be done.

Feedback

Unless the articles of Funworld (Pty) Ltd are amended (by special resolution), it will not be possible to make the payment. The articles will have to state that Funworld (Pty) Ltd may make payments to its members in terms of section 90 of the Companies Act. Once this has been done, the payments may be made provided there are no reasonable grounds for believing that the company is, or would be, after making the payment, unable to pay its debts as they become due in the ordinary course of business, or that the consolidated assets of the company would, after the payment, be less than its liabilities. If these requirements of solvency and liquidity are not satisfied the shareholders will be liable to refund the payment received.

SELF-ASSESSMENT

- 1 Xeno (Pty) Ltd concludes a contract with Mandy, one of the shareholders, to acquire her shares in the company. At the stage when payment becomes due, it appears that Xeno (Pty) Ltd can no longer comply with the requirements of solvency and liquidity set out in section 85 of the Companies Act. Advise Mandy on the legal position.

- 2 The shareholders of Gainmakers (Pty) Ltd are Amber, Roger and Phulani CC. Amber holds 40% of the shares and the other two shareholders 30% each. Amber wants to sell her shares, worth R100 000, to Phulani CC, but the corporation does not have sufficient funds to buy her out. The following scheme is proposed: Gainmakers (Pty) Ltd will purchase Amber's shares for R100 000. It will pass a special notarial bond over some of its movable property to secure the outstanding amount on Amber's loan account. Gainmakers (Pty) Ltd will then pay each of its remaining shareholders an amount of R60 000. It will also repay Phulani CC the amount outstanding on its loan account, currently R40 000. (The loan accounts are repayable on demand.) Gainmakers (Pty) Ltd will then re-issue the shares it acquired from Amber and allot them to Phulani CC. Phulani CC will use the funds acquired through the payment and the repayment on the loan account to pay for the new shares. The amount of R60 000 which is to be paid to Roger will be advanced to Gainmakers (Pty) Ltd on loan account.

Explain whether specific requirements have to be complied with in regard to any of the elements of the scheme and also whether the scheme or any part of it will constitute a contravention of the prohibition of financial assistance contained in section 38 of the Companies Act.

Feedback

- 1 Section 88 expressly provides that a contract for the acquisition by a company of its own shares will not be enforceable in these circumstances. If Mandy institutes an action against Xeno (Pty) Ltd, the company will have to prove that there are reasonable grounds for believing that (a) the company is, or would be, after making the payment, unable to pay its debts as they become due in the ordinary course of business; or (b) the consolidated assets of the company fairly valued would after the payment be less than the consolidated liabilities of the company. If Xeno (Pty) Ltd can prove this, Mandy will not be able to enforce the contract, but will remain entitled to payment as soon as the company is lawfully able to pay her. If the company is wound up before she has been paid in full, she will be ranked in priority to the other shareholders of her class who have not sold their shares to the company.
- 2 This question involves the acquisition by a company of its own shares (s 85), the making of payments to members by reason of their membership (s 90) and the prohibition against financial assistance (s 38). When confronted with such a question, you should identify the different issues, discuss them separately and apply the principles to the facts. Always remember, however, to answer the specific question(s) asked, in this case by explaining the requirements of section 85 and section 90 and by applying section 38 to the facts. You may use subheadings in your answer.

The acquisition by Gainmakers of its own shares

You should first discuss the requirements for the acquisition by Gainmakers (Pty) Ltd of

its own shares from Amber. These would include an enabling provision in the articles, a special resolution and, of course, compliance with the solvency and liquidity requirements. You may also, depending on the formulation of the question and the marks allocated to it, discuss sections 86 to 88. Keep in mind that, as pointed out earlier in this study unit, if the articles of Gainmakers (Pty) Ltd do not presently allow it to acquire its own shares, they may be altered by special resolution (s 62) and that the special resolution allowing Gainmakers (Pty) Ltd to proceed with the purchase its own shares may be passed at the same general meeting (s 201).

The payments to the shareholders

You should explain the provisions of section 90 in respect of payments to shareholders. The payment of R60 000 to each shareholder falls within the definition of “payment” in section 90(3) and is not covered by any one of the exceptions in that subsection. For this reason, the payment will have to comply with the requirements of section 90, namely that the articles must authorise it and that the solvency and liquidity tests must be satisfied. The facts do not state what the articles of Gainmakers (Pty) Ltd provide in respect of dividends or payments to members. It is also possible that the articles could provide that dividends may be paid only out of profits, in which case the articles would have to be complied with (or amended). It is not clear what Gainmakers (Pty) Ltd’s financial position is and you need not judge whether it will be able to comply with section 90 and/or the common law.

Will section 38 be contravened?

The last part of your answer should address the possible contravention of section 38. You should first state what the section provides. You do not have to quote the actual wording, but you should ensure that all the essential elements are reflected in your statement. You should briefly explain the meaning of these elements, such as “financial assistance” and “for the purpose of or in connection with ...”, referring to applicable case law such as the *Lipschitz* case. The next step would be to discuss each element of the proposed scheme and motivate whether or not it constitutes prohibited financial assistance. The acquisition by the company of Amber’s shares in terms of section 85 cannot be regarded as **financial** assistance, although it does facilitate the acquisition of shares by Phulani CC. The security given in respect of Amber’s loan account is unobjectionable, because the assistance relates to a loan account and not to the acquisition of **shares**. The repayment of Phulani CC’s loan account constitutes a repayment to a creditor of a debt which is presently due (provided that Phulani CC has formally demanded repayment) and does not constitute prohibited financial assistance. The dividend or payment to Phulani CC and Roger would also not amount to prohibited assistance as long as it is properly made, that is, subject to section 90 and/or the articles. The fact that Phulani CC will use the repaid loan account and the “dividend” to subscribe to and pay for the new shares, does not change the transactions into transgressions of section 38. Also when the scheme is considered as a whole, there is no basis for concluding that section 38 will be contravened.

Company groupings

The learning outcome of this study unit is that you are able to apply the law relating to holding and subsidiary companies to a given set of facts.

In order to achieve this outcome you must know and understand:

- the definitions of a holding and a subsidiary company
- the rules regulating the legal relationship and transactions between holding and subsidiary companies
- the fiduciary duties of directors of companies that form part of a group.

Prescribed Material

Corporate Law Chapter 24 **excluding** paragraphs 24.12–24.23

Companies Act sections 1(3)–(5); 37; 38; 39; 89; 226; 227; 259.

Sage Holdings Ltd v The Unisec Group Ltd 1982 (1) SA 337 (W) [case 246]

The Unisec Group Ltd v Sage Holdings Ltd 1986 (3) SA 259 (T) [case 247]

Bevray Investments (Edms) Bpk v Boland Bank Bpk 1993 (3) SA 597 (A) [case 253]

OVERVIEW

***Corporate Law* pars 24.01–24.02**

There are many reasons why it may be desirable for one company to control another, including the elimination of competition between companies, the pooling of technical expertise and even the control of a particular industry without falling foul of the Competition Act 89 of 1998. It may also assist in efforts to decentralise management where various aspects of a business are performed by different companies in the group.

In Van der Merwe et al *South African Corporate Business Administration* (1995) 24–1 it is pointed out that there may be tax and other advantages in forming large groups of companies, but in spite of this there seems to be a worldwide trend to revert to smaller

independent economic entities because they are easier to manage. One of the reasons for this is the danger that where control of a holding company changes, a whole group or industry could fall into the hands of a new controller.

The regulation by the Companies Act of company groupings is necessary for two important reasons. First, there should be proper accounting as there is a danger, particularly where the holding company is a private company, that some financial information could be concealed from shareholders or creditors of the holding company. Secondly, the Act attempts to prevent abuse which could arise as a result of the control by the holding company over the subsidiary. Abuse is most likely to occur where the subsidiary makes a loan to or provides security in favour of the holding company or its directors.

GROUP OF COMPANIES

Corporate Law pars 24.03–24.10

Companies Act ss 1(3)–(5)

***Sage Holdings Ltd v The Unisec Group Ltd* [case 246]**

***The Unisec Group Ltd v Sage Holdings Ltd* [case 247]**

When reading the two prescribed cases keep in mind that they were decided before an amendment to the definition of a subsidiary in section 1(3) was enacted in 1992. However, according to *Hahlo* on page 426 the principles applicable to the interpretation of section 1(3)(a)(i)(bb) in particular, remain the same. Note that a close corporation cannot be deemed a subsidiary in terms of section 1(3) as a company cannot be member of a close corporation.

Activity

Daylight Ltd holds 50% of the shares and voting rights in Night (Pty) Ltd. In terms of the articles of association of Night (Pty) Ltd, a member has the right to nominate one director for every 25% of the shares the member holds. The board consists of five directors. Vacancies that are not filled by nominated directors are filled by directors chosen by majority vote of the members. In terms of an agreement between Daylight Ltd and Mr Sun, who holds 30% of the shares in Night (Pty) Ltd, Daylight Ltd has an option to buy Mr Sun's shares at any time. Consider whether Night (Pty) Ltd will be deemed to be a subsidiary of Daylight Ltd.

Feedback

Daylight Ltd does not hold or control the majority of voting rights in Night (Pty) Ltd (see s 1(3)(a)(i)(aa) and (cc) of the Companies Act) nor is Night (Pty) Ltd a sub-subsidiary of a subsidiary of Daylight (see s 1(3)(a)(ii)). The only remaining question is whether

Daylight Ltd has the right to appoint or remove directors of Night (Pty) Ltd which directors have the majority of voting rights at board meetings (s 1(3)(a)(i)(bb)). At present Daylight Ltd only has the right to appoint 2 of the 5 directors, but should it acquire Mr Sun's shares it will be able to appoint 3 of the 5. The question is whether this right to acquire the shares can be interpreted as a right to appoint another director even before the shares are actually acquired. If the decision in the *Unisec* case is followed, it would seem to be so, as the option can be exercised at any time. No decision on this point has been made since the amendment to section 1(3) of the Companies Act in 1992, however, and there remains a measure of uncertainty whether the court will interpret the option in the same way.

SUBSIDIARY AS A MEMBER OF ITS HOLDING COMPANY

Corporate Law pars 24.24–24.26
Companies Act ss 38(2)(d); 39; 89

The amendments to the Companies Act which repealed the previous prohibition against a subsidiary company acquiring shares in its holding company were promulgated in 1999. Note the special conditions attached to such an acquisition of shares by a subsidiary company in its holding company (discussed in paragraphs 24.24–24.25). Not only may a subsidiary company now acquire shares in its holding company, but the subsidiary may also receive financial assistance from the holding company for this acquisition (see s 38(2)(d). See also **Study Unit 10** for a discussion of s 38.)

Activity

First Ltd holds 51% of the shares in Second Ltd which holds all the shares in Third (Pty) Ltd. The directors of Second Ltd would like Second Ltd or Third (Pty) Ltd to acquire shares in First Ltd so that they would at least have some say in the more important decisions taken by First Ltd. Consider whether you would advise them to acquire these shares in the name of Second Ltd or Third (Pty) Ltd to achieve this purpose.

Feedback

Third (Pty) Ltd is deemed to be a subsidiary of First Ltd because Third (Pty) Ltd is a subsidiary of Second Ltd which, in turn, is a subsidiary of First Ltd (see the definition of a subsidiary in s 1(3)(a)(ii) of the Companies Act). This means that First Ltd is also regarded as the holding company of Third (Pty) Ltd. Although section 89 of the Companies Act now allows a subsidiary company to acquire up to 10% of the shares in its holding company, section 39 provides that no voting rights attached to such shares

may be exercised while the shares are being held by the subsidiary company. This means that irrespective of whether the shares in First Ltd are held by Second Ltd or Third (Pty) Ltd neither company will have any voting rights as members of First Ltd and the directors will not be able to achieve their stated purpose through this acquisition.

REGULATION OF TRANSACTIONS BETWEEN RELATED COMPANIES

Corporate Law pars 24.27–24.31

Companies Act ss 37; 226; 227; 259

***Bevray Investments (Edms) Bpk v Boland Bank Bpk* [case 253]**

It is important not to confuse the fields of application of section 37 and section 226.

Section 37 **allows** a **subsidiary** company (hereinafter referred to as the “lending company”) to make a loan to or provide security for an obligation of its **holding** company or another subsidiary of that holding company (ie a **fellow-subsidiary**) subject to the requirement that such transactions must be reflected in the annual financial statements of the lending company. The directors and other officers of the subsidiary and the holding company are furthermore made personally liable for damages suffered by the lending company as a result of terms and conditions in the lending agreement which were unfair or failed to provide reasonable protection to the lending company. None of these provisions, however, apply if all the members of the lending company consent to the transaction (s 37(5)).

Section 226, on the other hand, **prohibits any company** from making a loan to or providing security for an obligation of any **director or manager** of itself, its holding company or a fellow-subsidiary, or to any company or body corporate **controlled** by one or more of its directors or managers. This prohibition is subject to certain specified exceptions set out in sections 226(2) and 226(3).

The judgment in the prescribed case of *Bevray Investments* [case 253] deals with the abovementioned exceptions and more specifically with the exception contained in section 226(2)(a)(ii) which allows the provision of security by a company for an obligation of one of its own directors or managers on condition that all the members of the company give their prior consent or consent to a specific transaction is given by way of special resolution. Bevray Investments provided security for a loan made by Boland Bank to one Voges, a director and the manager of Bevray Investments. Bevray Investments was a wholly owned subsidiary of Taskor (Pty) Ltd of which Voges was also a director. The question was whether the fact that Voges was also a director of Bevray’s holding company (Taskor), caused the provision of security to be prohibited without exception in terms of section 226(1)(a)(ii). The majority decision of the court was that on the ordinary grammatical interpretation of the section, a subsidiary company could

make a loan to one of its own directors (provided the required consent had been obtained) even though that director happened to be a director of the holding company as well.

Activity

Bob is a director of Fullblast Ltd and also of its wholly owned subsidiary Halfmast (Pty) Ltd. Consider whether Halfmast (Pty) Ltd would be allowed to make a loan to Bob although Bob is a director of its holding company Fullblast Ltd, and if so, what requirements must be satisfied.

Feedback

Section 226(1)(a)(ii) of the Companies Act prohibits a company from making a loan to a director of its holding company but section 226(2)(a)(i) allows a company to make a loan to its own director provided the necessary consent of members is obtained. As Fullblast Ltd is the only member of Halfmast (Pty) Ltd, the consent of Fullblast Ltd would constitute consent by all the members of Halfmast (Pty) Ltd and according to the judgment in the *Bevray* case [case 253], the fact that Bob is also a director of the holding company, does not preclude the subsidiary company (Halfmast (Pty) Ltd) from granting a loan to Bob in his capacity as director of Halfmast (Pty) Ltd.

FIDUCIARY DUTIES OF DIRECTORS OF A COMPANY WITH AFFILIATED COMPANIES

Corporate Law par 24.32

The important aspect here is that where a person serves as director of a holding company and of its subsidiary, such director owes a fiduciary duty to each company based on his office as director of that company. In his capacity as director of the holding company, he owes no fiduciary duty to its subsidiary company, and vice versa.

Activity

Tshepo is a director of Power Ltd, the holding company of Flowers (Pty) Ltd, but she is not a director of Flowers (Pty) Ltd. She is also a member of Trees CC which has made a profit arising from a contract between itself and Flowers (Pty) Ltd. Consider whether Tshepo has to disclose her interest in this contract to the members of Flowers (Pty) Ltd.

Feedback

Tshepo does not owe any fiduciary duty to Flowers (Pty) Ltd because she is not a director of that company and her position as director of its holding company, Power Ltd, does not create such a fiduciary relationship either. Tshepo thus does not have to disclose details of this contract and the resulting profit to Flowers (Pty) Ltd.

SELF-ASSESSMENT

Angus Ltd is a member of and holds a majority of the voting rights in Jersey Ltd. Jersey Ltd is a member of Merino Ltd and has the right to appoint or remove Ben, a director of Merino Ltd who holds 60% of the voting rights at board meetings of Merino Ltd, from the board of directors. Describe the relationship between Angus Ltd and Merino Ltd.

Feedback

Angus Ltd is the holding company of Jersey Ltd as it is a member of and holds a majority of the voting rights in Jersey Ltd (see s 1(3)(a)(i)(aa) of the Companies Act). Jersey Ltd is the holding company of Merino Ltd, because it is a member of Merino Ltd and is also able to appoint or remove a director who holds a majority of the voting rights at meetings of the board (see s 1(3)(a)(i)(bb)). Merino Ltd is therefore a subsidiary of a subsidiary (Jersey Ltd) of Angus Ltd. Therefore Merino Ltd is a sub-subsubsidiary of Angus Ltd, which is the holding company (see s 1(3)(a)(ii)).

STUDY UNIT 12

Arrangements, compromises and takeovers

The first learning outcome of this study unit is that you are able to apply the law relating to compromises and arrangements to a given set of facts.

In order to achieve this outcome you must know and understand:

- the provisions in the Companies Act regulating schemes of compromise and arrangements
- the meaning of “compromise” and “arrangement”
- the meaning of “class”
- the procedure under section 311.

The second learning outcome of this study unit is that you are able to apply the law relating to takeovers to a given set of facts.

In order to achieve this outcome you must know and understand:

- the provisions in the Companies Act regulating affected transactions
- the prescribed general principles and rules of the Securities Regulation Code on Takeovers and Mergers
- the law regulating the compulsory acquisition of the securities of the minority shareholders.

Prescribed Material

Corporate Law Chapter 25, **excluding** paragraphs 25.49–25.62

Companies Act sections 311–313; 440A–440N; 98

Securities Regulation Code on Takeovers and Mergers general principles 1–11; rule 8.1; rule 29

Ex parte Federale Nywerhede Bpk 1975 (1) SA 826 (W) [case 264]

Ex parte Natal Coal Exploration Co Ltd 1985 (4) SA 279 (W) [case 266]

Ex parte NBSA Centre Ltd 1987 (2) 783 (T) [case 267]

Ex parte Griffen Shipping Holdings Ltd 1991 (1) SA 7654 (D)[case 275]

Ex parte Garlick Ltd 1990 (4) SA 324 (C) [case 269]

Haslam v Sefalana Employee Benefits Organization 1998 (4) SA 964 (W) [case 287]

ARRANGEMENTS AND COMPROMISES

Corporate Law pars 25.04–25.18

Companies Act ss 311–313

***Ex parte Federale Nywerhede Bpk* [case 264]**

***Ex parte Natal Coal Exploration Co Ltd* [case 266]**

***Ex parte NBSA Centre Ltd* [case 267]**

***Ex parte Griffen Shipping Holdings Ltd* [case 275]**

***Ex parte Garlick Ltd* [case 269]**

A company might need to come to an arrangement or compromise with its members or creditors that is binding on all the members or creditors of a particular class. However, it may be very difficult, if not impossible, to negotiate with and to get the agreement of each member or creditor individually. Thus the Companies Act provides a procedure which, if followed, enables the company to negotiate with all the persons in a group and also to bind all of them to the terms agreed upon by a specified majority of those persons. Note that even persons who voted against the scheme would be bound by it.

In summary, section 311 of the Companies Act provides that an arrangement or compromise can be entered into between a company and its members (or any class of them) or the company and its creditors (or any class of them) which arrangement or compromise will be binding on all the members (or class of them) or all the creditors (or class of them) provided certain procedures are followed.

Basically the **procedure** involves:

- a proposal of a scheme of arrangement or compromise between the company and its members (or class of them) or the company and its creditors (or class of them)
- an application to the court for permission to call a meeting (or meetings) to consider the arrangement or compromise
- sending certain information to the members or creditors involved
- holding the meeting(s)
- voting on the proposed scheme which is required to be approved by a specified majority of creditors or members
- making another court application for the sanctioning of the scheme (this is only done if the scheme obtained the required approval)
- filing the scheme with the Registrar (if the court sanctions the scheme).

Note that although the word “company” is defined in section 311(8) for the purposes of section 311 as meaning any company liable to be wound up under the Companies Act, this does not necessarily mean that a company that enters into an arrangement or compromise with its members or creditors must be one which is in the process of being wound up or even one which is in financial difficulty. Although a company in financial difficulty may propose a compromise between it and its creditors, a scheme of arrangement can be proposed between a solvent company and its members.

A **scheme of compromise** could be used where a company is in financial difficulty and is in provisional liquidation. An example of a scheme of compromise is as follows:

The company proposes to conclude a scheme of compromise with its creditors. In terms of the proposed scheme, a third party (sometimes referred to as the offeror) agrees to pay a sum of money to the liquidators of the company for the benefit of and distribution to the creditors. When the creditors have received their distribution in respect of the debt owing to them, the debts are deemed (after having been reduced by a nominal amount) to have been ceded to the third party. The company is required to recognise the third party as its new creditor. The company is released from liquidation and can continue to trade. (Note that at the same time that the compromise is agreed to, the third party usually acquires all the shares in the company and becomes the controller of the company. As he is now a major creditor of the company he may also wish to be able to control its activities.)

Schemes of arrangement have been used to make a company a wholly owned subsidiary of another company. An example of a scheme of arrangement is as follows:

A company proposes an arrangement with the holders of shares not already held by the holding company. The scheme shareholders agree to give up their shares in exchange for shares in the holding company. The company thus becomes a wholly owned subsidiary.

Considerable debate arose over the **meaning of an “arrangement”**. The main points of the debate are set out below.

In *Ex parte Federale Nywerhede Bpk* [case 264] FVB Ltd and companies which it controlled held about 80% of the shares in FN Ltd. FVB Ltd wished to make FN Ltd a wholly owned subsidiary and to get rid of the outside shareholders. A scheme was proposed between FN Ltd and the outside shareholders in terms of which their shares in FN Ltd would be cancelled (using the old reduction of capital procedure) and they would receive shares in FVB Ltd.

Coetzee J (as he then was) accepted the dictum of Brightman J in the English case of *In re NFU Development Trust Ltd* [1973] 1 All ER 135 where it was stated (at 140) that “[c]onfiscation is not my idea of an arrangement. A member whose rights are expropriated without any compensating advantage is not, in my view, having his rights re-arranged in any legitimate sense of that expression”. Coetzee J went on to hold that the concept of an arrangement involved some element of give and take in the form of a compensating advantage which was enforceable.

Difficulties then arose as to whether the compensating advantage had to be in the form of shares in another company or whether it was acceptable for the shares of the scheme shareholders to be exchanged for **cash**. In other words, did the rights of the shareholder have to continue to exist, albeit in a different form or could they lose their rights as shareholders altogether in exchange for cash?

In 1984 in *Ex parte Satbel (Edms) Bpk: In re Meyer v Satbel (Edms) Bpk* 1984 (4) SA 347(W) Coetzee J (as he then was) decided that a scheme of arrangement which sought to deprive the scheme shareholders of their shares and where the compensating advantage was simply a right to a sum of money (no matter how fair the amount) did not fall within the concept of an arrangement. The compensating advantage must consist of or include other rights. This approach was followed in the case of *Ex parte Natal Coal Exploration Co Ltd* [case 266]. Read the extract from the judgment of Stegman J carefully where he explains why cash is not adequate to make the scheme an arrangement in terms of the section. (See page 499–500 of the casebook.) What do you think of this reasoning?

However, in the case of *Ex parte NBSA Centre Ltd* [case 267] Coetzee DJP effectively backtracked on what he had said earlier. Study the extract of his judgment in your casebook at page 502 carefully for this. He stated that he was wrong in his view that a cancellation or acquisition of another person's shares in exchange for a monetary consideration could not fall under an arrangement within the ambit of section 311. Also read the minority judgment of Goldstone J.

Note that not only must there be an "arrangement" but it must also be one **as between the company and its members**.

In *Ex parte Federale Nywerhede Bpk* [case 264] the court held that the totality of the proceedings must give rise to rights which are enforceable against the company. In *Ex parte NBSA Centre Ltd* [case 267] Coetzee DJP stated that all the relevant aspects of the scheme and the surrounding facts should be considered to determine whether the arrangement is one as between the company and its shareholders. Goldstone J (who delivered the minority judgment) was of the view that the arrangement was clearly one as between the company and the shareholders because the company had a very material interest in the arrangement and also had a vital role to play in relation to the mechanics of the scheme. In the later case of *Namex (Edms) Bpk v Kommissaris van Binnelandse Inkomste* 1994 (2) SA 265 (A), a case dealing with a scheme of compromise, Goldstone JA explained that section 311 schemes are valuable to the business community and that a narrow interpretation should therefore not be placed on the section. He concluded that it was not necessary that the company play an excessively active role in the scheme but that if it was only a passive role, the scheme would not be viewed as one between the company and its shareholders. For a consideration of the role that the company played in a scheme of arrangement, you must study the scheme in *Ex parte Griffen Shipping Holdings Ltd* [case 275] and the judgment of Levinsohn J.

For a consideration of the basis on which shareholders should be divided into classes, see the case of *Ex parte Garlick Ltd* [case 269] and the judgment of Friedman J.

Activity

The ordinary shares in Marco Ltd were held by Paulo (Pty) Ltd, Stefano Ltd (a subsidiary

of Paulo (Pty) Ltd) and several other shareholders. A scheme of arrangement was proposed in terms of section 311 of the Companies Act by Marco Ltd. The effect of the scheme was that Paulo (Pty) Ltd would acquire all the ordinary shares in Marco Ltd that it did not already hold. It was provided that the scheme shares would be converted into redeemable preference shares which would be redeemed at a specified redemption price. The scheme was approved at a meeting of the ordinary shareholders where Stefano Ltd voted in favour of the scheme.

The company (Marco Ltd) has now applied for the sanctioning of the scheme. A shareholder who voted against the scheme argues that the scheme should not be sanctioned. It is argued that no valid meeting of the ordinary shareholders was held because Stefano Ltd was present and voted at the meeting. It is asserted that Stefano Ltd constituted a separate class of shareholder and should have voted at a separate meeting.

Consider whether Stefano Ltd constitutes a separate class of shareholder.

Feedback

In order to answer this question fully you should start by briefly explaining that section 311 of the Companies Act permits a scheme of arrangement between a company and a class of shareholders. The arrangement must be approved by the prescribed majority of shareholders in the class.

The issue raised in the question is whether Stefano Ltd forms part of the class of shareholders who voted on the arrangement or whether it should have considered the scheme in a separate class meeting. The difficulty with Stefano Ltd is that although it is an ordinary shareholder and would have the same rights as the other scheme shareholders, it is a subsidiary of Paulo (Pty) Ltd and thus would have a community of interest with its holding company.

As there is no statutory definition of the word “class”, you would need to refer to the cases which have dealt with the meaning of the word and the basis on which shareholders should be divided into classes. You will find a consideration of these issues in *Corporate Law* paragraphs 25.13–25.15 and also in the case of *Ex parte Garlick Ltd* [case 269]. Note the other cases which are discussed and the comments and criticisms which are considered.

After having set out the cases, comments and criticisms you must come to a conclusion on the facts. It would seem that as the basis for a division of shareholders into classes would be a similarity of rights, Stefano Ltd would not constitute a separate class of shareholders. However, the court may take into account the fact that Stefano Ltd which is a subsidiary of Paulo (Pty) Ltd has interests which differ from those of the other scheme shareholder when it decides whether to sanction the scheme.

TAKEOVERS

Corporate Law pars 25.19–25.48

Companies Act ss 98; 311; 440A–440N

Securities Regulation Code on Takeovers and Mergers general principles 1–11; rule 8.1; rule 29

***Haslam v Sefalana Employee Benefits Organization* [case 287]**

Prior to the amendment of the Companies Act in 1989 by the insertion of Chapter XVA entitled “Regulation of Securities”, takeovers were regulated by sections 314–321 of the Companies Act. A takeover offer or scheme was defined and the law required the offeror to make certain disclosures. The rest of the task of regulating takeovers was left to the Johannesburg Stock Exchange (as it was then known).

However, Chapter XVA introduced a whole new approach. A Securities Regulation Panel was established and it was given the task of regulating takeovers or, as they are now called, “affected transactions”. On the establishment, functions and powers of the Panel, study sections 440B, 440C, 440D and 440M of the Companies Act and *Corporate Law* paragraph 25.25.

In order to regulate affected transactions, the Panel made what is called the Securities Regulation Code on Takeovers and Mergers which was approved by the Minister. The Code, as indicated by its title, regulates takeovers and mergers. It contains general principles and rules applicable in respect of takeovers or mergers involving certain offeree companies. It is interesting to note however that although the title of the Code contains the words “takeovers” and “mergers”, these words are not used in either the Code or the Companies Act. It is thus advisable to learn to refer to such transactions as “affected transactions”.

Although you are not required to study the Code in detail, you should note that you will find a copy of the Code in the book which contains the Companies Act and Close Corporations Act. (See Pretorius *Companies Act 61 of 1973 and Close Corporations Act 69 of 1984 Including the Insider Trading Act 135 of 1998* (Juta) or Strydom *Company Legislation Handbook* (Butterworths) referred to under prescribed books.)

The Panel administers the Code which has the force of law. No one is entitled to enter into or propose an affected transaction, unless they comply with the rules of the Code. Although the Panel may grant a person an exemption from complying with the Code, it has the power to take action to enforce compliance if no exemption has been granted. Study section 440L of the Companies Act.

Type of transaction

In order to understand the **type of transaction** regulated by the Code, you must study the definition of an “affected transaction” in section 440A(1) of the Companies Act.

The summary of the definition in paragraph 25.27 of *Corporate Law* is a little superficial. Note that the transactions covered by the portions of the definition contained in section 440A(1)(a) and (b) of the Act involve securities and the definition concentrates on the effect of the transaction rather than on how the transaction is structured. However, you should contrast this with “a disposal as contemplated under section 228” of the Act which is also covered by the definition of an affected transaction (see section 440A(1)(c)). What do you notice?

Other definitions that are important for an understanding of the definition of “affected transaction” are the definitions of “control”, “specified percentage” and “acting in concert”. These definitions are all found in section 440A(1) of the Companies Act. Also note that certain persons are deemed to be acting in concert by section 440A(2) of the Companies Act.

Mandatory offers

One of the main objects of the Code is to ensure fair and equal treatment of all holders of the same securities in relation to an affected transaction. The Code contains a number of general principles and rules aimed at achieving this purpose. For example, rule 8.1 of the Code requires comparable offers to be made to acquire all outstanding securities in the company when there is an acquisition of control or a consolidation of control. These are referred to as **mandatory offers**. (See *Corporate Law* paragraph 25.32.) You must study rule 8.1 of the Code in conjunction with the definition of an “affected transaction”, especially that portion of the definition contained in section 440A(1)(b) of the Act. Also study general principle 10 of the Code. (See below.)

Rule 8.1 of the Code provides as follows:

“Whenever an affected transaction occurs, then the person or persons who have acquired control, or who acquire further securities in excess of the limits prescribed by the rules, shall unless the Panel rules otherwise, extend offers to holders of any class of equity capital, whether voting or non-voting, and also to the holders of any class of voting capital of which such persons acting in concert with him are holders, to acquire all of their securities or such portion of their securities as the Panel on application may determine. In making such determination, the Panel shall have regard to the facts of the case, the general principles of the Code and equity. The offers shall be for the same or comparable consideration. Offers for different classes of equity securities shall be comparable and the Panel shall be consulted in advance in such cases: Provided that for the purposes of this rule the limit prescribed shall be the acquisition in any period of 12 months of securities carrying more than 5% of the voting rights by the person or persons holding not less than the specified percentage but not more than 50% of the voting rights of a company.”

General principle 10 of the Code states:

“An affected transaction normally gives rise to an obligation to make a general offer to all other holders of relevant securities. Where an acquisition is contemplated as a result of which a person may incur such an obligation, he shall, before making the acquisition, ensure that he is able and will continue to be able to implement such an offer.”

Study rule 8.1 and work out when the obligation to make a mandatory offer arises.

The rationale for the mandatory offer provisions is that they provide some measure of protection to non-controlling shareholders because the rule curtails the activities of a person who wishes to gain control of a company by buying out one or two of the larger controlling shareholders, ignoring the smaller minority shareholders. As the offeror is obliged to make offers to the outstanding shareholders to acquire their shares, minority shareholders are not required to remain in a company in which control has changed or where a person has further consolidated his control.

The case of *Sefalana Employee Benefits Organisation v Haslam* 2000 (2) SA 415 (SCA) is relevant as far as mandatory offers are concerned. Although it involved the mandatory offer rule before it was amended in 1998, the case is still important regarding the meaning of the phrase “acquisition of securities” and mandatory offers generally. This case is not dealt with in your casebook but it forms part of the prescribed material and is considered below. Please note that the extract of the case which appears in your casebook (see case 287) is the judgment of the court *a quo* which was overruled on appeal by the Supreme Court of Appeal.

The facts of the case are briefly as follows: The defendant agreed to buy a controlling shareholding of more than 30 % of the shares in the offeree company. (Note that at the time the specified percentage was 30%. It has now been increased to 35%.) It was common cause that the transaction amounted to an affected transaction. The defendant buyer subsequently repudiated the agreement. The seller of the shares accepted the repudiation and cancelled the contract before any offers were made to minority shareholders. The court had to decide whether the agreement to buy the shares gave rise to an obligation to make mandatory offers to the minority shareholders.

Cameron J in the court *a quo* considered that two factors were important in resolving the issue. These were the definitions of the words “acquisition” and “securities” in the Code and the Companies Act, as well as the underlying purpose and rationale of the Code. The court *a quo* concluded that the agreement resulted in the buyer acquiring an interest in respect of sufficient securities and even though the agreement was subsequently cancelled, the defendant buyer had an obligation to make mandatory offers to the minority shareholders. You should study the judgment of Cameron J in order to improve your general understanding of mandatory offers.

The decision of the court *a quo* was reversed on appeal. Marais JA, who delivered the

unanimous judgment of the Supreme Court of Appeal held that on the facts the defendant buyer had not incurred an obligation to make an offer to the minority shareholders. A brief summary of the decision of the SCA which is taken from an article by Luiz “Mandatory Offers” (2000) 12 *SA Merc LJ* 382 at 388–389, follows.

“The main basis on which the court decided that there was no obligation to make mandatory offers to the minority shareholders was that there had in fact been no change in control and there was no prospect of the defendant buyer acquiring control. Marais JA explained that as the minority shareholders were no longer in danger of having to remain in a company in which control had changed without their approval, the mischief which the Act and the Code had been set up to regulate was ‘entirely absent’.

The court expressed the view that the Act and the Code should not be read in isolation and that the only circumstances under which Parliament wished to ensure that shareholders are treated equally was when there is a change of control. Marais JA stated that even if one assumed that the simple conclusion of the agreement amounted to an acquisition of shares giving the defendant purchaser control of the company, when the agreement was cancelled before any offer was made to minority shareholders, ‘the rationale for the making of a mandatory offer ... no longer existed and it would have been pointless to require an offer to be made to them. No discernible legislative purpose would have been served by it.’ Later in the judgment, the judge stated that even if there had been the required acquisition, the fact that it was cancelled before offers were made to minority shareholders ‘without the situs of control having been disturbed in any way’, meant that no obligation to make offers arose.”

Instead of concentrating on the definitions of “acquisition” and “securities” as Cameron J had done, the SCA asked what mischief the Act and the Code, in particular the mandatory offer provisions, were attempting to regulate. Luiz (at 390) explains that “[w]hen the court found that the mischief was no longer present in that no change of control would occur, it concluded that there was no basis for applying the provisions imposing an obligation to make mandatory offers”. What do you think of this approach?

Luiz (at 393) asserts that although the SCA was correct when it stated that the main thrust of the Code and the applicable legislation is to regulate affected transactions, Marais JA “was not correct when he asserted that the definition of ‘affected transaction’ makes a ‘change of control a **sine qua non** of an affected transaction’ ”. Is this correct? Study the definition of an affected transaction and come to your own conclusion.

Different takeover techniques

As far as the **different takeover techniques** are concerned, you should note that rule 29(a)(iv) of the Code provides that except in so far as the Panel or the Supreme

Court permits or orders otherwise, the provisions of the rules relating to disclosure and where possible timing and periods of notice apply as far as they can. Thus if the transaction falls within the definition of an affected transaction and the offeree company is one to which the Code applies, an offeror cannot avoid the application of the Code by, for example, structuring the transaction as a scheme of arrangement. For a summary of rule 29(a)(i) and (ii), study *Corporate Law* page 464 footnote 91.

Compulsory acquisitions

While an offeror may make an offer to acquire all the securities in the offeree company, it is possible that the offer may not be accepted by all the holders of the securities. Although it is not necessary for a person to hold all the securities in a company in order to control the company, the offeror may, for example, wish to make the offeree company a wholly-owned subsidiary. The Companies Act makes it possible for an offeror to compulsorily acquire all the securities of the company in certain circumstances. Study the relevant provisions which are summarised in *Corporate Law* paragraphs 24.41–25.48.

Activity

Franco wishes to acquire a controlling interest in Salem Ltd. He has approached two shareholders in the company and it seems that they are willing to sell their shares to him at a specified price. If he buys their shares, he will hold enough shares to give him control of 35% of the votes at the general meeting of the company. He is then approached by a minority shareholder who tells him that if he goes ahead and acquires the shares, he might be required to make an offer to all the minority shareholders in the company to acquire their shares at the same price. Franco does not wish to acquire any other shares. In any event he does not have enough money to buy any further shares in the company.

Advise Franco whether what he has been told by the minority shareholder is true and if so, the basis upon which he would be required to make such an offer to the minority shareholders of Salem Ltd.

Feedback

The minority shareholder is referring to the potential obligation to make a mandatory offer to the minority shareholders of the company under rule 8.1 of the Securities Regulation Code on Takeovers and Mergers. However, before you can advise Franco whether what he has been told is correct you would need to consider whether the situation is one to which the rule would apply. Consider whether the proposed transaction to purchase the shares from the two shareholders would amount to an affected transaction, whether the offeree company (ie Salem Ltd) is one to which the Code would apply and whether the obligation to make a mandatory offer is triggered.

As to whether or not the transaction is an affected transaction, consider the definition of an “affected transaction” contained in section 440A(1) of the Companies Act. Read this definition in conjunction with the definition of “control” and that of “specified percentage”. It would seem that the proposed transaction would amount to an affected transaction.

The question whether the company is one to which the Code applies will be answered if you look at Section A(3) of the Code which is summarised in *Corporate Law* paragraphs 25.28–25.29. It would seem that Salem Ltd is a company to which the Code applies.

Study rule 8.1 to ascertain whether the obligation to make a mandatory offer is triggered. If Franco buys the shares of the two shareholders, an affected transaction would have occurred and Franco would have acquired control. This would trigger an obligation to make mandatory offers to the minority shareholders. Franco would be required to make an offer to them to acquire their shares at the same price that he acquired the shares of the other two shareholders.

The fact that he might not have enough money to make the mandatory offer should be of concern to Franco. He must note general principle 10 of the Code. If he does not have enough money to implement the mandatory offer, he should not conclude the transaction which would trigger the obligation. However, he could approach the Panel and request them to rule that he need not make the mandatory offer.

SELF-ASSESSMENT

Penny Lane (Pty) Ltd, a company originally started by the 5 Lane sisters, is now a flourishing cosmetics manufacturer with 12 shareholders who each hold 1 share in the company. Lonrev Ltd, a major cosmetics company, which holds 1 share in Penny Lane (Pty) Ltd, wishes to make an offer to acquire all the issued shares in the company and has decided it will offer each other shareholder R1 million. The board of Lonrev Ltd has heard that all the shareholders, except the oldest Lane sister, are very keen to sell their shares. However, Lonrev Ltd does not wish to acquire anything less than 100% ownership of Penny Lane (Pty) Ltd. The board of Lonrev Ltd does not wish to structure the deal as a scheme of arrangement.

Advise Lonrev Ltd regarding the rules which regulate such a transaction and how it could structure an offer to ensure that it would not have to acquire less than all the issued shares.

Feedback

It is clear from the facts that Lonrev Ltd wishes to acquire total control of Penny Lane (Pty) Ltd. If the transaction falls under the definition of an affected transaction and if

Penny Lane (Pty) Ltd (the offeree company) is one to which the Securities Regulation Code on Takeovers and Mergers applies, the transaction would be regulated both by the Companies Act and the Code.

In order to decide whether the proposed offer falls under the definition of an affected transaction, you must consult the definition found in the Companies Act. See especially section 440A(1)(a)(ii) of the Act. It would seem that the proposed transaction is covered by the definition.

Another question is whether Penny Lane (Pty) Ltd is a company to which the Code applies. The company is a private company and it has 12 shareholders. Lonrev Ltd is planning to offer R1 million to each shareholder. Work out whether this makes the company one to which the Code applies. Look at Section A(3) of the Code which is summarised in *Corporate Law* paragraphs 25.28–25.29. It would seem that Penny Lane (Pty) Ltd is a company to which the Code applies.

Another aspect of the question is how to structure the offer in such a way so as to ensure that Lonrev Ltd does not have to acquire anything less than all the shares of Penny Lane (Pty) Ltd. One way of doing this would be to structure the offer so that it becomes possible to take advantage of section 440K of the Companies Act if the specified acceptance is received. The offer to acquire the shares could be made conditional on receiving acceptance from at least nine-tenths of all securities whose transfer is involved. If this acceptance is achieved within the required time, Lonrev Ltd could invoke the power to compulsorily acquire the shares of the minority who might refuse to accept the offer. You would need to consider the provisions of section 440K here. If the required acceptance is not received, the offer would lapse and Lonrev Ltd would be in the same position it would have been had the offer not been made.

STUDY UNIT 13

Insider trading

The learning outcome of this study unit is that you are able to apply the law relating to insider trading to a given set of facts.

In order to achieve this outcome you must know and understand:

- the relevant provisions of the Insider Trading Act.

Prescribed Material

Corporate Law Chapter 10 paragraphs 10.36–10.38

Insider Trading Act sections 1–7; 11(10); 12

INTRODUCTION

***Corporate Law* par 10.36**

Although your textbook explains the reasoning behind the introduction of the Insider Trading Act, the Act is dealt with rather superficially and the material is insufficient for the purposes of this course. You are therefore required to study the prescribed provisions of the Insider Trading Act 135 of 1998 as well as the explanation which follows below.

OFFENCES AND DEFENCES

***Corporate Law* par 10.36 Insider Trading Act ss 1–4**

The Insider Trading Act considerably broadens the scope of offences relating to what is commonly referred to as insider trading. Three types of conduct are now prohibited. The first prohibition relates to dealing, the second to encouraging or discouraging dealing and the third covers improper disclosure of inside information.

It is an offence for any individual who knows that he or she has inside information to **deal** directly or indirectly, for his or her own account or for any other person, in securities or financial instruments to which such information relates or which are likely to be affected by it (s 2(1)(a)). Should a criminal action be brought against an alleged offender, the prosecution need not show that he dealt on the basis of the inside information but must show that the person knew that he was in possession of inside information at the time that he dealt in the relevant securities. In order to escape liability it would be up to the accused to establish one of the defences referred to in section 4(1) of the Act on a balance of probabilities (see s 4(3) as well). A broker who knows that she has inside information and who is instructed by a client to purchase securities to which the information relates, would be able to raise the defence that she was acting on the specific instructions of the client, unless of course the inside information was disclosed to her by the particular client.

It is also an offence for any individual who knows that he or she has inside information to **encourage** or to cause another person to deal or to **discourage** or to stop another person from dealing in securities or financial instruments to which the information relates or which are likely to be affected by it (s 2(1)(b)). Whether certain conduct amounts to encouragement or discouragement would be for the courts to decide. For an offence to be committed, it is probably not necessary for the inside information to be disclosed as such. The available defences are set out in section 4(1). Note, however, that these are not the only possible defences (study s 4(3)).

Our Insider Trading Act now also makes it an offence for any individual who knows that he or she has inside information to **disclose** that information to another person (s 2(2)). Study the defences which can be raised in this context (s 4(2) and (3)).

RELEVANT DEFINITIONS

Corporate Law par 10.37 **Insider Trading Act ss 1; 3**

In order to understand whether a person has contravened any one of the prohibitions contained in the Insider Trading Act one needs to consider the definitions of the various words used in the Act.

Central to all the insider trading offences is that the individual must know that she has “**inside information**” (s 1). Before information would qualify as inside information it must satisfy a number of criteria. The first is that it must be “specific or precise” and this would exclude speculation and rumour. The second is that the information must not have been made public. The Legislature inserted section 3 in an attempt to clarify whether information is public information. This section includes a non-exhaustive list of circumstances in which information **must** be regarded as having been made public

and another list in which information **may** be so regarded. In the circumstances covered by the second list, it will be up to the courts to decide whether the information has been made public.

The third criterion is that the inside information must have been obtained or learned as an insider. Here you would have to consult the definition of “**insider**”. A primary insider includes an individual who gained the information through being a director, employee or shareholder of an issuer of securities or financial instruments to which the information relates. Note that the size of an individual’s shareholding is irrelevant in this context. An individual who has access to inside information by virtue of her employment, office or profession is also classified as an insider. There need be no direct connection between the individual’s employment, office or profession and the issuer of the securities or financial instruments to which the inside information relates. This category covers a large number of individuals, for example legal advisers, accountants, bankers and others. Further, an individual who has inside information and who knows that the direct or indirect source of it was a person mentioned above will be an insider.

The fourth criterion which must be satisfied is that the information must be such that if it were made public it would be likely to have a material affect on the price or value of any securities or financial instruments. In other words, the information must be price or value sensitive.

Previously, the offence of insider trading could be committed by “any person”. This meant that the offence could have been committed by a natural or a juristic person, for example, a company. However, in terms of our new insider trading provisions, the offences can be committed only by an “**individual**”. Note, however, that the common-law principles of vicarious liability apply to the civil liability established under section 6 of the Insider Trading Act (see s 6(11)).

Although it is central to establishing whether the dealing or encouraging offence has been committed, the Insider Trading Act does not define “**deal**” or “**dealing**”. However, section 2(1)(a) does make it clear that dealing directly or indirectly for your own account or for any other person in the circumstances is prohibited. Note that in the English law “**dealing**” is defined to cover the acquisition or disposition of securities either as a principal for one’s own account or as an agent for another, as well as the direct or indirect procurement of an acquisition or disposal of securities.

Note, also, that the insider trading legislation covers dealing in “**securities**” as well as “**financial instruments**”. Both terms are defined. (See s 1 of the Insider Trading Act.) The definition of ‘securities’ in the Insider Trading Act includes shares as well as other securities such as debentures and certain other rights and options.

SANCTIONS AVAILABLE

Corporate Law par 10.38

Insider Trading Act ss 5–7; 11(10); 12

Any individual who contravenes the insider trading provisions contained in section 2 commits an **offence**. Penalties are provided for in section 5. When deciding on a penalty, the court is required to take into account any civil award previously made under section 6 which arises out of the same cause (s 7(1)). Note that if the Attorney-General (now known as the National Director of Public Prosecutions) declines to prosecute for an alleged offence, the Financial Services Board (FSB) may institute a prosecution in respect of that offence (s 11(10)).

Although under the previous dispensation any person who contravened the insider trading provisions was liable to any other person for any loss or damage he caused that person, there was some doubt about the usefulness of this civil remedy. Besides reserving the common-law rights of any person who is aggrieved by any dealing contemplated in the Act to bring an action, the new provisions have introduced what has been called a derivative **civil action** which can be instituted by the FSB against individuals involved in a contravention of the insider trading provisions (s 6). The FSB is now responsible for investigating matters related to insider trading, bringing civil actions and distributing awards to claimants.

In terms of section 6(1) the FSB can institute civil proceedings against any individual who knows that he has inside information and who deals (directly or indirectly) for his own account in the securities or financial instruments to which the information relates or which are likely to be affected by the information if that individual profits or avoids a loss through the dealing. Obviously, the FSB will not be successful if the individual concerned raises a valid defence which is proved on a balance of probabilities. The individual described here is subsequently referred to as “the individual referred to in subsection (1)” and we shall refer to this individual as Anton.

The FSB can sue Anton for payment of the amount of the profit made or the loss avoided as a result of the dealing (s 6(4)(a)(i)). See section 6(4)(b) for the factors the court can take into account when determining this amount. The FSB is also entitled to sue Anton for a penalty for compensatory or punitive purposes (s 6(4)(a)(ii)). The latter sum is to be determined by the court but it may not exceed three times the profit gained or the loss avoided. In assessing the amount to be awarded, the court must take into account any criminal penalty previously imposed which arises out of the same cause (s 7(2)). The FSB can also sue for interests and costs (s 6(4)(a)(iii) and (iv)). Money awarded to the FSB as a result of any civil action will be distributed to the individuals affected by insider trading. (See s 6(5) and 6(6) of the Act for who can claim and how this money will be distributed.)

In terms of section 6(2)(a) the FSB can bring civil proceedings against an individual (let us call him Burt) if he knows that he has inside information and he discloses it to Anton

("the individual referred to in subsection (1)"). If Burt fails to prove a defence, he can be declared jointly and severally liable, together with Anton, for the amount of the profit made or the loss avoided by Anton, plus interest and costs. Thus although it would be a criminal offence for Burt (if he knows that he has inside information) to **simply disclose** that information to Anton (unless Burt has a valid defence) it seems that the FSB will not succeed in a civil action against Burt under this subsection unless it can also be shown that Anton, knowing he had inside information, dealt for his own account in the relevant securities or financial instruments (without a valid defence) and made a profit or avoided a loss.

In terms of section 6(2)(b) an individual (let us call her Connie) who knows that she has inside information and who encourages or causes Anton ("another person") to deal in the relevant securities or financial instruments and has no valid defence can be held jointly and severally liable together with Anton ("the individual referred to in subsection (1)") to pay the FSB the amount of the profit made or the loss avoided by Anton, plus interest and costs. The subsection read as a whole means that it would be necessary to show that Connie knew she had inside information, that she encouraged Anton to deal, that Anton (knowing he had inside information) dealt for his own account in the relevant securities thereby making a profit or avoiding a loss and that neither Anton nor Connie had a valid defence.

Unfortunately the wording of section 6(2)(c) is a bit confusing. In terms of section 6(2)(c) an individual (let us call him David) who knows that he has inside information and who deals (directly or indirectly) in the relevant securities or financial instruments **for any person** can be held jointly and severally liable, together with the individual referred to in subsection (1) to pay the FSB the amount of the profit made or the loss avoided by that individual plus interest and costs unless he has a valid defence. If you read subsection (1) again you will notice that it refers to an individual who deals (directly or indirectly) in the relevant securities for his **own account** and makes a profit or avoids a loss and has no valid defence. (We have called this individual Anton.) It would seem that section 6(2)(c) is there to cover the situation where Anton (who knows he has inside information relating to the securities) deals indirectly through David (possibly a broker, who also knows that he has inside information relating to the securities) and Anton makes a profit or avoids a loss and neither Anton nor David has a valid defence. (See the earlier comments made regarding a defence a broker may have in this context.) David would be jointly and severally liable with Anton for the profit made or loss avoided by Anton, as well as interest and costs.

Note that not only can the individuals referred to in subsection (2) of section 6 (in our examples, these would be Burt, Connie and David) be jointly and severally liable with Anton for the profit he made or loss he avoided, interest and costs, but they could also be liable for a sum determined by the court (this sum is not to exceed three times the amount of the profit made or loss avoided) as well as being required to pay all the commission or consideration received for disclosing, encouraging, discouraging or dealing (s 6(3)). The inclusion of the word "discouraging" in the subsection is interesting because no mention is made in subsection (2) of civil liability for discouraging.

An **Insider Trading Directorate** has been established by section 12(1) as a committee of the FSB. The Directorate is to exercise the power of the FSB to institute any civil proceedings contemplated under the Act in the name of the FSB (see ss 12(1) and 11(4)(a)). The Directorate is entitled to withdraw, abandon or compromise any civil proceedings instituted in terms of section 6 of the Act. However, it should be noted that any agreement of compromise must be made an order of court and the amount to be paid under the compromise must be made public (s 12(13)). Where there have been no civil proceedings but an agreement of settlement has been reached, the FSB may apply to have the agreement made an order of court (s 12(14)).

SELF-ASSESSMENT

Hermione is the personal assistant to the managing director of Zantrade Ltd, a listed company involved in the development, manufacture and distribution of toys. She is required to take minutes at a meeting of the board of directors where the development of a new product is discussed. Hermione realises that if the company releases the new product it will have a positive effect on the company's profitability. She tells her husband, Lucas, about the meeting and the new product. Lucas immediately instructs his broker to buy shares in Zantrade Ltd. When Hermione hears what her husband has done, she advises her friend, Macey, to buy shares in Zantrade Ltd. When Macey asks her why she should do this, Hermione simply replies "Because I say so". Macey does not, however, act on this advice. After the new product is released, the price of Zantrade Ltd's shares rises considerably. Lucas sells his shares at a considerable profit.

Consider whether criminal proceedings could be brought against Hermione and Lucas under the Insider Trading Act of 1998.

Feedback

You should explain that the Insider Trading Act of 1998 prohibits three types of conduct, viz dealing, encouraging (or discouraging) dealing and disclosing of inside information. The question is concerned with the possibility of bringing criminal proceedings against Hermione and Lucas.

Hermione has disclosed information to Lucas and she has also tried to encourage Macey to deal in the shares of Zantrade Ltd. Give a summary of the law and the definitions relevant to these two offences (see ss 1 and 2 of the Act). This would show what the prosecution would need to prove to successfully prosecute her for these two offences. Apply the law to the facts and come to a conclusion.

Lucas has dealt in the shares of Zantrade Ltd by purchasing and subsequently selling the shares at a profit. Give a summary of the law and the definitions relevant to this offence. Apply the law to the facts and come to a conclusion.

Note that if you answered a similar question in an examination, you will be awarded marks if you correctly set out the law and show how you applied it to the facts, even if your conclusion on the facts is not entirely correct.



General introduction to the law of close corporations

This is a general introduction to the law of **Close Corporations**. It explains what you need to understand and have a working knowledge of before you can embark upon this part of the module. You will not be directly examined on this material but you may need to draw on it in order to fully understand the other legal principles and be able to apply them to factual situations. A working knowledge of the topics discussed below is assumed.

The development of the Close Corporations Act

The aim of the Close Corporations Act 1984 is to provide a suitable business form for the single trader or small business with only a few participants. When compared with a company, the close corporation provides a fairly uncomplicated and consequently less expensive business form while retaining the advantage of legal personality. Since the Close Corporations Act came into operation in January 1985, the use of a close corporation as a form of business enterprise in South Africa has grown in popularity. For more information on this, read *Corporate Law* Chapter 33 pages 574–576.

Concept of a close corporation

The legal requirements under which the close corporation operates are basic and far simpler than the Companies Act. The close corporation has its own distinctive features one of which is that it is a juristic person distinct from its members. A comparison can also be made between a close corporation and a partnership. For more information on this topic, read *Corporate Law* Chapter 33 pages 576–578.

Advantages and disadvantages

It is important to know that there are advantages and disadvantages to a close corporation. Some of the advantages are simplicity in management and decision making and that no returns need to be submitted to the Registrar of Close Corporations. Some of the disadvantages are that every member is an agent of the corporation and the simplicity and informality of the corporate structure may facilitate fraud within the corporation. For more information on this topic, read *Corporate Law* Chapter 33 pages 579–580.

Formation of a close corporation

Companies are required to comply with the Companies Act, its regulations and its many administrative formalities. Matters have been simplified in the case of close corporations which acquire legal personality and corporate status by registration in terms of the Close Corporations Act 69 of 1984. Incorporation is effected by the Registrar of Close Corporations and for this purpose, close corporations are required to lodge only a single document, called the founding statement. An association agreement which regulates the internal matters of the close corporation insofar as it does not conflict with the provisions of the Close Corporations Act, may also be entered into by the members of a close corporation. For more information on this topic, read *Corporate Law* Chapter 34.

Conversion of a close corporation

Note that it is possible to convert a close corporation into a company with the written consent of all its members and provided all its members become members of the company (see section 29C(1) of the Companies Act). The Registrar must give notice of the conversion in the Government Gazette.

A company having ten or fewer members who all qualify for membership of a close corporation may also be converted into a close corporation. An application for conversion of a company into a close corporation must be signed by all the members of the company and contain a statement that upon conversion the corporation's assets will exceed its liabilities and that after conversion it will be able to pay its debt in the ordinary course of business (see section 27(2)(a) of The Close Corporations Act). For more information on this topic, read *Corporate Law* Chapter 34.

It is important to note that *Hahlo* does not discuss cases on close corporations. You must, however, study the cases which are discussed in the prescribed book and/or in the study guide.

STUDY UNIT
14

Membership and member's interest

The learning outcome of this study unit is that you are able to apply the requirements and procedures for acquiring and terminating membership of a close corporation to a given set of facts.

In order to achieve this outcome you must know and understand:

- the requirements for membership of a close corporation
- the nature of a member's interest
- how a member's interest is acquired, transferred and terminated
- the circumstances under which a close corporation may provide financial assistance for the acquisition of a member's interest and how this differs from the relevant company law provisions relating to financial assistance.

Prescribed Material

Corporate Law Chapter 35 **excluding** paragraphs 35.32–35.37
 Close Corporations Act sections 28–41

MEMBERSHIP

***Corporate Law* pars 35.01–35.14**
Close Corporations Act ss 28–37

Look at paragraphs 35.03 to 35.07 to see who will qualify for membership in a close corporation. You should contrast this with *Corporate Law* paragraph 36.12 which sets out the provisions in regard to which members are disqualified from taking part in the management of a close corporation. Note that at no time may the number of members of a close corporation exceed ten. The reason for the limitation on the number of members is that, by keeping the number low, the corporation can operate successfully despite the fact that in principle all members are entitled to play an active part in the management and representation of the corporation.

Activity

Indicate which of the following persons may become members of a close corporation in terms of section 29 of the Close Corporations Act:

- John, whose estate has been sequestrated
- Susan, John's 19-year old daughter
- Purdey, John's wife
- Lonely Star (Pty) Ltd, a private company of which John is the only shareholder
- John's father-in-law, the trustee of a testamentary trust with Purdey and Hopeful CC as the only beneficiaries of the trust
- John's mother, Betty, who is mentally incapacitated
- Peter, the nominee of Vacations Galore (Pty) Ltd

Feedback

The answer is contained in paragraphs 35.03-35.07. Since even minors, insolvents or other legally disabled persons may become members of a close corporation, John and Susan may be members if they are entitled to hold a member's interest. Purdey also qualifies as she is a natural person and there are no limitations on married women. Betty may become a member but will have to be represented by her curator. Juristic persons qualify for membership only under certain circumstances. Lonely Star (Pty) Ltd is not exempted in terms of any of the relevant exceptions and thus cannot become a member. John's father-in-law will not qualify even though he is a natural person because a juristic person, Hopeful CC, is also a beneficiary of the trust. Peter will not qualify, because he acts as the nominee for Vacations Galore (Pty) Ltd, a juristic person.

MEMBER'S INTEREST

Corporate Law pars 35.15–35.31
Close Corporations Act ss 38–40

A person becomes a member of a close corporation by acquiring a member's interest either directly from the corporation or from an existing member (or members) or from his (or their) deceased or insolvent estate(s). Although there is no exact definition of a member's interest in a close corporation, you will have a better understanding of the meaning of a member's interest once you have studied paragraph 35.19.

In paragraph 35.18 mention is made of the fact that a close corporation may acquire a member's interest from an existing member. Contrary to the position in respect of companies, which have only been allowed to acquire their own shares since the amendment of the Companies Act in 1999, close corporations have been able to acquire a member's interest since the commencement of the Close Corporations Act (s 39). Section 38(c) of the Close Corporations Act determines what happens to a

member's interest acquired by the corporation, since the corporation may not be a member of itself. (See *Corporate Law* p 601 footnote 41). For the same reason the corporation may not acquire a member's interest if the seller is the only member.

The Companies Act has in fact followed the provisions of the Close Corporations Act in that emphasis is placed on liquidity and solvency when a company acquires its own shares. However, the Close Corporations Act goes even further than the Companies Act by also allowing the corporation to give financial assistance to **any person** for the acquisition of a member's interest, again subject to the requirements of solvency and liquidity as well as the written consent of every member to prevent abuse (see s 40 of the Close Corporations Act). Compare this to the provisions of section 38 of the Companies Act 61 of 1973 which still prohibits the giving of financial assistance by a company to another person for the purchase of the company's own shares.

Activity

Alex has been appointed as trustee of the insolvent estate of Bernard. Bernard holds a 10% member's interest in Fighters CC. What procedure must Alex follow to dispose of Bernard's member's interest in the corporation? Would Alex have been compelled to follow the same procedure had he been the executor of Bernard's deceased estate?

Feedback

Section 34 of the Close Corporations Act prescribes the procedure that must be followed by the trustee in the disposal of the interest of an insolvent member: Alex must sell Bernard's member's interest to the corporation, an existing member or an outsider who qualifies for membership, notwithstanding any contrary provisions in the association agreement. Before he can sell it to an outsider, however, Alex must give written notice of the intended sale to the corporation and every remaining member. They then have 28 days in which to buy the member's interest at the same price and on the same terms as the outsider. As executor of Bernard's deceased estate, however, Alex is bound to any relevant provisions in the association agreement (s 35). If there are no such provisions, he must transfer the member's interest to an heir or legatee if such person qualifies for membership and all the remaining members give their consent. Only if transfer to an heir or legatee is not possible, must the executor follow the same procedure as for an insolvent estate. (See *Corporate Law* paragraphs 35.25–35.26.)

SELF-ASSESSMENT

Andy, Bert and Clive are the only members of Lucky CC. Andy wishes to sell his member's interest in Lucky CC to Harry, but the latter is having problems obtaining the necessary funds to purchase this interest.

- 1 Discuss fully if and how Lucky CC may provide any financial assistance to Harry for this purpose, as well as whether Lucky CC may simply buy the member's interest itself.
- 2 Under what circumstances, other than through a voluntary disposal of his member's interest, may Andy cease to be a member of Lucky CC?

Feedback

- 1 It is possible for Lucky CC to provide financial assistance for the purchase of Andy's interest by Harry if the prior written consent of all the members is obtained (s 40 of the Close Corporations Act). In terms of section 39, Andy may also sell his member's interest to Lucky CC itself on condition that the prior written consent of all the other members is obtained. In both cases Lucky CC must be solvent (ie its assets, fairly valued, must exceed its liabilities) and able to pay its debts as they become due in the ordinary course of business after providing the financial assistance or making the payment. (See *Corporate Law* footnote 29 on page 599.)
- 2 Andy's membership of Lucky CC may be terminated by a forced disposal if his estate is sequestrated (s 34), by disposal from his estate after his death (s 35), or if his member's interest is attached and sold in execution (s 34A). It can also be terminated by deregistration (s 26) or liquidation and dissolution of Lucky CC (s 66) or by an order of court (s 36). (See *Corporate Law* par 35.14.)

STUDY UNIT 15

Internal relations

The learning outcome of this study unit is that you are able to apply the law regulating the internal relations of members of a close corporation to a given set of facts.

In order to achieve this outcome you must know and understand:

- the role of the association agreement in a close corporation
- who is disqualified from taking part in the management of a close corporation
- the remedy available to a member in the case of unfairly prejudicial conduct by the corporation or another member
- the duties owed by a member to the close corporation and how they can be enforced
- the rules regulating payments and the provision of loans and security to members by the corporation.

Prescribed Material

Corporate Law Chapter 36
Close Corporations Act sections 42–52

THE ASSOCIATION AGREEMENT AND OTHER AGREEMENTS

***Corporate Law* pars 36.01–36.11**
Close Corporations Act ss 44–47

An association agreement is an agreement among the members of a close corporation to regulate the internal relations. Some matters, however, cannot be altered by an association agreement and the provisions of the Close Corporations Act must be followed in such instances. This includes those matters where the Act requires the written consent of all the members of the corporation. (For a list of these see par 36.10.)

Although it is preferable to have an association agreement, such an agreement is not compulsory. In the absence of an association agreement the provisions of section 46 will apply and each member will be entitled to participate in the management of the business of the corporation subject only to the restrictions contained in section 47.

The association agreement constitutes a contract between the corporation and its members as well as among the members *inter se*. New members are automatically bound by an existing formal association agreement, which is not the case with the type of agreement referred to in section 44(3).

It is important to note that the doctrine of constructive notice is specifically excluded as far as association agreements are concerned by section 45 of the Close Corporations Act.

Activity

Thabo wishes to register a close corporation with himself, his father and his son as members. As he will be providing most of the capital for the business, he wants to ensure that all major decisions of and contracts entered into by the corporation will have his consent. Consider whether he will be able to insert such a clause in the association agreement.

Feedback

Section 46 of the Close Corporations Act lists those matters which may be varied by an association agreement. This list includes the right to represent the corporation which means that Thabo may stipulate that he will be the only member authorised to contract on behalf of the corporation. (It might not, however, protect him or the corporation completely in his or their relationship with outsiders, as the doctrine of constructive notice does not apply to the association agreement. See Study unit 16 for a discussion of the external relations of a close corporation and more specifically par 37.09 of your textbook on the exclusion of this doctrine.) As far as other decisions are concerned, it would be unnecessary to include any stipulations in the association agreement if his member's interest is substantially more than those of the other members as a member's number of votes corresponds with his percentage interest unless the association agreement provides otherwise. (See *Corporate Law par 36.02(d)*.)

MANAGEMENT OF THE CLOSE CORPORATION

Corporate Law pars 36.12-36.13
Close Corporations Act ss 46-48

Generally, every member may participate in the management of the business of a close

corporation. This is subject thereto that a member's capacity is not limited by an association agreement or by a provision of the Close Corporations Act. In terms of section 47 of the Act, certain persons are excluded from participating in the management of a corporation. This is one of the provisions of the Act, referred to above, which may not be altered by an association agreement.

Activity

Would it be necessary to include a provision in the association agreement excluding a 19-year old member from taking part in the management of the close corporation or would he be automatically excluded by the Close Corporations Act?

Feedback

In terms of section 47 of the Close Corporations Act a person under legal disability is disqualified from taking part in the management of a close corporation **except** a minor of at least 18 years whose guardian has lodged a written consent to the minor's participation. It would therefore be necessary to specifically exclude such a minor in the association agreement to prevent him from becoming entitled to participate in the management by lodging a written consent from his legal guardian.

FIDUCIARY DUTIES AND DUTIES OF CARE AND SKILL

Corporate Law pars 36.14–36.21

Close Corporations Act ss 42–43

The members of a close corporation stand in a special relationship to one another and in this respect they are very similar to partners. In spite of this, the members owe their **fiduciary duties** to the **corporation** and not to fellow members, owing to the fact that the corporation is an independent legal person (section 42(1) of the Close Corporations Act). For the meaning of "fiduciary relationship", see subsection 42(2) of the Close Corporations Act. The Act does not provide for directors, and every member has powers of management, the logical result of which is that every member has fiduciary duties towards the corporation.

In accordance with the general aim of the Act to simplify the legal position of close corporations and to eliminate uncertainties which sometimes occur in the case of partnerships and companies, the provisions of the Act in this area are largely a summary of the common-law principles in respect of the fiduciary duties of company directors as these principles have crystallised in the courts. The courts will therefore probably allow themselves to be led by well-tried directives of company law when

these provisions of the Act have to be interpreted, obviously taking into consideration the important differences between companies and close corporations. Note that section 42(2)(b)(iii) specifically prohibits competition by a member with the close corporation. This is in direct contrast to the situation regarding a director who may, apparently, compete with his company (see *Corporate Law* par 10.19).

A member who is guilty of a breach of his fiduciary duties will be liable to the corporation. Note, however, that in terms of section 42(4) almost any breach of fiduciary duties can be ratified, on condition that all members consent thereto. The problems encountered with ratifiable and non-ratifiable actions in the derivative action in company law will therefore not occur here.

[In paragraph 36.16 at the end of the third line from the top, the word “not” has erroneously been omitted just before “exceed”. Please insert the missing word in your textbook.]

Apart from their fiduciary duties, members also owe **duties of care and skill** to the corporation. A member must act with the degree of care and skill that may reasonably be expected from a person of his knowledge and experience. For example, an engineer who is also a member of a close corporation, should therefore act with the degree of care and skill that may reasonably be expected from an engineer with his knowledge and experience. This corresponds largely to the duty of care and skill required by the common law from a company director (*Corporate Law* par 10.31).

Activity

Secretariat CC decides to buy computer equipment and the company to which the tender is awarded pays Joe, the member who negotiated the deal on behalf of the corporation, a “commission”. When the other members find out about this, all but one of them are satisfied with Joe’s explanation and decide that Joe may keep this commission. Consider whether the dissenting member can compel Joe to pay this money over to the corporation.

Feedback

Section 42(4) of the Close Corporations Act provides that a breach of fiduciary duty by a member may be condoned by the written approval of all the members. If it can be proved that the possibility of receiving a commission probably influenced Joe’s decision to award the contract to this particular company, he has committed a breach of section 42(2)(b)(i). If one member refuses to sign the written approval, Joe will be obliged to pay the commission to Secretariat CC.

REMEDIES FOR MEMBERS AND THE CLOSE CORPORATION

Corporate Law pars 36.22–36.30

Close Corporations Act ss 49–50

A clear distinction should be made between section 49 and section 50 of the Close Corporations Act. While the rights of a **member** are dealt with in section 49, the rights of the **corporation** are dealt with in section 50.

Section 49 of the Close Corporations Act deals with the situation where the member's own rights are affected through unfairly prejudicial conduct by the corporation or one or more other members. It is, in essence, a repetition of the shareholder's personal action in terms of section 252 of the Companies Act in company law. The first reported case in which the meaning and effect of section 49 of the Close Corporations Act had to be pronounced upon by the court was *Gatenby v Gatenby* 1996 (3) SA 118 (EC). The facts were briefly as follows: two brothers each obtained a 50% interest in a close corporation which owned a hotel. Over the years the applicant invested more capital in the corporation than the first respondent. The first respondent shared his interest in the corporation with his wife, the second respondent, so that they each held a 25% interest in the corporation. The business had traded at a loss and was in need of further capital to become successful. Propforum 14 (Pty) Ltd offered to purchase the assets of the corporation. While the applicant was in favour of such a sale, which would enable the corporation to pay its debts (including the applicant's loan account), the two respondents did not want to accept the offer. The relationship between the applicant on the one hand and the two respondents on the other, had deteriorated to such an extent that it was no longer possible for them to continue the business together.

The applicant wished to withdraw from the business altogether and applied to the court for relief in terms of section 49(1) and (2) of the Close Corporations Act. He contended that the failure of the corporation to accept the offer to purchase its assets and instead to continue conducting the ordinary business of the corporation was an act which was unfairly prejudicial, unjust and inequitable to him.

In relying on authorities which interpreted and applied section 252 of the Companies Act, the court found that its power to "make such order as it thinks fit ... for regulating the future conduct of the affairs of the corporation" in terms of section 49(2) was not restricted to an order relating to the pursuance of the objects contained in the founding statement, in this case to conduct the business of a hotel. The object of section 49 was to assist the victim of the oppressive conduct and in this regard the court had a wide discretion, including the far-reaching power to compel one member to purchase the interest of another at a fair price, whether he wished to do so or not. This was also in line with a common feature in legislation relating to companies and close corporations, and the equitable common-law principle that no co-owner, partner, shareholder or member was normally obliged to remain such against his will where this was unfair or

oppressive to him. It would not advance the objects of section 49 to limit the court's power to making orders relating to the day-to-day running of the business of the corporation; section 49 was designed for an extraordinary situation. Moreover, the plain meaning of the words in this section empowering a court to make an order "regulating the future conduct of the affairs of the corporation" included ordering the sale of the corporation's assets so that it could use the proceeds to pay its debts.

The court was satisfied that section 49(2) gave it the power to order the sale of a corporation asset in order to enable a member who was being prejudiced to be paid out for his interest and thereby to bring about a termination of his membership. The court ordered the close corporation to accept the offer by Propforum 14 (Pty) Ltd for the purchase of the assets of the close corporation and furthermore authorised the applicant to sign the necessary documents on behalf of the close corporation to help with the implementation of this order and to give transfer of the assets to Propforum 14 (Pty) Ltd.

In terms of section 50, any other member may institute proceedings on behalf of the corporation against a member or former member in certain circumstances where the corporation's own rights are at stake.

Activity

Secretariat CC has bought computer equipment for its business. The members find out that the company from which the computer equipment was bought paid a "commission" to Joe, the member of Secretariat CC who negotiated the contract on behalf of the corporation. Only one member of the corporation, Susan, refuses to accept Joe's explanation and insists that Joe should pay the commission to Secretariat CC. What action could Susan institute against Joe if he refuses to pay over his commission to the close corporation?

Feedback

Susan could institute action in terms of section 50(1)(b)(i) of the Close Corporations Act as she would be instituting proceedings on behalf of the corporation for a breach of Joe's fiduciary duty to the corporation and not because she has personally been prejudiced. Prior notice must be given to all other members of the corporation of her intention to institute such proceedings. After the proceedings have been instituted, they may only be withdrawn or settled with the leave of the court (s 50(2)). If Susan's action is unsuccessful, the court may order her to pay Joe's costs and those of the corporation if it finds that she instituted the proceedings without *prima facie* grounds (s 50(3)).

PAYMENTS TO MEMBERS

Corporate Law par 36.31
Close Corporations Act s 51

The criteria for payments by a corporation to any member are solvency and liquidity. A member who receives a payment contrary to these provisions is liable to the corporation for it. The rules governing the payments are set out in section 51 of the Act.

The solvency criterion provides that after any payment (which would include a distribution of income) to members has been made, the assets of the corporation fairly valued must exceed its liabilities.

The liquidity criterion imposes two further strict constraints, in that after a payment to members has been made

- the corporation must be able to pay its debts as they become due in the ordinary course of business, and
- such payment must in the particular circumstances not in fact render the corporation unable to pay its debts as they become due in the ordinary course of business.

Activity

Sophia is a member of a close corporation but is not involved in its management. She has been informed that the corporation intends repaying the contribution of another member and fears that the corporation will not survive financially if this substantial amount is repaid. Consider whether she can prevent this repayment.

Feedback

In terms of section 51 of the Close Corporations Act the requirements of solvency and liquidity must be met before any payment may be made to a member by reason of his or her membership. Repayment of a contribution is included in this section and if Sophia can prove that the corporation will be insolvent or unable to pay its debts after such repayment, the corporation will be prohibited from making such repayment.

PROHIBITION ON LOANS TO OR SECURITY ON BEHALF OF MEMBERS

Corporate Law par 36.32
Close Corporations Act s 52

Section 52 of the Close Corporations Act prohibits loans and the provision of security by a close corporation to its members and legal persons controlled by them. This section applies unless the express written consent of all the members has previously been obtained. Section 52 can be seen as a simplified version of the prohibition contained in section 226 of the Companies Act.

Activity

Lerato, Jane and Sophia are members of a close corporation. Sophia wishes to sell her member's interest and Lerato is anxious to buy it. Lerato does not have the funds to pay for the member's interest and wants the close corporation to lend the money to her. Compare the requirements of the Close Corporations Act that have to be complied with in this instance with the requirements that would apply if the loan to Lerato were to pay the deposit on a house she wants to buy.

Feedback

A loan to acquire a member's interest has to comply with the requirements of section 40 of the Close Corporations Act. This means that the prior written approval of every member must be obtained and the liquidity and solvency requirements must be satisfied. If the loan is for another purpose, it is in principle prohibited unless the express consent in writing of all the members is obtained beforehand (s 52). Solvency and liquidity requirements are not applicable.

SELF-ASSESSMENT

Peter buys a truck at an auction and then offers it for sale to Chickens CC, of which he is a member, but at a substantial profit. Tom, another member of the corporation, is determined to prevent this transaction, but he holds only a small member's interest and is always outvoted by the other members. Consider whether he would be successful in a bid to stop the sale of the truck to Chickens CC.

Feedback

Section 42 of the Close Corporations Act provides that every member owes a fiduciary duty to the corporation. Section 42(2)(b) specifically prohibits a member from deriving personal economic benefit to which he is not entitled as this would amount to a conflict of interests. However, section 42(4) allows the members of the close corporation to consent to this benefit being obtained. The section requires the written consent of all the members, and not just of the majority. Tom will thus be able to stop the sale to Chickens CC from taking place.



STUDY UNIT 16

External relations

The learning outcome of this study unit is that you are able to determine whether in a given situation a close corporation will be bound to a contract entered into on its behalf.

In order to achieve this outcome you must know and understand:

- the requirements for pre-incorporation contracts for close corporations
- the difference between the capacity of a close corporation and the authority of members to represent the corporation
- the legal principles relating to the capacity and representation of a close corporation
- the regulation of transactions in a group and of loans and the provision of security.

Prescribed Material

Corporate Law Chapter 370

Close Corporations Act sections 2(4); 17; 29(1); 52-55; 63(d)

PRE-INCORPORATION CONTRACTS

***Corporate Law* pars 37.01–37.07**

Close Corporations Act s 53

The need to secure a contract often arises before the close corporation is incorporated. The common law, however, does not make provision for a person to act as the agent of a principal not yet in existence. To overcome this problem, section 53 of the Close Corporations Act allows the close corporation to ratify a pre-incorporation contract concluded by a person professing to act as an agent or trustee for the corporation not yet formed, if certain requirements are met.

Apart from the statutory arrangement in terms of section 53, the common-law construction of the stipulation in favour of a third party can be used. Where this is the

case, A concludes with B a contract in A's own name, in terms of which B undertakes to render a performance of some kind to the yet to be incorporated corporation (the third party). As soon as the close corporation has been incorporated, it accepts the performance stipulated for it by A, and B is then bound as against the corporation to comply with the provisions of the contract. As the third party (the corporation) need not exist at the time of conclusion of the contract, and A acts in his own name as principal, it can be used effectively in the case of a yet to be incorporated corporation.

In *Build-A-Brick BK en 'n Ander v Eskom* 1996 (1) SA 115 (O) it was held that section 53 of the Close Corporations Act is permissive and not peremptory. Where a person acts in his own name as principal for a close corporation in the course of its formation, the agreement is fundamentally one for the benefit of a third party and in such a case it is not necessary to comply with the requirements of section 53. Compliance with the requirements of section 53 is only obligatory if the person is contracting as an agent and describes himself as an agent or trustee.

Activity

Benny enters into a written contract for the purchase of immovable property on which he intends building an office block as soon as a close corporation for this purpose has been registered. In the contract he is described as an agent for the corporation which has not yet been formed. After the corporation has been registered, the other members are unhappy about the purchase price and refuse to consent to the contract. Consider whether the seller can hold Benny liable.

Feedback

The contract complies with the requirements of section 53 of the Close Corporations Act as it is in writing and Benny is described as agent for the not yet formed corporation. All the members must therefore consent in writing to the ratification of the contract. Unless the contract specifically provides for Benny's personal liability if the close corporation refuses to ratify it, there is no personal liability and the contract simply lapses.

CAPACITY AND REPRESENTATION OF A CLOSE CORPORATION

Corporate Law pars 37.08–37.22

Close Corporations Act ss 2(4); 17; 54

Note the difference in the requirements for a contract to be valid and binding when it

is entered into by a partner on behalf of a partnership as opposed to a contract entered into by a member on behalf of a close corporation. The important distinction is that the scope of business of the close corporation plays no role whatsoever in this regard.

The two crucial questions in determining the liability of a close corporation in accordance with section 54 are, first, whether or not the representative was a member of the corporation, and second, whether or not the outsider was *bona fide*. Remember, however, that section 54 applies only to contracts with outsiders and does not apply when a close corporation enters into a contract with one of its members.

Activity

Henry, who is a non-active member of Building Bricks CC, enters into a contract in his personal capacity with the corporation. The authority of Sally to conclude contracts on behalf of the corporation, but who signed on behalf of the corporation, was excluded in the association agreement. Henry argues that he has never read the association agreement and did not know that Sally had no authority to act on behalf of the close corporation. As a result he was completely *bona fide* and thus protected by section 54.

Feedback

Even though Henry was *bona fide*, section 54 applies only to contracts with non-members of the corporation. The general principles of representation will apply, which means that the contract will not be binding on Building Bricks CC as Sally did not have express or implied authority to act on behalf of the corporation. The contract will only be binding if it is ratified by the corporation or if Henry can prove *estoppel*.

TRANSACTIONS IN A GROUP, THE REGULATION OF LOANS AND THE PROVISION OF SECURITY

Corporate Law pars 37.23–37.36

Close Corporations Act ss 29(1); 52; 55; 63(d)

As explained in the textbook, a close corporation is prohibited from having any juristic person as a member (s 29(1)) and should this prohibition be contravened, such a juristic person shall be held liable for every debt of the corporation incurred during the time this contravention continues (s 63(d)). Close corporations cannot therefore be associated with each other in the same way that holding companies and subsidiary companies can. For the same reason, a company cannot be the “holding company” of a close corporation. On the other hand, however, a close corporation can be a member of a company and even be the sole or controlling member, and it is for this

reason that certain restrictions imposed on holding companies are also made applicable to close corporations which have control over a company or companies similar to that of a holding company.

Activity

Selfhelp CC holds 60% of the shares in Supershop Ltd. Selfhelp CC has obtained overdraft facilities from Smiling Bank subject to Supershop Ltd registering a bond over its immovable property as security for any amount owed by Selfhelp CC to the bank. Consider whether Supershop Ltd may provide such security.

Feedback

If Selfhelp CC had been a company, it would have been the holding company of Supershop Ltd and in terms of section 55(1)(b) of the Close Corporations Act the provision of security by Supershop Ltd for an obligation of Selfhelp CC is thus regulated by section 37 of the Companies Act. This means that details of the security provided by Supershop Ltd must be stated in its annual financial statements unless all the members of Supershop Ltd consent to the security being provided. In terms of section 55(2) of the Close Corporations Act, read with sections 37(3)(a) and (b) of the Companies Act, the members and directors of Supershop Ltd and the members of Selfhelp CC will be personally liable for any damages that Supershop Ltd might suffer as a result of unfair conditions in the security agreement or the failure to provide reasonable protection for the business interests of Supershop Ltd.

SELF-ASSESSMENT

In the founding statement of Slim & Trim CC, the principal business of the corporation is described as “the import and sale of equipment designed to ensure the reduction of excess body weight”. In the association agreement entered into between the founding members, Joe, Cheryl and Lewis, it was agreed that no member would be entitled to conclude a contract on behalf of Slim & Trim CC for more than R50 000 without the prior written consent of the other members. In the name of Slim & Trim CC, Joe purchases the most recent weight-loss equipment available in Switzerland, which promises results twice as fast as the previous model. The purchase price of the equipment is R60 000.

Cheryl and Lewis have not given their consent to this sale as they do not believe that it is scientifically possible to achieve the required results so quickly. They are of the opinion that Joe was too credulous in clinching the deal and deny that Slim & Trim CC is liable under this agreement on the ground that Joe did not have the required authority.

Discuss whether Slim & Trim CC is liable under this contract and if so, whether it might be able to claim damages from Joe.

Feedback

Where an outsider deals with a corporation, any member of that corporation has the capacity to act as its agent (s 54(1)). Where a member acts on behalf of the corporation, the corporation is bound, irrespective of whether or not such member was duly authorised, except if the outsider knew or should reasonably have known that the specific member did indeed have no authority. As the question does not indicate that the seller knew, or should reasonably have known, that Joe did not have the authority to conclude the contract in question, the seller can hold Slim & Trim CC liable for the amount of R60 000.

An association agreement may regulate any matter, including internal relationships between the members *inter se* or between the members and the corporation, in a manner which is consistent with the provisions of the Act (s 44(1)). Association agreements bind the corporation to every member in his capacity as a member of the corporation and, again in such capacity, every member of the corporation to every other member (s 44(4)). Although the association agreement (which is optional) is similar in function to the articles of a company, the doctrine of constructive notice does not apply to close corporations. The association agreement is not open for public inspection and third parties are accordingly not deemed to have any knowledge of its contents.

As a member of the close corporation, Joe stands in a fiduciary relationship towards Slim & Trim CC. He must therefore act honestly and in good faith towards the corporation and must avoid any material conflict between his own interest and that of Slim & Trim CC. Since Joe acted contrary to the provisions of the association agreement, he is in breach of his fiduciary duty and Slim & Trim can, in turn, recover the amount of R60 000 from him in his personal capacity.

STUDY UNIT 17

Liability of members in terms of the Act

The learning outcome of this study unit is that you are able to determine the civil and criminal liability of a member of a close corporation in a given set of facts.

In order to achieve this outcome you must know and understand:

- the rules regulating the personal liability of members and others for debts of a close corporation
- the provisions regulating liability for reckless or fraudulent carrying on of the business of a close corporation
- the circumstances under which a close corporation would be deemed not to be a juristic person.

Prescribed Material

Corporate Law Chapter 38 **excluding** paragraphs 38.15–38.17

Close Corporations Act sections 63-65

LIABILITY OF MEMBERS AND OTHERS FOR CORPORATE DEBTS

***Corporate Law* pars 38.01–38.14**

Close Corporations Act ss 63–65

Section 63 of the Close Corporations Act, which provides for the liability of members and certain other persons for debts of the close corporation, was enacted with a view to ensuring compliance with a number of the provisions of the Act. The persons mentioned in paragraphs 38.03–38.09 of your textbook, together with the corpora-

tion, are jointly and severally liable for those debts of the corporation in the circumstances specified. Note that you are required to know exactly which persons are liable in each instance.

One of the specific circumstances mentioned is where the office of the accounting officer is vacant for a period of six months (see par 38.09). You should note that the Close Corporations Act provides that every corporation must appoint an accounting officer and that no person may be appointed as or hold the office of an accounting officer of a corporation, unless he is a member of a recognised profession named by the Minister in a notice in the *Government Gazette*. The accounting officer of a corporation has a right of access to the accounting records and documents of the corporation. The accounting officer also has certain statutory duties.

Section 64 of the Close Corporations Act makes provision for the liability of those persons (usually, but not always members) who were knowingly a party to the carrying on of the business of the corporation in a reckless or fraudulent manner.

In the case of the abuse of the separate juristic personality of a corporation, section 65 grants the court certain powers and more specifically it gives the court the power to pierce the corporate veil in certain defined circumstances. *Haygro Catering BK v Van der Merwe en Andere* 1996 (4) SA 1063 (C) was probably the first case in which the court held the members of a close corporation personally liable for the corporation's debts on the strength of section 65 of the Close Corporations Act. The facts were as follows: The first and second respondents were the sole members of the third respondent, a close corporation which traded as a butchery under the name "Mr Meat Man". The applicant, Haygro Catering BK, obtained default judgment in an unopposed action against "Mr Meat Man" for the unpaid purchase price of meat supplied to "Mr Meat Man". Up to this stage the applicant had been under the impression that "Mr Meat Man" was a partnership.

"Mr Meat Man" stopped trading and the applicant then established that it was owned by a close corporation. The name of the corporation was not displayed at its business premises nor did it appear on any of the cheques or stationery of the business. The applicant then brought an application in terms of section 65 for an order declaring the first and second respondents to be jointly and severally liable for the debt of the close corporation (the third respondent).

The court held that section 65 conferred a wide discretion. The court found on the facts that the non-use of the corporation's name and the fact that it had not been anywhere apparent that the applicant was dealing with a close corporation, resulted in a "gross abuse of the juristic personality of the corporation" (as provided for in section 65) and held that the first and second respondents were jointly and severally liable to the applicant for the third respondent's debt to the applicant.

The applicant relied on section 63(a) as an alternative ground for liability. The court did not have to rule on this as the action succeeded on section 65, the first ground of action. When the facts are considered, however, it is clear that section 63(a) did not

apply as it only finds application where the “name of the corporation is in any way used without the abbreviation required by section 22(1)”. In the present instance the name of the corporation was never used, only the trade name “Mr Meat Man”. Section 23(2) was also not applicable as it applies only where the order for goods is in writing, which in this case it was not. It is apparent from the *Haygro* case that section 65 provides protection in circumstances where sections 23(2) and 63(a) would not apply.

Apart from the specific provisions of the Close Corporations Act, the circumstances under which the corporate veil may be lifted in the case of a close corporation are unclear. The closest that our courts have come to deciding this point was in the case of *Von Wuldfliing-Eybers v Soundprops 2587 Investments CC* 1994 (4) SA 640 (C). The plaintiffs in this case claimed for improvements they had made to a townhouse owned by the close corporation. They had entered into a contract for the purchase of the member’s interest of the sole member of the close corporation, subject to the condition that a loan by way of mortgage bond over the townhouse could be obtained. This condition was not fulfilled and the sale was thus null and void. The plaintiffs had in the meantime, however, effected certain improvements to the townhouse and now instituted a claim for enrichment against the corporation.

Counsel for the defendant argued that as the close corporation was the real owner of the townhouse, the plaintiffs had merely occupied the townhouse on behalf of the close corporation. As such they were not *bona fide* occupiers of the townhouse (as they would have been in the case of a direct sale of the townhouse itself) and thus not entitled to compensation.

The court was of the opinion that the plaintiffs should be treated as if they had purchased the property itself, and not the member’s interest in the corporation, which was the owner of the property. This meant that the existence of the close corporation should be ignored, a view which was supported by the fact that the contract also ignored it by stipulating that occupational rent should be paid to the member and not to the close corporation. Conradie J found that the close corporation had no economic or business reason for its existence other than to avoid the payment of transfer duty. The court in any event concluded that no improvements of which the law could take cognisance had been made as the improvements were made solely for the sake of the plaintiffs’ own comfort and safety. The claim thus failed.

Although it would seem from this case that the existence of a close corporation can be ignored, commentators have submitted that there was no real piercing of the corporate veil in the legal sense. It was more a case of the existence of the close corporation in the specific circumstances being irrelevant to the issue at hand.

SELF-ASSESSMENT

Siphiwe receives a telephonic order from Bheki for the delivery of 100 bags of potting soil to a business called Pots & Plants. When his account remains unpaid after a month, Siphiwe finds out that the business has, in the meantime, been closed and that it is in

fact owned by Gardens Galore CC, of which Bheki and his wife are the only members. Advise Sipiwe whether he can claim the amount owed to him from Bheki and/or his wife personally.

Feedback

Sipiwe can institute an action in terms of section 65 against Bheki and his wife for payment of the account. According to the judgment in the *Haygro* case it was a gross abuse of the juristic personality of the corporation not to use its name anywhere in the business and not to give any indication that the business was in fact owned by the corporation. The section is wide enough to include every member of the close corporation, not just the person who placed the order, and an order can thus also be given against Bheki's wife to be held personally liable for the debt.

