

**DEPARTMENT OF MERCANTILE LAW**

**COMPANY LAW  
LML406T**

**Tutorial Letter 102/3/2010**

Dear Student

By now you should have received Tutorial letter 101/2010 which contains extremely important information regarding your module on company law. If you have not received it, you should contact the Department of Despatch immediately via the Unisa Contact Centre on 0861 670 411 (for RSA calls) or +27 11 670 9000 (for international calls).

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**1 INTRODUCTION**

**This Tutorial Letter contains the study guide to your prescribed textbook *Companies and other Business Structures in South Africa* by Dennis Davis, Farouk Cassim et al (2009) Oxford University Press Southern Africa. Whenever we refer to your textbook or prescribed textbook in this study guide, it will be a reference to *Companies and other Business Structures in South Africa*. Further details regarding your prescribed study material, including the textbook, can be found in your Tutorial Letter 101/2010 for this module.**

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

- tells you exactly which chapters and parts of chapters in the textbook are prescribed for this module;
- also lists the prescribed cases and other material you have to study for a specific study unit from the prescribed book by Pretorius et al *Hahlo's South African Company Law Through the Cases*;
- contains additional information which you also have to study for the examinations;
- explains some difficult concepts in more detail; and
- sometimes gives you a different point of view from the one explained in the textbook.

Therefore, this tutorial letter also forms part of your study material although the prescribed textbook is the primary source of your study material.

### **WHAT THE MODULE COMPANY LAW (LML406T) IS ALL ABOUT**

This module consists of selected topics concerning company law.

On completion of this module, you should be able to identify, analyse and solve complex legal problems relating to certain aspects of company law and engage with legal text in order to critically evaluate different viewpoints on corporate law issues. You should also have acquired the academic knowledge and skills relating to corporate law to enter a career in law.

### **COMPANY LAW IN SOUTH AFRICA**

The new Companies Act 71 of 2008 was signed into law by the President in April 2009 and is expected to come into force in the second half of 2010. When it comes into operation, this Act will repeal and replace the Companies Act 61 of 1973, except for Chapter 14 of the 1973 Act which will continue to regulate the winding up of insolvent companies. (The winding up of companies is not included in the prescribed work for this module.)

Companies will become even more important in future since the registration of new close corporations will not be allowed once the Companies Act of 2008 comes into force, although existing close corporations will be allowed to continue doing business for the foreseeable future.

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

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

**Paragraphs 2.1 to 2.11.4 of Chapter 2 are also not prescribed for a specific study unit, but you will have to familiarise yourself with their contents, particularly if this is your first encounter with the Companies Act of 2008. These paragraphs explain the different types of companies that may be registered in terms of the new Act, as well as the procedure and constitutive documents prescribed for incorporation. We will assume knowledge of all these aspects on your part.**

Note that the statement in paragraph 2.3 of the textbook, that the Companies Act is silent as regards piercing the corporate veil, is incorrect. Section 163(4) of the Act, which deals with remedies and enforcement, provides that if a court finds that the incorporation of a company or any act by or use of a company constitutes an unconscionable abuse of its juristic personality, the court may declare that the company will be deemed not to be a juristic person in respect of the rights, liabilities and obligations relating to the abuse. The wording of this provision is a combination of section 65 of the Close Corporations Act and the judgment in *Botha v Van Niekerk* (referred to in par 2.3). It ignores the view expressed in *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* which described the test of “unconscionable injustice” applied in *Botha v van Niekerk* as too rigid. The courts will probably still use the existing case law dealing with the common law rule of piercing the corporate veil when deciding what would constitute an unconscionable abuse. Section 164(4) is discussed in Chapter 11, paragraph 11.7 of your textbook and although also not prescribed, we suggest you read through it.

**Please also see the General Introduction to Company Law below for a brief summary of knowledge that we assume you already have.**

### **HOW TO USE THIS STUDY GUIDE**

At the beginning of each study unit, we supply the numbers of the prescribed chapters or parts of chapters for that study unit. We then subdivide the study unit into different parts and supply the numbers of the prescribed paragraphs for that particular subdivision. Please note that when, for example, paragraph 3.3 of your textbook is prescribed for a particular part, it means that you must study the whole of paragraph 3.3, including all its subparagraphs; in other words, you must study from the beginning of paragraph 3.3 until it ends at 3.3.9.

Remember that you must study **everything** in the prescribed parts of the textbook and in the study guide, **including decided cases that are discussed there**. In addition, you must also study the prescribed cases that are listed at the beginning of each study unit. These cases are contained in *Hahlo’s South African Company Law Through the Cases* (see Tutorial letter 101/2010 for details of this book) and the number of each prescribed case as found in this book is supplied in square brackets after the name and reference of the case.

The Companies Act 71 of 2008 is also prescribed separately, and you must study the sections of the Act which are discussed in the prescribed parts of your textbook and in this study guide. At the beginning of each study unit, we have listed those sections of the Act which are relevant for that study unit. You should read these sections in the Act itself as well, because it will often assist you in understanding its context and meaning.

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

The next step is to work through each subdivision of the study unit by reading the notes in the study guide on that part of the work, and then going back to the prescribed part of the textbook. We have tried to use the same headings as the textbook for subdivisions in the study guide, but sometimes we have combined more than one heading. You then read the relevant section(s) of the Companies Act of 2008 and the additional prescribed cases and notes in *Hahlo*. By studying only one part of a study unit at a time, the work is broken up into more manageable units, and it should be easier for you to cope with.

Please note that the feedback given after each activity only provides you will guidelines on how to approach the specific question asked in the activity. The feedback is not a model answer to the question.

We trust that you will enjoy studying this module and that you will find the knowledge you gain in the process to be of great value.

## 2 GENERAL INTRODUCTION TO COMPANY LAW

### Types and forms of companies

Two main types of companies can be incorporated in terms of the Companies Act of 2008 namely profit companies and non-profit companies.

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

There are four types of profit companies: a state-owned company, a public company, a personal liability company (the successor to the section 53(b)-company under the 1973 Act) and a private company. The types and forms of companies and their characteristics are discussed in Chapter 2, paragraph 2.6 of the textbook.

A state-owned company:

- Falls under the meaning of “state-owned enterprise” as determined in the Public Finance Management Act or is owned by a municipality;
- Is a National Government Business Enterprise;
- Is fully or substantially financed by the National Revenue Fund, tax, levy or other statutory money.
- Examples of state-owned companies: CSIR and SABS.

A public company:

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

A personal liability company:

- Mainly used by professional associations (such as attorneys);
- Directors are jointly and severally liable with the company for debts and liabilities contracted during their term of office. Section 19(3) uses the word “contracted” and not “incurred”, which was held by the court in *Fundtrust (Pty) Ltd (In Liquidation) v Van Deventer* 1997 (1) SA 710 (A) to limit this liability to contractual debts, and to exclude delictual and statutory liabilities.

A private company:

- Its MOI prohibits offering of shares to the public, cannot freely transfer shares;

A **non-profit company** is a company previously registered as a section 21 company in terms of the Companies Act of 1973. Its objects must relate to social activities, public benefits, cultural activities or group interests. A non-profit company must have directors, but they are not allowed to obtain any financial gain from the company other than remuneration for the work they perform. A non-profit company is not obliged to have members. If they do have members some may have voting rights and others not.

### **Pre-incorporation contracts**

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

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

A person who enters into such a contract is held jointly and severally liable for liabilities emanating from the pre-incorporation contract if incorporation of the company does not take place, or the company does not ratify any part of the agreement after incorporation.

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

Pre-incorporation contracts are discussed in paragraph 2.10 of your textbook.

### **The constitution of the company**

The Memorandum of Incorporation (MOI) is the founding document of the company. It is a document that sets out the relationship between the company and its shareholders; the company and the directors; the company and other parties within the company as well as the company and third parties. Provisions in the Memorandum of Incorporation may be changed from time to time.

Under the 1973 Act, there were two documents that had to be submitted for incorporation. These were the Memorandum of Association and the Articles of Association. Incorporation was not possible if both documents were not filed with the Registrar of Companies. In line with its objective of simplicity, the 2008 Act requires only one founding document, the Memorandum of Incorporation.

In terms of section 15(3), where both the Act and the Memorandum of Incorporation are silent regarding certain matters that have to do with the governing of the company, the board of directors of a company is generally allowed to make, amend or repeal rules.

Such rules must not be in conflict with the Memorandum of Incorporation of the company or with the Act. Before the rules of the board become effective, they must be published in the manner stated in the Memorandum of Incorporation or in the rules themselves, and, if prescribed by the Memorandum of Incorporation or by the rules, the rules must be filed as required. Twenty business days after publication of the rules or after the date stated in the rules (if any), the rules become effective. As soon as the rules become effective, they are binding on an interim basis, until put to the vote at the next general shareholders' meeting. For the rule to become permanent there must be ratification by an ordinary resolution at the general meeting.

**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 11 of your textbook.

## Study Unit 1

### Shareholders and Company Meetings

This study unit deals with the provisions of the Companies Act relating to the types and convening of meetings, voting rights and resolutions at meetings of shareholders.

☺ **Study Chapter 4 of your prescribed textbook!**

☺ **Study sections 58 to 65, and 66(1) of the Companies Act!**

#### Prescribed cases for this Study Unit:

*Davey and Others v Inyanga Petroleum (1934) Ltd and Another (1954) (3) SA 133 (W) [130]*

*Ebrahim v Westbourne Galleries Ltd and Others [1973] AC H 360 (HL) [292]*

*Getz v Spaarwater and Another 1971(2) SA 423 (W) [132]*

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

*In re Duomatic Ltd [1969] 1 ALL ER 161 (Ch) [136]*

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

*Sammel & Others v President Brand Gold Mining Co Ltd 1969 (3) SA 629 (A) [286]*

*Hahlo* text at 207 and 235

#### 1.1 Introduction

Paragraphs 4.1-4.2 of the textbook.

Section 66(1)

Unlike the Companies Act of 1973, where a shareholder was also referred to as a member of the company, the Companies Act of 2008 uses only the term “shareholder” in respect of a profit company. The term “member” of a company is reserved for non-profit companies who do not have shareholders. There is thus now a definite difference in meaning between a member and a shareholder.

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

Section 66(1) of the Companies Act of 2008 provides that the business and affairs of a company must be managed by or under the direction of its board, which has the authority to exercise all of the powers and perform any of the functions of the company, except to the extent that this Act or the company’s Memorandum of Incorporation provides otherwise. The directors thus have a duty to manage the company but shareholders retain control over the directors by their power to appoint and remove directors. Many important decisions of the directors must furthermore be approved by the shareholders.

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

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

## 1.2 Notice of Meetings

### Paragraph 4.3 of the textbook Section 62 of the Companies Act

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

### Activity 1.1

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

Advise Mr Ngcobo whether he was given proper notice.

### →Feedback

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

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

## 1.3 Representation by Proxy

### Paragraph 4.4 of the textbook Section 58 of the Companies Act

*Ingre v Maxwell* (1964) 44 DLR 765

*Davey and others v Inyaminga Petroleum (1934) Ltd and Another* 1954 (3) SA 133 (W)

The appointment of a proxy:

- Must be in writing and signed by the shareholder;
- Is valid for one year;
- May be for a specific period of time;
- May be for two or more persons concurrently exercising voting rights for different shares;



- A proxy may delegate authority to act on behalf of the shareholder to another person;
- A copy of the proxy appointment form must be delivered to the company before the shareholders meeting;
- A shareholder is not compelled to make an irrevocable proxy appointment;
- A shareholder may alter proxy by cancelling it in writing, appointing another proxy and deliver a copy of the revocation to the proxy and the company.

## Activity 1.2

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

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

### → Feedback

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

## 1.4 Demand to convene a shareholders' meeting

### Paragraph 4.5 of the textbook Section 61 of the Companies Act

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

## 1.5 Shareholders acting other than at a meeting

### Paragraph 4.6 of the textbook Section 60 of the Companies Act *Gohlke and Schneider v Westies Minerale (Edms) Bpk 1970 (2) SA 685 (A)* *In re Duomatic Ltd [1969] 1 ALL ER 161 (Ch)*

The Companies Act of 1973 provides that a particular annual general meeting need not be held if all the members who are entitled to attend such a meeting consent in writing. In such a case, any resolution that would have been dealt with at this meeting will also be deemed to be valid if it is in writing and signed by all the members entitled to vote at that meeting. Otherwise, resolutions have to be taken at properly constituted members' meetings.

However, in English and South African case law the common-law rule of unanimous assent was accepted. In terms of this rule, certain decisions may be valid without a meeting being held, if all the members are fully aware of the facts and all of them assented thereto, although it need not be in writing. In *Gohlke and Schneider v Westies Minerale (Edms) Bpk 1970 (2) SA 685 (A)* the court held that members may validly appoint a director to the board without any formal meeting being held because there was evidence of their unanimous consent.

The court in *In re Duomatic Ltd* [1969] 1 ALL ER 161 (Ch) held that the unanimous approval of directors' remuneration by the two directors holding all the voting shares in a company could be regarded as a resolution of a general meeting approving the payment.

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

### **Activity 1.3**

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

#### **→Feedback**

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

## **1.6 Annual General Meeting**

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

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

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

- Election of directors to the extent required by the Act or the company's Memorandum of Incorporation;
- Appointment of an auditor for the following financial year;
- Appointment of an audit committee;
- Presentation of the directors' report;
- Presentation of audited financial statements for the immediately preceding financial year;
- Presentation of an audit committee report;
- Any matter raised by shareholders.

### **Activity 1.4**

Zithulele Ltd will soon hold its annual general meeting. List the matters that must be discussed at this meeting.

#### **→Feedback**

See the list above.

## 1.7 Convening a meeting in special circumstances

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

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

## 1.8 Quorum

### Paragraph 4.9 of the textbook Section 64 of the Companies Act

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

### Activity 1.5

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

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

### →Feedback

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

## 1.9 Conduct of meetings

### Paragraph 4.10 of the textbook Section 63 of the Companies Act

Note the difference in the number of votes that may be exercised depending on whether voting takes place by a show of hands or on a poll. The textbook states that a person who abstains or fails to exercise his voting rights on a resolution will be deemed to have voted against the resolution. This statement is not based on any provision of the Act, and must also not be taken to mean that an abstention vote will be taken into consideration when determining whether a resolution has been adopted. The requirements for both a special and an ordinary resolution clearly state that the required percentage of votes **exercised** on the resolution must be in favour of the resolution to have it validly adopted. Only the votes of shareholders who actually exercise their votes are thus taken into consideration.

## Activity 1.6

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

### →Feedback

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

## 1.10 Majority rule

### Paragraph 4.11 of the textbook

This rule is not contained in the Act itself, but is a common-law rule. The protection of minority shareholders against oppression by the majority as a result of majority rule is discussed in Chapter 11 which is not prescribed for this module.

## 1.11 Exercise of voting rights

### Paragraph 4.12 of the textbook

#### Section 57(2)-(6) of the Companies Act

#### *Pender v Lushington (1877) 6 ChD 70*

Three possible situations are discussed under this heading. Briefly summarised, they are the following:

1. A profit company (other than a state-owned enterprise) with only one shareholder:
  - The shareholder may exercise all the voting rights.
  - Rules of setting a record date etcetera do not apply.
2. A profit company (other than a state-owned enterprise) with only one director:
  - The director may exercise any power or perform any function of the board at any time except when the Memorandum of Incorporation provides otherwise.
3. A company (other than a state-owned enterprise) where every shareholder is also a director:
  - Shareholders may decide on any matter to be referred by the board at any time, without notice or compliance with any internal formalities except when the Memorandum provides otherwise; subject to certain specified conditions.

The court in *Pender v Lushington (1877) 6 ChD 70* stated that shareholders, unlike directors, do not exercise their voting rights for the benefit of the company and can act entirely in their own interests. A shareholder has a right to have his or her vote recorded, even if that vote made no difference to the final results.

## Activity 1.7

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

### →Feedback

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

## 1.12 Shareholder resolutions

### Paragraph 4.13 of the textbook Section 65(7)-(11) of the Companies Act

Just like the Companies Act of 1973, the Companies Act of 2008 (in s 65(7) and (9)) also provides for two types of resolutions that may be taken in a shareholders' meeting, namely an ordinary resolution, requiring more than 50% of the votes exercised, and a special resolution, requiring at least 75% of the voting rights exercised. The important difference is that the Companies Act of 2008 allows a company to stipulate a higher percentage for approval of all or some ordinary resolutions in its Memorandum of Incorporation (except one for the removal of a director), or a lower percentage for a special resolution, on condition that there must always be a difference of at least 10% between the percentages required for an ordinary and a special resolution.

## Activity 1.8

Distinguish between ordinary and special resolutions.

### →Feedback

#### Ordinary resolution

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

#### Special resolution

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

## 1.13 Decisions that require a special resolution

### Paragraph 4.14 of the textbook

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

## 1.14 Postponement and Adjournment of meetings

### Paragraph 4.15 of the textbook

### Section 62(4)-(13) of the Companies Act

#### Activity 1.9

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

Advise the shareholders whether the meeting may be validly adjourned.

#### ➔ Feedback

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

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

## Study Unit 2

### Directors, Board Committees and the Company Secretary

☺ **Study paragraphs 6.1-6.13.6, 8.7 and 7.13**

**of your prescribed textbook!**

☺ **Study ss 1, 66, 67, 68, 69, 71, 72, 73, 75, 76, 78, 85, 86, 87, 88, 89 and 162 of the Companies Act!**

#### Prescribed cases for this Study Unit:

*Robinson v Randfontein Estate Gold Mining Co Ltd* 1921AD 168 [case 75]  
*Regal Hastings Ltd v Gulliver* 1All ER 378(HL) [case76]  
*Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd*1981 (2) SA 173(T) [case 80]  
*Sibex Construction (SA) (Pty) Ltd v Injectaseal CC* 1988 (2) SA 54 (T) [case 81]  
*Fisheries Development Corporation of SA v Jorgenson* 1980 (4) SA 156 (W) [case 87]  
*S v Marks* [case 221]  
*Re Hydrodam (Corby) Ltd* [case 138]  
*Panorama Developments (Guildford) Ltd* [case 213]

### 2.1 Introduction

In **study unit 1** you were introduced to one of the organs of a company namely the general meeting of shareholders. The shareholders of a company exercise their rights and the functions entrusted to them in the Companies Act 71 of 2008 or the Memorandum of Incorporation by adopting resolutions at the meeting of shareholders. In **study unit 2** we will introduce the other main organ of the company, namely the board of directors (all the directors acting collectively). The functions and responsibilities of a company director arise by virtue of the nature of the company. As you know, a company is a legal entity which exists separate 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 agents (representatives in the strict sense of the word). The board of directors is one of the organs through which the company acts. We will also introduce you to one of the office-bearers of a company namely the manager of a company.

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

- What is the legal position of a company director and the board of directors?
- What are the different types of directors?
- What is the difference between directors and managers?
- Who are ineligible or disqualified from becoming directors?
- How are directors appointed and removed?
- How is the meeting of the board of directors conducted?
- How are company secretaries appointed?
- What are the duties of company secretaries?

## 2.2 Meaning of the word “director” and the different types of directors.

Paragraph 6.1 of your textbook

Sections 1(definition of a director), 66(4)(a)(i-iii), 66(4)(b) and 68 of the Companies Act

*S v Marks* [case 221]

*Re Hydrodam (Corby) Ltd* [case 138]

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

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

Different **types of directors** have been recognised by both the King Code and the Companies Act. The textbook refers to the King II report of 2002 (in footnote 3) but there is also now a third King Report on Corporate Governance (King III) which became effective in September 2009 but does not differ very substantially from its predecessor. However, remember that the King Codes are not law. They do not have the force of law and are therefore not enforceable, except for provisions that have been included in an Act or have been made compulsory in another way, for example by being included in the listing requirements of the JSE Ltd for companies who wish to list on the stock exchange. They are guidelines to indicate the principles that a company should adhere to for purposes of good governance.

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

- Executive directors
- Non-executive directors
- Independent directors

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 (1994) identified four important functions as part of non-executive director’s duties. They are summarized in Halo at 241.

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

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 memorandum of incorporation. The controllers behind nominee directors are included in this category, although internally they are not regarded as directors. They are not, for example, entitled to directors’ remuneration and, should the memorandum of incorporation permit an ordinary director to convene an extraordinary general meeting, the *de facto* director will not be able to do so. The second category of *de facto* directors concern persons who are in fact appointed to the office, but where there is some defect in their appointment or qualifications. These persons are legally also not directors, although some of them are treated as such. Their actions prior to the discovery of the defect in their appointment or qualifications are, nonetheless, valid. See in *Re Hydrodam (Corby) Ltd* [case 138].



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

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

### **Activity 2.1**

Study paragraph 6.1 of your textbook and then do the following:

Distinguish between the different types of directors as recognised in the Companies Act.

### **Feedback**

Refer back to paragraph 6.1 in your textbook and make sure you understand the differences between the different types of directors. You should be able to give the characteristics of each type of director.

## **2.3 Directors and managers**

Paragraph 6.2 of your textbook

*Moresby White v Rangeland Ltd* [case 159]

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

There are many differences between being a director and being a manager. A **manager** is an **employee** of a company whereas a **director does not have to be an employer**. Managers and directors also differ in their roles with regards to *inter alia*, leadership, decision making and their respective duties and responsibilities. The board of directors for example are responsible for the leadership and direction of a company whilst the managers' tasks are to carry out the strategy on behalf of the directors. Directors are also responsible for organisational decision making while managers are concerned with the implementation of such decisions and policies.

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 regards see *Moresby White v Rangeland Ltd* [case 159].

For a detailed discussion on the difference between directors and managers refer to the table on page 80-82 of your textbook.

### **Activity 2.2**

Study paragraph 6.2 of your textbook and then answer the following question:

John is the new manager of Rand Air (Pty) Ltd. He wants to know if he also has to be a director of the company. Explain to John the differences between a manager and a director.

*Hint:* You may make use of the table on pages 80-81 of your textbook to answer the question.

## ➔ Feedback

You should now know the difference between a manager and a director. You should also note that apart from the duties discussed in the table on pages 80-83 of your textbook you will be introduced to director's duties in particular in Study Unit 3. This will include certain fiduciary duties. Note that an employee or manager of a company has duties similar to that of the fiduciary duties of a director towards a company. See *Phillips v Fieldstone Africa (Pty) Ltd and Another* (2004) 1 All SA 150 (SCA) ; *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD and *Daewoo Heavy Industries (Pty)Ltd v Banks and Others* ( 2004) 2 All SA 530 (C) in this regard( par 6.2 of your textbook).

## 2.4 Number of directors and consent

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

The different types of companies should each have a certain minimum number of directors in terms of the Companies Act. A person becomes a director of a company when that person:

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

See *S v Vandenberg and Others* 1979 (1) SA 208 (D) in par 6.3 of your textbook for a further discussion in this regard.

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

## 🌀 Activity 2.3

Study paragraph 6.3 of your textbook and answer the following question:

Starbucks (Pty) Ltd appointed Mr Botha to its board of directors together with the two existing directors by means of a special resolution taken at a company meeting. The memorandum of incorporation authorises any director to buy computer equipment on the company's behalf. Mr Botha enters into a contract with ABC Computers CC for the purchase of five computers. After the contract has been concluded it comes to Mr Botha's attention that he had not been validly appointed as a director of Starbucks (Pty) Ltd as he had not accepted his appointment in writing. Mr Botha is uncertain whether the contract that he concluded to purchase the computers from ABC Computers CC is valid.

## ➔ Feedback

Remember that (in spite of the requirement that certain types of companies must have a minimum number of directors) where a company does not have the prescribed minimum directors this does not negate or limit the authority of the Board. This will also not invalidate anything done by the Board or the company.

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

Paragraph 6.4 of your textbook

Sections 66(2)(a) and (b), 66(4)(a)(ii-iii), 66(10) and 66(11) of the Companies Act

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

### Activity 2.4

Study paragraph 6.4 of your textbook and answer the following question:

The Memorandum of Incorporation of Locke Ltd states that

- (1) a minimum number of 6 directors must be appointed;
- (2) the shareholders of the company will be allowed to elect at least 30% of any alternate directors;
- (3) directors will be entitled to a fixed remuneration, as determined from time to time;
- (4) a director may only serve a term of 5 (five) years.

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

### Feedback

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

## 2.6 Ineligible and disqualified persons

Paragraph 6.5 of your textbook

Sections 69(7)(a-c), 69(8)(a) and (b)(i-iv), 69(11) and 69 (12) of the Companies Act

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

- Note: If a person is **ineligible** to be appointed as a director, this means that such person is **absolutely prohibited** from becoming a director without any exceptions.

If a person is **disqualified** from being appointed as a director this means that, with the exception of a person who has been prohibited from being a director by a court of law, a person may still be appointed as a director of a company with the permission of the court. The other disqualifications (as stated in the table on pages 87-88 of your textbook) are thus **not absolute** because the court has the discretion on application to allow such disqualified persons to be appointed as directors.

## Activity 2.5

Study paragraph 6.5 of your textbook and then do the following:

1. Make a list of the persons ineligible to be appointed as directors of a company.
2. Make a list of the persons who are disqualified to be appointed as directors of a company.

### Feedback

After you have studied the paragraph you will be able to state who will be ineligible to be appointed as a director of a company and who are disqualified from being appointed as a director of a company.

#### **a. Director disqualifications: exemptions**

Paragraph 6.6 of your textbook

Sections 69(8)(b), and 69(11)-(12) of the Companies Act

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

#### **2.7.1 Exemptions by a court**

Paragraph 6.6.1 of your textbook

Sections 69(11) and 69(8)(b) of the Companies Act

A court may exempt certain disqualified persons from the disqualification.

## Activity 2.6

Study paragraph 6.6.1 of your textbook and then answer the following questions:

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

### Feedback

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

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 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.”

### 2.7.2 Director disqualifications: exemptions for certain private companies

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

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

### Activity 2.7

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

1. What were the factors that affected the discretion of the court?
2. Why was the court more lenient towards the private company and do you support this approach?

### Feedback

The court correctly held in the *Ex Parte Barron* case that it could be more lenient in a case where a private company is affected than where a public company is affected. This is due to the fact that a director of a public company deals with funds in which a vast number of people are involved. Such a director should obviously be under more scrutiny than a director of a private company.

## 2.8 Application to declare a person delinquent or under probation

Paragraph 6.7 of your textbook  
Section 162 of the Companies Act

The power given to a court to declare a director either delinquent or under probation, is introduced into South African company law for the first time by the Companies Act of 2008. This is in addition to the power of the courts to prohibit a person to be a director for which both the Companies Act of 1973 and the Companies Act of 2008 provide. Depending on the grounds on which a person has been declared to be a delinquent, he will subsequently be either unconditionally disqualified from being a director for the rest of his life, or disqualified for a period of at least seven years and subject to any conditions that the court considers appropriate. An order of probation, on the other hand, may not exceed a period of five years and may be made subject to any conditions that the court considers appropriate, such as a designated remedial programme. Refer to the table on pages 91-94 of your textbook for a summary of who may apply to court, the grounds for application, the order sought and the effect of the order. You should also take note that three additional grounds to apply for an order of delinquency are available to the Commission or

Takeover Regulations Panel (see page 94 of your textbook in this regard).

## **Activity 2.8**

Study page 94 of your textbook and answer the following question:

1. Garry is a director of Centro Pharmaceuticals (Pty) Ltd. Centro has found a new cure for pneumonia. Gary gives the formula to the senior scientist of Acerbic Pharmaceuticals (Pty) Ltd against payment of a fee. Centro Pharmaceuticals (Pty) Ltd is very upset about this.

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

## **Feedback**

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

- Who may make an application
- The grounds for an application.
- Order sought
- Effect of an order.

Your answer should reflect the following:

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

### **2.8.1 Application to court to suspend or set aside a delinquency order**

Paragraph 6.7.1 of your textbook

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

## **Activity 2.9**

Read paragraph 6.7.1 of your textbook and answer the following question.

It is the year 2014. Steven was a director of Hamilton (Pty) Ltd but in 2011 the court declared him a delinquent because he used information obtained as a director for his personal advantage. He feels that he has now rehabilitated himself and has met all the conditions of his court order. He would like to serve as director of Hamilton (Pty) Ltd once again. Explain whether Steven will be able to apply to a court to suspend the order of delinquency.

## ➔ Feedback

Steven will be able to apply for the suspension of the order of delinquency as 3 years have passed since the order of delinquency was made and the order was not based on one of the two grounds which would have resulted in an unconditional declaration subsisting for his lifetime. He will, however, have to satisfy the court that he has rehabilitated himself and have met all the conditions of his court order.

### 2.9 First directors of a company

Paragraph 6.8 of your textbook  
Section 67 of the Companies Act

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

### 🌀 Activity 2.10

Read paragraph 6.8 of your textbook and answer the following question.  
What must be done by the board of a company if after its incorporation the number of directors of that company is lower than the minimum number of directors required for that company?

## ➔ Feedback

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

### 2.10 Vacancies on the Board

Paragraph 6.9 of your textbook  
Section 70 of the Companies Act

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

### 🌀 Activity 2.11

Read paragraph 6.9 of your textbook and answer the following questions.

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

## ➔ Feedback

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

## 2.11 Filling of vacancies

Paragraph 6.10 of your textbook  
Section 70 of the Companies Act

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

### Activity 2.12

Read paragraph 6.10 of your textbook and answer the following questions.

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

### Feedback

Refer to paragraph 6.10 of your textbook.

## 2.12 Removal of directors

Paragraph 6.11 of your textbook  
Section 71 of the Companies Act

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

### Activity 2.13

Read paragraph 6.11.1-6.11.3 of your textbook and complete the following:

1. Fill in the following table, which is about the removal of a director:

Name the kind of resolution needed by a shareholders meeting to remove a director	
State the number of days notice that must be given	
Can a director be removed in terms of the 2008 Companies Act by a shareholder's meeting despite an agreement between any shareholder and a director? What was the position before the 2008 Companies Act? Hint : see page 97 of your textbook and the <i>Amoils v Fuel Transport case</i> on page 97 of your textbook	
List the grounds upon which a director may be removed by the board of directors.	
Will the director still have a claim for damages in terms of a separate employment contract with the company?	



Hint: see the <i>De Villiers v Jacobsdal Saltworks</i> case on page 98 of your textbook.	
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## ➔ Feedback

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

### 2.13 Board committees

Paragraph 6.12 of your textbook  
Section 72 of the Companies Act

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

The Minister of Trade and Industry may in terms of the Companies Act 71 of 2008 prescribe that a company or certain category of company must have a social and ethics committee. Section 94(2) of the Companies Act requires that at each annual general meeting, a public company, a state-owned enterprise or any other company which has voluntarily decided to have an audit committee, must appoint an audit committee for every financial year. The audit committee must have at least three members and consist only of non-executive directors of the company who have not been involved in the day to day management of the company in the preceding three financial years. (You will find a list of the functions of an audit committee in Chapter 8, paragraph 8.6 of your textbook.)

The King Code (previously discussed in paragraph 2.1) also proposed that board committees should be established to assist the directors by giving detailed attention to important areas. Examples of such committees include an audit committee and remuneration committee.

### Activity 2.14

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

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

## ➔ Feedback

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

### 2.14 Board meetings

Paragraph 6.13 of your textbook  
Section 73 of the Companies Act

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

### 🔗 Activity 2.15

Read paragraph 6.13.1-6.13.6 of your textbook and complete the following table:

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

## ➔ Feedback

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

### 2.15 The mandatory appointment of a company secretary

Paragraphs 8.7 and 7.13 of your textbook  
 Sections 86-89 of the Companies Act  
*Panorama Developments (Guildford) Ltd* [case 213]

The company secretary is the chief administrative officer of his or her company. A public company or state owned enterprise (see section 8 of the Companies Act for the different categories of companies) is obliged to appoint a company secretary who is knowledgeable or experienced in the relevant laws, while other companies are not obliged to have a company secretary but may appoint one.

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

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

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

It is also possible for a body corporate or a partnership to be appointed to hold the office as company secretary. This can be done provided that every employee of that juristic person or partner or employee of that partnership is not disqualified from being appointed company secretary. See paragraph 8.7 of your textbook for a list of the persons who will be disqualified from being appointed as a company secretary. Every company secretary must be a permanent resident of the Republic, and must remain so while serving in that capacity (section 86).

A company secretary stands in the position of an employee of the company and is accountable to the company's board. The exact nature of his or her duties depends on the terms of his or her employment contract but must include the duties stated in section 88 of the Companies Act. The last item in the list of a company secretary's duties stated in the textbook, is a reference to the duty on every company to file an annual return (not to be confused with a company's annual **financial** statements) containing certain prescribed information ( s 33). Section 33(3) provides that every company must designate a director, employee or other person as the company's compliance officer in this annual return. In the case of a company with a company secretary, the company secretary will thus automatically be the compliance officer.

The board of directors can take a resolution to remove a company secretary. A company secretary may insist that a statement setting out the company secretary's contention to the circumstances be included in the annual financial statements, relating to that financial year. A company secretary may resign from office by giving one months notice or less that one months notice with the approval of the board.

## Activity 2.16

Lulu, the company secretary of Maxwell Ltd, fraudulently ordered office furniture from a supplier stating they were needed by the company for business purposes. In fact, she had the furniture delivered to her own home and sold it for her own gain.

The company knew nothing about these transactions, and now denies liability in terms of the contract concluded on its behalf by Lulu. Advise the supplier whether he can hold the company liable in terms of the contract.

### ➔ Feedback

The question deals with the authority of a company secretary to make representations and to conclude contracts on behalf of the company. The facts are similar to those in *Panorama Developments (Guilford) Ltd*. Based on the decision, the company may be bound by the contract, because a company secretary has ostensible (apparent) authority to conclude contracts that concern the day to day running of the business. Buying office furniture will probably fall into this category.

## 2.16 Registration of secretaries and auditors

Paragraph 8.8 of your textbook  
Section 85 of the Companies Act

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

## Activity 2.17

1. Briefly state the information that must be disclosed in a company's record of appointment of a company secretary or auditor.
2. Briefly state the information that must be disclosed in a company's record of appointment of a firm or juristic person as company secretary or auditor.

### ➔ Feedback

See paragraph 8.8 of your study guide.

### ➔ Final Reflection

You have seen that the ownership of a company is vested in the general meeting of members (study unit 1) and that the control of the company is vested in the board of directors. Do you think it is a good principle to separate ownership and control or should the members of the company also manage it? It is here that the principle of the separate legal personality of the company comes into play again. It is the company that owns its assets and that is responsible for its liabilities, not the shareholders. The shareholders only hold a right to share in those assets, should the company be wound up. You will learn more about membership and shareholders in study unit 1.

## Study Unit 3

### Duties of Directors

😊 **Study paragraphs 6.14-6.14.5 of your prescribed book!**

😊 **Study sections 75-78, of the Companies Act!**

#### Prescribed cases for this Study Unit:

*Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378 (HL) **[case 188]**

*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]**

*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 Fertilisers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd* 1981 (2) SA173 (T) **[case 193]**

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

### 3.1 Introduction

In this study unit we will explain the duties of directors.

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

- What is meant by the partial codification of the directors' duties?
- What do the fiduciary duties entail?
- What is meant by the duty of reasonable care?
- What is meant by a conflict of interests?
- What does acting in good faith and with a certain degree of care, skill and diligence entail?
- Under what circumstances may directors and prescribed officers be held liable for losses incurred by the company?
- What is the business judgment rule and what does it mean?
- To whom do indemnification and directors' insurance apply?

### 3.2 Duties of Directors

Paragraph 6.14 of the textbook

Sections 75, 76, 77 and 78 of the Companies Act

Under the 1973 Act the duties of directors were found mainly in the common law and in Codes of Corporate Practice such as the King Report. The common law position is that directors have a fiduciary relationship with the company. This refers to all directors of companies. In *CyberScene Ltd and Others v i-Kiosk Internet and Information (Pty) Ltd* 2000 (3) SA 806 (C) (discussed in par 6.14 of your textbook) the court confirmed that even non-executive directors have a fiduciary relationship with the company. It must be noted though, that a director's fiduciary duty is owed to the company itself and not to the other directors or other individuals within the company.

At common law directors are subject to fiduciary duties to act in good faith and in the best interests of the company, and to the duty to exercise their powers with care and skill.


The fiduciary duties generally entail:

- avoiding a conflict of interests between the director's personal interests and the interests of the company;
- not exceeding the limitations of their power;
- maintaining an unfettered discretion; and
- exercising their powers for the purpose for which they were conferred

The Companies Act 71 of 2008 now introduces a partly codified regime of directors' duties which includes duties similar to the common-law fiduciary duties and the duty to perform their functions with reasonable care and skill. However, the common law is not excluded by the statutory provisions, and will continue to apply except insofar as it is specifically amended by the Act or is in conflict with a provision of the Act.

 **Note that for purposes of the codified duties, the term “director” is extended in such a way that it includes:**

- **An alternate director**
- **A prescribed officer**
- **A person who is a member of a committee of a board of the company or of the audit committee of a company regardless of whether or not the person is also a member of the company's board.**

 **Note that the codification of duties of directors does not mean that the directors do not have common law duties anymore. The codified duties are not intended to serve as a replacement for the common law duties. When interpreting the Act, courts will continue to take the common law and court decisions made before the Act came into being, into consideration.**

There are two distinct methods of codification. The first method is complete codification. When there is a complete codification, the codified rules must be rigidly adhered to. They replace the common law and leave no room for further development to take place. The second method is partial codification. When partial codification occurs, the codified rules and the common law rules are both recognised. This flexibility leaves room for further development of the law.

 **Note that codification of directors' duties as found in the 2008 Act amounts to a partial codification of the company law.**

### **3.2.1 Standards of Directors' Conduct**

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

**Briefly summarised, the newly codified duties of directors in the Companies Act of 2008 are the following:**

- (1) To disclose to the board any personal financial interest in matters of the company (s 75).
- (2) Not to use the position of director, or information obtained as director, to gain an advantage for himself or another person, or to knowingly cause harm to the company or a subsidiary (s76(2)(a))
- (3) To disclose to the board of directors any material information that comes to a director's attention (s 76(2)(b)).
- (4) To act in good faith and for a proper purpose (s76 (3)(a))
- (5) To act in the best interests of the company (s76 (3)(b))
- (6) To act with a reasonable degree of care, skill and diligence (s76 (3)(c))

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

Paragraph 6.14.2 of the textbook

Sections 75 and 76(2) of the Companies Act

*Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378 (HL)

*Atlas Organic Fertilisers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd* 1981 (2) SA173 (T) **[case 193]**

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


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

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

As stated above, a director has a fiduciary relationship with the company and must avoid making use of company information for his or her own benefit. A director must also avoid causing harm to the company.

Section 75 of the Act provides for the disclosure of directors' financial interests if they conflict with those of the company. Two different situations are regulated in this provision. If a director is the only director but not the only shareholder of the company, he must disclose any personal interest in an agreement or other matter of the company to the shareholders and obtain their prior approval by an ordinary resolution before he enters into this agreement or deals with the matter. In all other cases, disclosure must be made to the board of directors of any personal financial interest of the director in a matter to be considered at a board meeting and this director may not be present or take part in the discussion.

A director may also make an advance general disclosure of his personal financial interests to the shareholders or board, as the case may be. Such disclosure should be made by means of a written notice. The notice must explain the nature and extent of the interest.

 **Note that this notice will continue to be valid until such time that it is changed or withdrawn by the same director.**

Moreover, there is a possibility of a director having a personal financial interest in a matter to be discussed at a meeting of the board of directors or he may be aware of the fact that a related person has a personal financial interest in the matter. In such a situation section 75 provides that the director must:

- Disclose the interest and its general nature **before** the matter is considered at the meeting.
- Disclose material information relating to the matter that he is **aware** of
- **If required** to do so by the other directors, disclose any observation or pertinent insights relating to the matter.

In terms of section 75, once a director has made the disclosures he must leave the meeting and must be excluded from participating in the consideration of that particular matter. Although the director will be regarded as being present for other purposes of the meeting, when it comes to the determination of whether a resolution has sufficient support to be adopted, the director will not be regarded as being present.

The director is prohibited from executing any document on behalf of the company in relation to the matter unless he has been specifically requested or directed to do so by the board of directors.

Section 75(6) caters for situations where a director or a person related to the director acquires a financial interest in an agreement or other matter in which the company has a material interest, after approval by the company of the agreement or other matter has been made. In such a case, the director is obliged to disclose:

- The nature and extent of that interest
- The material circumstances relating to the director or related person's acquisition of that interest.

The disclosure must be done promptly to the board of directors or to the shareholders.

The validity of a decision of the board or of an agreement approved by the board is not affected by the personal interest of a director or of a person related to the director, provided that there is approval or ratification by an ordinary resolution of the shareholders.

Where a director has failed to comply with the disclosure requirements in section 75, any interested person has the right to make an application to the court for an order declaring that the transaction or agreement that had been approved by the board or by the shareholders, is valid.

The following are circumstances under which the provision dealing with the disclosure of personal financial interests does not apply:


- (1) It is not applicable to a director of a company with regards to a decision that may have an effect on
  - all of the directors of the company in their capacity as directors, or
  - a class of persons, despite the fact that the director is one of the members of the class of persons, unless the only members of the class are the director or persons related or interrelated to the director.
- (2) It is also not applicable to a director of a company with regards to a proposal to remove that director from office as contemplated in section 71.
- (3) It does not apply to a company or its director, if one person holds all of the beneficial interests of all of the issued securities of the company and is the only director of that company.



Where a person is the only director of a company but does not hold all of the beneficial interests of all of the issued securities of the company, such a person may not

- approve or enter into any agreement in which he or a related person has a personal financial interest, or
- as a director, determine any other matter in which the person or a related person has a personal financial interest unless an ordinary resolution of the shareholders approves the agreement or determination, after the director has disclosed the nature and extent of that interest to the shareholders.

Section 76(2)(a) of the Act prohibits the abuse of his position by a director. It protects information that a director has access to while acting as a director. A director is prohibited from making use of information obtained by virtue of his office, for his own personal gain or for another person's benefit. Section 76(2) also states that a director should avoid knowingly causing harm to the company or to its subsidiary.

 **Note that section 76(2)(b) states that a director must communicate to the board at the earliest practicable opportunity any information that comes to the director's attention. It further states that he need not do so if he reasonably believes that the information is immaterial to the company; is generally available to the public or is known to the other directors. Where there is a legal or ethical obligation of confidentiality that prevents the director from making a disclosure, he is also not obliged to disclose the information.**

### **Activity 3.1**

Lynne is one of the directors of Lilla (Pty) Ltd which builds trailers for purposes of selling and renting them. She has been a director of the company for ten years. At the beginning of last year she and her husband started making animal cages which they intend to sell locally. She has not informed the company about this as she does not see the need to do so. For metal and steel they use the same suppliers that Lilla (Pty) Ltd buys from. Towards the end of last year, Lynne took part in a decision which prevented the purchase of steel from a supplier that was closing down business. Soon thereafter, Lynne and her husband bought an excess amount of steel from that same supplier.

At the beginning of this year Lilla (Pty) Ltd was struggling as a result of the recession and could not afford to purchase more steel. Lynne offered to sell her steel to the company on credit. The company agreed to pay over a period of two years. Lynne and her husband make a 100% profit from the sale. Has Lynne acted in accordance with her fiduciary duties to the company? Has she contravened any provision of the Act?

### **Feedback**

Read *Regal Hastings Ltd v Gulliver* and also note *Robinson v Randfontein Estates Gold Mining Co Ltd* and note the court's decision that a director "is not allowed to make a secret profit at the other's expense or place himself in a position where his personal interests conflict with his duty".

You must also note the fact that Lynne has not disclosed her financial interest and she took part in a decision in which she had a personal financial interest

### **3.2.3 Acting in good faith and with a certain degree of care, skill and diligence**


Paragraph 6.14.3 of the textbook

Section 76(3) of the Companies Act

*Fisheries Development Corporation v Jorgensen* 1980 (4) SA 156 (W)

The discussion in the textbook focuses on the duty to act with care, skill and diligence, but the duties to act in good faith and for a proper purpose, and in the best interests of the company, are equally important. Whereas the duty to act in the best interests of the company speaks for itself, the duty to act for a proper purpose perhaps needs some explanation. This is one of the fiduciary duties recognised in terms of our common law as well, and requires that directors should use their powers for the real or true purpose for which these powers were given. One example of a breach of this duty that has often occurred in practice, is where boards issued shares to dilute the voting rights of other shareholders or obtain more votes for themselves to ensure their continued control over the company, instead of using this power for its real purpose, namely to obtain more capital for the company.

As previously stated, a director is expected to exercise his powers and to perform his functions in good faith and in the best interest of the company. This is a common law principle which has been partially codified in the act. The Act requires a director to exercise a degree of care, skill and diligence that may reasonably be expected of a person performing the functions of a director. A director is expected to take reasonably diligent steps to ensure that he is informed about a particular matter.

 **The test used to determine what a reasonable director would have done in the same circumstances is both an objective and a subjective test because it takes into account issues such as the general knowledge, skill and experience of that particular director.**

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

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

A director will also escape liability where he or she had a rational basis for believing and actually believed that the decision was in the best interest of the company.

Note the list of persons and bodies on page 109 of the textbook that a director may rely on for information.

### **Activity 3.2**

You have been appointed as a director of Seesaw Ltd. You have been reading about directors being held liable for losses incurred by companies. This worries you. You are mainly concerned about the possibility of being held liable for not exercising the required care, skill and diligence. Write down what you think is expected of you.

### **Feedback**

As you do this, keep in mind the following:

- The test applied to determine what a reasonable director would have done in a particular situation is an objective test.
- See *Fisheries Development Corporation of SA Ltd v Jorgensen*; *Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* in which the court stated that “the extent of the director’s duty of care and skill depends to a considerable degree on the nature of the company’s business and on any particular obligations assumed by or assigned to him”.

### 3.2.4 Liability of directors and prescribed officers

Paragraph 6.14.4 of the textbook


Sections 22(1), 44, 45, 47 48 and 77 of the Companies Act

A director may be held liable for loss or damages suffered, or costs incurred by the company as follows:

- For a breach of the first five duties in the list (in 3.2.1 above), a director will be held liable in accordance with the common law principles relating to breach of a fiduciary duty, while for a breach of the duty of care, skill and diligence, liability will be on the basis of the common law principles of delict.
- Where the director acted without authority, whilst knowing that he lacked the necessary authority.
- **Note:** The third item in the list in paragraph 6.14.4 of the textbook, namely that a director can be held liable if he acted in contravention of the provisions of the Act with regards to pre-incorporation contracts (regulated by s 21), is wrong and based on an incorrect reading of section 77(3)(b). The last-mentioned subsection refers to the liability of a director who acquiesced in the carrying on of the company's business in contravention of section 22(1), which is the section prohibiting a company from carrying on its business recklessly, with gross negligence or fraudulently, or trading under insolvent circumstances.
- The director took part in an act or omission whilst knowing that was it intended to defraud another.
- The director signed, agreed to or provided authority for the publication of false or misleading financial statements.
- The director signed, agreed to or authorised the publication of a prospectus or a written statement containing an untrue statement or a statement stating that consent had been given by a person to be a director of the company, when such consent had not been given and the director was aware of this
- Where a director took part in a meeting or in the making of a decision where formalities prescribed by the Act were not complied with.
- Where a director, despite having knowledge that the shares were not authorised, failed to vote against the issuing of any unauthorised shares.
- Where the director, despite his knowledge of the fact that the securities did not comply with the provisions of the Act, took part in the issuing of the unauthorised securities.
- Where the director took part in the granting of options to any person, whilst knowing that the any share for which the options could be exercised or into which securities could be converted had not been authorised.
- Where the director took part in making a decision granting financial assistance to any person for the acquisition of securities of the company whilst knowing that the provision was in contravention of s. 44 of the Act or of the Memorandum of Incorporation. In terms of s. 44 when the solvency and liquidity of the company allows for this, financial assistance may be given by a company.
- Where the director is provided with financial assistance or with a loan in direct contravention of s. 45 of the Act or the company's Memorandum of Incorporation.
- Where the director took part in resolution approving a distribution despite knowing that the distribution was contrary to the provisions of section 46.
- Where there is an acquisition by the company of its shares or the shares of its holding company, in contravention of s.46 and s. 48.
- Where there is an allotment of share in contravention of Chapter 4 of the Act.

 **Note that the director is held jointly and severally liable with any other person who is or may be liable for the same act.**

The company must see to it that the proceedings to recover loss, damages or costs are commenced within three years of the act or omission giving rise to liability.

 **Note that in any proceedings except for wilful misconduct or wilful breach of trust, the court may exercise its discretion and relieve the director wholly or partially from any liability or on any terms the court considers just. It may relieve the director from liability if it is apparent that the director has acted honestly and reasonably. A director is allowed to approach the court for relief.**

### **Activity 3.3**

Angela has been appointed as a director of Usizo (Pty) Ltd. She approaches you with a request to explain what the business judgment rule is. Assist Angela.

### **Feedback**

This is a concept introduced to South African corporate law by the 2008 Act. It enables directors who have contributed to a company's loss while acting in good faith and in the interest of the company, to escape liability for the loss suffered by the company.

#### **3.2.5 Indemnification and directors' insurance**


Paragraph 6.14.5 of the textbook  
Section 78 of the Companies Act


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

Except to the extent that a company's Memorandum of Incorporation provides otherwise, a company is allowed to advance expenses to a director for purposes of defending litigation in

Section 78 also allows a company to take out indemnity insurance to:

- protect the director against any liability or expenses for which the company is permitted to indemnify a director,
- protect itself against any expenses that the company is permitted to advance to a director of for which the company is allowed to indemnify a director.

 **Note that indemnification and directors' liability as provided for in section. 78 includes current and former directors of companies.**

 **Note that where a company has paid money, directly or indirectly, to or on behalf of a director of the company or of a related company, in a manner which is not consistent with the above mentioned restrictions, the company may claim restitution from the director.**

### **Activity 3.4**

It has been discovered that Sizwe, the former managing director of Ndou (Pty) Ltd allowed the company to carry on business while it was in a state of insolvency. This resulted in additional liabilities to the company. Sizwe is not worried about personal liability as the company indemnified him. He also feels that now that he is no longer a director of the company he cannot possibly be held liable for the loss. Is Sizwe indemnified?

### **Feedback**

As you answer this question note that indemnification where liability arises as a result of the director having allowed business to continue while the company was insolvent is not allowed. You must also note that the provisions of section 78 include former directors of companies.

### **Reflection**

In this study unit you learnt about the duties of directors. The partial codification of the duties provides clarity with regards to certain aspects of the directors' duties. The common law still plays an important role in this regard and it is expected that more developments will occur as courts deal with disputes concerning duties of directors. Do you think that codification was really necessary?

## Study Unit 4

### Capacity and Representation of a Company

☺ **Study paragraphs 2.12-2.14 of your prescribed textbook!**

☺ **Study sections 19 and 20 of the Companies Act!**

#### Prescribed cases for this Study Unit:

*Royal British Bank v Turquand* (1856) 6 El. & Bl. 327; 119 ER 886) [207]

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

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

*Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480; [1964] All ER 630 [206] and [212]

#### 4.1 Introduction

In **study unit 3** we learnt about duties of directors. We learnt that duties of directors are codified under the Companies Act 71 of 2008. In this study unit we will explain the legal capacity and representation of a company. It therefore firstly concerns the power or legal capacity of a company to perform a specific act, and secondly, the authority of the person representing a company to act on behalf of the company.

You will learn how a company can be bound by transactions that are beyond its capacity entered on its behalf by directors. You will also learn that if an outsider acted in good faith while contracting with the company, the company will be bound by the transaction even though a formal internal requirement has not been complied with.

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

- What is meant by the capacity of a company?
- What is the *ultra vires* doctrine? What are the consequences if a company acts outside its capacity?
- Under what circumstances does a person have the authority to represent a company and bind it to a contract?
- What is the purpose of the *Turquand* rule and how does it operate under the Companies Act of 2008?

#### 4.2 Legal capacity of a company and the *ultra vires* doctrine

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

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

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

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

Section 19(1) of the Companies Act of 2008 now considerably widens the capacity of a company because it provides that a company has all the legal capacity and the powers of a natural person except to the extent that a juristic person is incapable of exercising any such power or the company's Memorandum of Incorporation provides otherwise. The capacity of a company is therefore not limited by its main or ancillary objects or business (which will probably not even be mentioned in the Memorandum of Incorporation).

Although the company's Memorandum of Incorporation may limit, restrict or qualify the purposes, powers or activities of the company (in other words impose restrictions on the legal capacity of the company) in terms of section 19(1)(b)(ii), any such restrictions would not render invalid any contract that conflicts with these restrictions (s 20(1)(a)). Thus, the contract remains valid and binding on the company and the other party to the contract. Section 20(6) of the Act provides that each shareholder has a claim for damages against any person who fraudulently or due to gross negligence causes the company to do anything inconsistent with the Act or a limitation, restriction or qualification on the powers of the company as stated in its Memorandum of Incorporation, unless ratified by special resolution in terms of section 20(2).

However, if the company or directors have not as yet performed the planned act (for example concluded the contract) that is inconsistent with a limitation or qualification of the company's powers contained in the Memorandum of Incorporation, one or more shareholders, directors or prescribed officers of the company may obtain a court order restraining (i.e. preventing) the company or directors from doing so. A third party who did not have actual knowledge of this limitation or qualification and acted in good faith, will in such a case have a claim for any damages suffered as a result (s 20(5)).

In terms of section 20(4), shareholders, directors, prescribed officers and a trade union representing employees of the company may also institute proceedings to prevent the company from doing anything inconsistent with the Act. Note that it is only in this instance that a trade union may prevent the company from acting.

## Activity 4.1

The main business of Steelbelts Railway Carriages (Pty) Ltd is to make and sell railway carriages.

Mr Buckley, one of the directors, is authorised by the board of directors to act on behalf of the company. Mr Buckley concludes a contract with Mr Matthews for the purchase of a holiday flat.

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

## ➔ Feedback

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

### 4.3 Representation

Sections 19(4)–(5), 20(2), (3), and (5)–(8)

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

A company may also be bound to a contract on the basis of estoppel where the person purporting to conclude the contract on its behalf lacked actual authority, express or implied, but the other party to the contract had been misled by the company into believing that he did have authority. This is referred to as ostensible or apparent authority. (See the discussion in 4.6 below.)

Note that where the authority of the directors to act on behalf of the company is limited by the Memorandum of Incorporation, the shareholders may ratify, by special resolution, any action that was inconsistent with this limitation, except if it was also a contravention of the Act (s 20(2) and (3)).

The shareholders, directors and prescribed officers also have the same powers (in terms of s 20(5)) to restrain the company or directors from doing anything inconsistent with such a limitation or restriction as they have when the company intends acting *ultra vires* (see the discussion in 4.2 above). A bona fide third party also has the same right to damages as described above. Section 20(6) also applies to this situation, meaning that every shareholder has a claim for damages against a person who fraudulently or due to gross negligence caused the company to act in contravention of this limitation or restriction on the authority of the directors, unless the action has been ratified by shareholders as described above.

### 4.4 The Doctrine of Constructive Notice

Paragraph 2.14 of the prescribed textbook  
Section 19(4)–(6) of the Companies Act

The doctrine of constructive notice provides that third parties dealing with the company are deemed to be fully acquainted with the contents of the public documents of the company. Section 19(4) of the Act partly abolishes this doctrine. Thus, third parties contracting with the company will no longer be deemed to have had notice of the contents of the public documents of a company merely because they have been filed with the Commission or are accessible for inspection at the office of the company. But, section 19(5) of the Act provides for two exceptions. Firstly, a person is deemed to have knowledge of any provision of a company's Memorandum of Incorporation in terms of section 15(2)(b) (relating to special conditions applicable to the company and additional requirements regarding their amendment). This is subject to the condition that the Notice of



Incorporation contains a prominent statement drawing attention to such a provision as required by section 13(3). The second exception applies to a personal liability company. A person is also regarded as having received notice and knowledge of the effect of section 19(3) on a personal liability company. Section 19(3), in turn, provides that the directors and past directors of a personal liability company are jointly and severally liable, together with the company, for any debts and liabilities of the company contracted during their respective periods of office.

## Activity 4.2

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

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

Was Mr Matthews supposed to know that the consent of the general meeting of Steelbelts Railway Carriage (Pty) Ltd was required for the validity of a contract of that size?

## Feedback

Section 19(4) of the Act provides that third parties contracting with the company are not deemed to have had notice of the contents of the public documents of a company merely because they have been filed with the Commission or are accessible for inspection at the office of the company. Therefore, Mr Matthews is not expected to know that the consent of the general meeting was required for the validity of a contract of that size.

## 4.5 The *Turquand* Rule

Paragraph 2.14 of the prescribed textbook

Section 20(7) of the Companies Act

*Royal British Bank v Turquand* (1856) 6 El. & Bl. 327; 119 ER 886)

*Wolpert v Uitzigt Properties (Pty) Ltd* 1961 (2) SA 257 (W)

*Tuckers Land and Development Corporation (Pty) Ltd v Perpellief* 1978 (2) SA 11 (T)

The *Turquand* rule was derived from *Royal British Bank v Turquand* (1856) 6 El. & Bl. 327; 119 ER 886). According to the common-law *Turquand* rule, an outsider contracting with the company in good faith is entitled to assume that all internal requirements and procedures have been complied with. The company will be bound by the contract even if the internal requirements and procedures have not been complied with. The exceptions are: if the outsider was aware of the fact that the requirements and procedures have not been complied with; or if the circumstances under which the contract was concluded were suspicious. It was formulated to keep an outsider's duty to inquire into the affairs of the company within reasonable bounds.

In *Wolpert v Uitzigt Properties (Pty) Ltd* 1961 (2) SA 257 (W) the articles of the company provided that the board of directors could authorise a person to sign promissory notes on its behalf. Clearly the board could authorise anyone to sign promissory notes on its behalf. In *Wolpert*, one of the company's ordinary directors signed promissory note on behalf of the company without

authorisation and the question arose whether the outsider was entitled to assume that the director was authorised to do so.

The court found that an outsider with express or constructive notice of the articles could assume that someone was authorised the notes, but not that a specific person was authorised. The *Turquand* rule only comes into operation if an internal formality is required.

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

Section 20(7) of the Companies Act of 2008 appears to codify the *Turquand* rule by providing that a person dealing with a company in good faith is entitled to assume that the company has complied with all of the procedural requirements in terms of this Act, its Memorandum of Incorporation and any rules of the company unless the person knew or reasonably ought to have known of any failure by the company to comply with its formal and procedural requirements. This section also modifies the *Turquand* rule by preventing a third party from invoking the rule where he ought reasonably to have known of non-compliance by the company. It differs from the common law *Turquand* rule which requires that the third party must not have had any suspicion of non-compliance by the company. In spite of the apparent similarity between the *Turquand* rule and the provisions of section 20(7), the *Turquand* rule has not been abolished by the statutory provision, because section 20(8) specifically states that section 20(7) “must be construed concurrently with, and not in substitution for, any relevant common law principle relating to the presumed validity of the actions of a company...”.

### Activity 4.3

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

Mr Buckley, one of the directors, is authorised by the board of directors to act on behalf of the company. Mr Buckley concludes a contract with Mr Matthews for the purchase of equipment that will be used in the process of manufacturing railway carriages to the value of R150 000 without the authorisation of the company in general meeting. Mr Matthews knows about this provision because he has dealt with the company before but he assumes that the approval of the general meeting has been obtained since it has always been obtained for previous transactions.

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

### Feedback

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

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

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

#### **4.6 The Doctrine of Estoppel**

*Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480; [1964] All ER 630  
**[206] and [212]**

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

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

## Study Unit 5

### Corporate Finance: Shares and Debentures

☺ **Study paragraphs 3.1-3.6 (excluding 3.3.8) of your prescribed textbook!**

☺ **Study ss 35, 36, 37, 39, 40, 41(3), 43 and 47 of the Companies Act!**

#### Prescribed cases for this Study Unit:

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

### 5.1 Introduction

Paragraph 3.1 of the textbook.

A company obtains the funds it needs for its business by two possible means, namely equity financing and debt financing. Equity financing entails the issuance of shares in return for money, which makes up the share capital of a company. Debt financing takes the form of loans, which could either be bank loans or debt securities issued in a similar manner as shares. The traditional debt security is called a “debenture”.

The providers of equity financing are the shareholders of a company. They receive return on their investment in the form of dividends. If the company is wound up, and after all the creditors of the company are paid, the shareholders are entitled to the balance of the assets of the company. The providers of loan capital are creditors of the company. The return on their investment is interest and the principal amount of the loan must be paid back by a specific time.

Shareholders’ investment is more risky, because there is usually no guarantee that they will receive a dividend in a given year. However, shareholders have power over the affairs of the company in that they appoint the directors of the company and are entitled to vote at general meetings (see study unit 1).

The reason why a company decides on a specific type of financing differs and is largely based on economic factors. The debt:equity ratio of a company reflects the composition of the company’s capital structure. In other words, if a company has a debt:equity ratio of 1:2 it means that it has twice as much capital in the form of equity as in the form of debt.

If a company does well it might be in the best interest of its shareholders to increase debt financing and decrease equity financing. The advantage is shown through the effect of ‘gearing’ or “leveraging”.

*Gearing can be explained as follows:*

If a company has 100 ordinary shareholders and a share capital of R100 000 and debentures of R100 000 bearing interest at 10 per cent per annum, the company has raised capital of R200 000 and its debt-equity ratio is 1:1. The company will have to show an annual profit of at least R10 000 to pay the interest due. If the company shows a profit of less than R10 000, the shareholders will not receive any dividends. However, all the profit above R10 000 will, depending on management’s strategy, be available for dividends. If the company is performing well, it can afford to have fewer shareholders who receive a higher return on investment.

Suppose the same company shows a profit of R100 000. In the given scenario the first R10 000 must go towards the service of the debt instrument. R90 000 is still available for dividend distribution, which means that each shareholder may receive up to R900 in dividends.

Now suppose that the company did not make use of gearing, but chose to raise all its capital by way of equity. It raised R200 000 from the issuance of 200 shares to 200 shareholders. The full R100 000 is available for dividend distribution, but since it has to be divided by 200, each shareholder may receive a maximum of R500 in dividends.

It is obvious that the company in this example could afford even higher gearing. Suppose the company converted 50 of its ordinary shares into preference shares, redeemable at the option of the company, and the company redeems them. It then continues to raise R50 000 through the issuance of further debentures on the same terms as the first series of debentures. The company still has capital in the amount of R200 000 but it now has a debt:equity ratio of 3:1.

Suppose the company shows a profit of R100 000. It pays R15 000 in interest on its debt instruments. It still has R85 000 available for dividend distribution. However, there are now only 50 shareholders. This means that each shareholder may receive up to R1 700 in dividends.

You will notice from the prescribed textbook that it is no longer possible in terms of the Companies Act to issue par value shares. However, in terms of Schedule 5 paragraph 6(3), par value shares will continue to have the par value assigned to them. The Minister may make further regulations to assist in the conversion of these shares into no par value shares, but the rights attached to the shares must as far as possible be preserved. Any diminishment of the rights due to conversion to no par value shares must be compensated.

As a result of the abolishment of par value shares, it is no longer possible to issue shares at a discount or at a premium. The provisions regulating share capital and non-distributable reserves also fall away.

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

- What is the legal definition of a share?
- How can the classes of shares authorised by a company, and the rights attached to those classes of shares, be amended?
- What types of preference shares does one find?
- Under what circumstances will the holder of non-voting shares have the right to vote?
- When must the board obtain the approval of the shareholders before they may issue shares?
- What are pre-emptive rights?
- How is adequate consideration for an issue of shares determined? And on what basis may the determination be challenged?
- What is the definition of a debenture?
- How do I determine whether a security is a share or a debenture?

## 5.2 Definition of a 'share'

Paragraph 3.2 of the prescribed textbook.  
Section 35 of the Companies Act.

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

The Memorandum of Incorporation of a company must set out the classes of shares and the number of each class that a company is authorised to issue. This is referred to as the authorised share capital of a company. A company may only issue shares that are authorised by the Memorandum of Incorporation. However, a company's board may increase or decrease the authorised share capital. They may further reclassify any shares authorised but not issued.

The board decides when to issue shares and how many shares must be issued. In other words, not all the authorised shares need to be issued.

The decision in *Standard Bank of SA Ltd v Ocean Commodities Inc* (see par 3.2 of your textbook) provides the classical definition of a share in the view of the courts. Apart from the definition in the Companies Act, this definition is also very important.

## 5.3 Classes of shares

Paragraph 3.3 of the prescribed textbook.  
Section 36 of the Companies Act.

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

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

The rights attached to a specific class of share are determined by the Memorandum of Incorporation and the terms of issue of the shares. The Memorandum of Incorporation must set out the classes of shares that the company is authorised to issue as well as the number of shares of each class it may issue (section 37). It must further set out the preferences, rights, limitations and other terms associated with that class of shares. However, a company could designate a class of shares in the Memorandum of Incorporation without setting out the preferences, rights or limitations that those shares will confer, and leave it open for the board of directors to decide on these terms at a later stage (section 37(1)(d)).

The board has the power to increase or decrease the authorised shares of the company and to reclassify shares that have not yet been issued. The company must then file a Notice of Amendment to the Memorandum of Incorporation to set out these changes effected by the board. In terms of the Companies Act of 1973, alterations of share capital could only occur after a special resolution to such effect by the general meeting. This remains an option in the Companies Act of 2008 (section 36(2)(a)), but will probably rarely occur.

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

### 5.3.1 Preference shares

Paragraph 3.3.1–3.3.5 of the prescribed textbook.

Section 37 of the Companies Act.

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

In return for the preferential rights to dividends, the right of preference shareholders to vote is usually curtailed in the Memorandum of Incorporation (section 37(5)(a)). However, even if the Memorandum of Incorporation provides that preference shareholders do not have the right to vote, the Companies Act provides that they have an irrevocable right to vote on any proposal to amend the preferences, rights, limitations and other terms associated with their shares (section 37(3)(a)).

In terms of section 194 of the Companies Act of 1973, preference shareholders would always have the right to vote when their preference dividend or a redemption payment on the preference shares remained in arrear and unpaid. This provision is not repeated in the new Act. Also in terms of the old Act, preference shareholders could always vote on resolutions which directly affected the rights or interests attached to their shares, and resolutions for the winding-up of the company or for a reduction of share capital were expressly listed as circumstances that would affect the rights of preference shareholders and on which they would have the right to vote. The new Act does not mention the proposed winding-up of a company as a specific resolution on which a preference shareholder would have the right to vote.

*Utopia Vakansie-Oorde Bpk v Du Plessis* will still provide valuable guidance in this regard. The court held that the concept of “interests” were much wider than the concept of “rights”. The court further held that “affect” implies that the rights or interests of the preference shareholders must potentially be prejudiced by the proposed resolution. It is submitted that the proposed winding-up of a company will directly affect the interests of preference shareholders and that this will still be a resolution on which the preference shareholders will have the right to vote in terms of the new Act.

There must always be at least one class of shareholders of the company that may vote at a meeting of shareholders and at least one class of shareholders entitled to the net assets of the company upon its liquidation (section 37(4)). In other words, a company is not allowed to only issue preference shares that do not grant their holders the right to vote.

The different types of preference shares are discussed in your textbook. One further limitation that can be put on shares, and which is especially used as a condition of preference shares, is the possibility to redeem the shares at a future date or on the occurrence of a specific event (section 37(5)(b)). When a share is redeemed, it is considered a distribution in terms of section 46 of the Act which must comply with the provisions of that section (see study unit 6).

### Activity 5.1

Jean-Pierre is a preference shareholder of Cape Fabric Mills Ltd, a company that manufactures fabric for the clothing industry. The preference shares do not confer the right to vote. The clothing industry has recently been under severe pressure due to competition from the Far East. Consequently, the demand for fabric has decreased to the extent that a resolution is proposed for the winding-up of Cape Fabric Mills Ltd.

Jean-Pierre is very upset about the resolution. Advise him on whether he has the right to vote on the proposed resolution.

## → Feedback

You need to discuss the relevant sections of the Act and the *Utopia Vakansie-Oorde* decision. Although the law is not yet settled on this question, you need to come to a conclusion in your answer.

### 5.3.2 Ordinary shares

Paragraph 3.3.6 of the prescribed textbook.

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

As is the case with preference shareholders, if a resolution is proposed to amend the preferences, rights, limitations and other terms associated with their shares, the Companies Act provides that such shareholders have an irrevocable right to vote on such proposals (section 37(3)(a)).

### 5.3.3 Deferred shares

Paragraph 3.3.7 of the prescribed textbook.

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

### 5.3.4 Capitalisation shares

Paragraph 3.3.9 of the prescribed textbook.  
Section 47 of the Companies Act.

Capitalisation shares are issued when the board of a company decides to reward current shareholders in the form of more shares, rather than in the payment of a cash dividend. The capitalisation shares can be issued to specific classes of shareholders. The terms of the offer of capitalisation shares could also give the shareholders the option to rather receive a predetermined cash amount than the capitalisation shares. In such a case the pay-out is considered a distribution in terms of the Act that must conform to the requirements of section 46 (see study unit 6).

## 5.4 Issue of shares

Paragraph 3.4 of the textbook.  
Section 41(3) of the Companies Act.

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

Please take note of the circumstances discussed in the textbook in which an issue of shares must be approved by a special resolution of the shareholders. Also note that where the voting power of a class of shares that is to be issued, is equal to or exceeds 30 per cent of the total voting power of all the shares of that class held by shareholders immediately before the transaction or series of transactions, a special resolution by *all* the shareholders is required (section 41(3)). In other words, if there are Class A and Class B shares, and an issue of further Class B shares exceed the threshold, both Class A and Class B shareholders must vote in favour of the resolution.



## Activity 5.2

Forget-Me-Not Ltd has 100 ordinary shares and each share carries one vote. The board of directors of Forget-Me-Not Ltd wants to issue a further 100 ordinary shares, which will also carry one vote per share. Advise the board whether they need the consent of the shareholders' meeting to authorise the issue of shares.

### ➔ Feedback

If a further 100 shares are issued which each have one vote, there will be 200 ordinary shares, and the new shareholders will carry 50 per cent of the vote. This exceeds the limitation set in section 41(3) of the Act. The issue must therefore be approved by a special resolution of the shareholders of the company.

#### 5.4.1 Right of pre-emption

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

The reason why this provision was included in the Companies Act is to guard against the dilution of ownership in private companies. Dilution of ownership can be explained as follows: Suppose that Fidelity (Pty) Ltd has two shareholders each holding 10 shares. At a meeting of shareholders they will have equal voting power. Suppose that Fidelity (Pty) Ltd wants to issue 20 more shares. If a third person acquires all 20 of these shares, that person will have half of the voting rights at a meeting of shareholders. The original shareholders will now only have a 25 per cent voting power in the meeting of shareholders. If they exercise their right of pre-emption, each of them will be entitled to half of the 20 shares, and consequently they would retain the same voting power in the company as before.

It is important to remember that pre-emptive rights only apply where the proposed issue of new shares is for cash. If the shares will be issued in return for another form of consideration, these rights will not apply.

#### 5.4.2 Adequate consideration

Section 40 of the Companies Act.

Section 40 of the Companies Act provides that the board may only issue shares for adequate consideration. The board must determine what an adequate consideration for the shares will be. The Act therefore leaves a lot of discretion for this determination in the hands of the board. The determination may only be challenged on the grounds that it constituted a breach of the standard of conduct expected of directors (section 76) and is in breach of their fiduciary duties or in delict (section 77). (See study unit 3.)

However, the effect that a successful challenge of the determination of the consideration by the board will have on the subscriber, still remains uncertain. Van der Linde ("The Regulation of Share Capital and Shareholder Contributions in the Companies Bill 2008" (2009) *TSAR* 39 at 50) argues that the consequences will depend on whether the determination remains valid or whether it is invalidated by the challenge. If it remains valid, the subscriber will be unaffected, because shares are regarded as fully paid once the determined consideration is received (section 40(4)). If it is invalidated, the subscriber might be liable for the difference between the consideration already tendered and the adequate determination as indicated after the challenge. For now, the effects of such a challenge remain unresolved.

Negotiable instruments and future services, future benefits and future payment are all allowed as consideration for newly issued shares, but shares may only be transferred to the subscriber to the extent that the instruments have become negotiable by the company, or to the extent that the subscriber has fulfilled his or her future obligations. Meanwhile, these shares are issued and kept in trust. The voting rights attached to such shares held in trust may not be exercised. Any distributions with respect to shares held in trust (see study unit 6) may be credited against the remaining value of the consideration still contained in an instrument that is not negotiable by the company or for future services, benefits or payment. The shares held in trust may not be transferred to a third party without the company's express consent. The shares may be transferred to the subscriber on a quarterly basis to the extent that the instruments have become negotiable by the company or the future services, benefits or payments have been satisfied. If the negotiable instrument is dishonoured, or the subscribing party has failed to fulfil his obligations in terms of the agreement between him or her and the company, the shares must be returned to the company and cancelled.

## 5.5 Debentures

Paragraph 3.5 of the textbook.  
Section 43 of the Companies Act.

Whereas the Companies Act of 1973 made mention of "debentures" as a form of issued company debt, the new Act refers to "debt instruments". However, even the definition of "debenture" was never finally settled in South African law, nor in English law. For now it is safe to assume that the terms "debt instrument" and "debenture" can be used interchangeably.

The holder of a debenture is a creditor of the company. The duties of the company towards debenture holders can be secured or unsecured. A trustee will usually be appointed to hold security on behalf of the debenture holders. The trustee must be unrelated to the company or its officers and must be a person who, in the board's opinion, has the requisite knowledge and experience to carry out the duties of a trustee. If the company defaults on its commitments to the debenture holders, the trustee will be able to enforce the security on their behalf, without the need for every debenture holder to institute action individually.

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

## 5.6 Hybrid securities

Paragraph 3.6 of the prescribed textbook.

The classification of securities as either equity or debt is especially important when the proceeds of these investments must be taxed. Dividends received are usually not taxable, whereas interest received is treated as income.

On the other hand, the treatment of these issues in the accounts of the company is also important. If the issue was in the form of debt, the interest payable will be an expense for the company which can be deducted from its taxable income and decrease the amount of tax payable.

Each security must be considered on its own. When you consider whether a security is debt or equity, consider all the factors set out in the prescribed textbook which indicate the one or the other, and come to a conclusion.

### Activity 5.3

Sarah's grandmother bequeathed a number of securities to her in her will. In the will, these securities are described as "preference shares". However, when Sarah receives the share certificates, she notices that the terms of issue of the shares indicate that interest is payable on all preference dividends that are in arrears at a specified rate. Furthermore, the shares are redeemable at a certain date and they do not carry the right to vote at meeting of shareholders. She is unsure whether to treat the income received from these securities as dividends or as interest payments. Advise Sarah on the nature of the securities.

### ➔ Feedback

In your answer you should distinguish between shares and debentures. Compare the securities issued to Sarah to this theory and come to a well-argued and substantiated conclusion.

## 5.7 Securities registration and transfer

Sections 49-56 of the Act

**The textbook does not deal with this topic, but we regard it as necessary for you to have a basic knowledge of these provisions. You do not have to study the relevant sections, but only the discussion below.**

The distinction between certificated and uncertificated securities made by the Companies Act of 1973 is found in the new Act as well. Although a holder of securities may choose whether to hold securities in certificated or uncertificated form, only uncertificated securities may be transferred on the JSE Ltd (s 49(6)). The bona fide transferee of uncertificated securities is also again protected in case of fraud, illegality or insolvency of which he had no knowledge (s 53(4)-(5)).

Whereas the Companies Act of 1973 contained separate provisions for the regulation of shares and debentures, they are now regulated together by the provisions on the registration and transfer of securities. In terms of section 1 of the Securities Services Act 36 of 2004, which applies to the Companies Act of 2008 (see s 1), securities include, among others, shares, stocks and depository receipts in public companies and other equivalent equities (except shares in a share block company as defined in the Share Blocks Control Act, 1980); notes; derivative instruments; bonds; debentures; participatory interests in a collective investment scheme as defined in the Collective Investment Schemes Control Act, 2002; and instruments based on an index; but excludes money market instruments.

Every company must maintain a register of its issued securities, containing the prescribed information, including the total number of uncertificated securities, the names and addresses of the holders to whom certificated securities were issued and the number of securities issued to each, the number of shares held in trust, and either the number of certificated debt instruments issued or the names and addresses of the registered holders and beneficial holders of certificated debt instruments (s 50(1)-(2)). The securities register is sufficient proof of the facts recorded in it, in the absence of evidence to the contrary (s 50(3)). The records of the CSD participant or CSD in respect of uncertificated securities are deemed to form part of the company's securities register (s 50(3)).

The minimum content of a securities certificate is prescribed in section 51(1). Each certificate has to be signed by two persons authorised by the board but the signature can be affixed by autographic, mechanical or electronic means (s 51(2)). The certificate is prima facie proof that the named securities holder owns the securities (s 51(1)(c)).

Shares are transferable in any manner provided for or recognised in the Act or other legislation (s 35). Any transfer of certificated securities must be reflected in the company's securities register (s 51(5)). The entry may be made only if the transfer is evidenced by a proper instrument of transfer delivered to the company or if transfer took place by operation of law (s 51(6)). The company has to record the name and address of the transferee, the description of the securities or interest that was transferred, the date of transfer and the value of any outstanding consideration in respect of shares (s 50(5)).

Sections 52 to 55 regulate the registration and transfer of uncertificated securities and prevail over any conflicting provisions of the Act, any other law, the common law, the company's Memorandum of Incorporation and any other agreement (s 49(4)). These provisions are similar to section 90A of the 1973 Act.

The disclosure of beneficial interests in securities is regulated in section 56 in substantially the same way as in section 140A of the 1973 Act. Note that a company's Memorandum of Incorporation may apparently restrict, or maybe even forbid that its securities may be registered in the name of one person for the beneficial interest of another person.

## Study Unit 6

### Capital Maintenance

☺ **Study paragraphs 3.7-3.10 of your prescribed textbook**

☺ **Study sections 44, 46, 47 and 48 of the Companies Act!**

#### Prescribed case for this Study Unit:

***Lipschitz v UDC Bank Ltd 1979 (1) SA 789 (A) [case 138]***

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

- Which transactions will be considered as “distributions” in terms of the Companies Act 71 of 2008?
- What are the requirements before a company may repurchase its shares?
- What is a dividend?
- What are the requirements before a company may give financial assistance to a person so that that person may buy shares in the company?

#### 6.1 Capital maintenance

Paragraph 3.7 of the prescribed textbook.  
Section 48 of the Companies Act

👍 **You do not need to study the historical background on pages 53, 54 and the first part of 55 of your textbook, but you must read through it because it puts the new regulation of capital maintenance in perspective.**

Originally companies were required to maintain their share capital. In other words, they were not allowed to return to shareholders some of the funds originally given in return for their shares, nor were companies allowed to issue shares at a discount, causing the company to gain less share capital in return for the shares than the nominal value of the shares reflected. However, the rule on capital maintenance was gradually relaxed through amendments to the Companies Act of 1973.

On pages 54-55, your textbook lists seven rules that flowed from the capital maintenance concept. In the discussion under paragraph 3.7, the textbook explains the effect of the Companies Act of 2008 on the situations described in rules 4 (a subsidiary becoming a member of its holding company) and 6 (a company purchasing its own shares).

Section 48(2)(a) allows a company to acquire its own shares if the decision to do so satisfies the requirements of section 46, which is the section that regulates distributions (discussed in 6.2 below). Note that although the textbook refers to the “repurchase” of its shares by the company, the Act uses the word “acquire”, which has a wider meaning. Since this is considered to be a distribution, the acquisition of its shares by a company must meet all the requirements of a distribution, including that it must be authorised by the board and satisfy the solvency and liquidity tests.

Section 48(2)(b) allows any subsidiary of a company to acquire shares in that company, subject to the conditions that (i) no more than 10% of all the issued shares of any class of shares of the company may be held by, or for the benefit of all the subsidiaries of that company taken together; and (ii) no voting rights attached to those shares may be exercised while the shares are held by a subsidiary of the company.

All acquisitions of its shares by a company or its subsidiary are subject to the following: After the company or subsidiary has acquired the shares, there must be shares left other than convertible or redeemable shares (s 48(3)(b)).

There must be shares in issue that are held by shareholders other than the company's subsidiaries (s 48(3)(a)). Remember that shares acquired by the company itself must be cancelled and will thus revert to being authorised but unissued shares (s 35(5)(a)).

An agreement for the acquisition of shares is enforceable, provided the requirements of section 48(2) and (3) as described above have been met, including that the solvency and liquidity test can be satisfied and the necessary unconvertible and unredeemable shares remain in issue to a shareholder other than the company's subsidiaries (s 48(4)). However, should a company be unable to fulfill its obligations in terms of a repurchase agreement because of the operation of section 48(2) or (3), section 48(5)) provides the following remedy:

- The company must apply for a court order in terms of this subsection (probably an order to suspend the acquisition of the shares). The company bears the burden of proof that fulfilment of its obligations will breach the requirements of section 48(2) or (3).
- The court may make an order that is just and equitable in view of the financial circumstances of the company, ensuring that the person to whom the company is required to make a payment in terms of the agreement is paid at the earliest possible date, keeping in mind when the company will be able to satisfy its other financial obligations as they fall due and payable (s 48(5)(c)).

The Act does not provide for any other order, and if this is the only order the court could make, it will not be able to address the company's inability to comply with the non-financial requirements such as the types of shares that must remain in issue.

If the company acquired shares without meeting the solvency or liquidity tests or any of the other requirements of section 48, the agreement between the shareholder and the company in terms of which the company would repurchase his shares, apparently remains enforceable. However, in terms of section 48(6), the company may within two years after the acquisition apply to court for an order to have the repurchase reversed. The court may then order -

- the person from whom the shares were bought to return the consideration received, and
- the company to issue to that person an equivalent number of shares of the same class as those acquired.

A director who was present at the meeting when an acquisition of shares in terms of section 48 was approved, or participated in the making of this decision, and who failed to vote against it despite knowing that the acquisition was contrary to sections 46 (requirements for distributions) or 48, will be liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of this approval ( s 48(7)).

### Activity 6.1

Mega-Manufacturers Ltd took a decision to repurchase shares. The board of directors considered the solvency and liquidity tests and was satisfied at the time that these requirements were met. However, afterwards it emerged that a patent belonging to the company was grossly overvalued in its financial statements. Mega-Manufacturers Ltd has now applied to have the transaction reversed. Advise Asanda, one of the shareholders whose shares were repurchased, on her legal position.

## ➔ Feedback

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

### 6.2 Distributions

Paragraph 3.8 of the prescribed textbook.

Sections 1 (definition of “distribution”) and 46 of the Companies Act

In the Companies Act of 1973 the concept of “distributions” was rather narrowly defined. Payments made to shareholders in their capacity as shareholders were included in the concept, but a repurchase of shares by a company and a redemption of shares were expressly excluded. In the Companies Act of 2008 the last-mentioned actions are now also classified as distributions.

Section 46 of the Companies Act regulates distributions. In terms of section 1, the following actions are regarded as distributions:

- (a) a direct or indirect transfer by a company of money or other property of the company, other than its own shares, to or for the benefit of its own shareholders or those of another company within the same group of companies, by way of
  - (i) a dividend,
  - (ii) a payment in lieu of a capitalisation share,
  - (iii) consideration for the acquisition of its own shares or those of another company in the group, or
  - (iv) any other transfer of money or property in respect of any of the shares of that company or of another company within the same group of companies.
- (b) incurrence of a debt or other obligation by a company for the benefit of one or more holders of any of the shares of that company or of another company within the same group of companies; or
- (c) forgiveness or waiver by a company of a debt or other obligation owed to the company by one more holders of any of the shares of that company or of another company within the same group of companies.

A distribution may be made in the following circumstances:

- The board of directors must authorise the distribution unless it is made in terms of an existing legal obligation of the company, or a court order.
- It must reasonably appear that the company will satisfy the solvency and liquidity test immediately after completing the distribution.
- The board of the company must acknowledge, by way of a resolution, that it has applied the solvency and liquidity test and reasonably concluded that the company will satisfy this test immediately after completing the proposed distribution.

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

*Solvency test:* considering all reasonably foreseeable financial circumstances of the company at that time, the assets of the company, fairly valued, equal or exceed the liabilities of the company as fairly valued.

*Liquidity test:* considering all reasonably foreseeable financial circumstances of the company at that time, it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of 12 months after the distribution.

If the distribution was in the form of giving a loan to a shareholder or forgiving a loan made to a shareholder, the period runs from 12 months after the test was considered.

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

### **Activity 5.4**

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

### **→Feedback**

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

## **6.3 Options**

Paragraph 3.9 of the prescribed textbook.  
Section 42 of the Companies Act

This aspect is discussed in sufficient detail in your textbook.

## **6.4 Financial assistance for the purchase of shares**

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

In terms of the Companies Act of 1973 it was prohibited for a company to provide financial assistance to a person to enable the person to acquire shares or other securities in the company, except for some very specific exceptions.

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

The decision to assist a person to acquire shares in the company rests with the board of directors, but must be in accordance with the conditions stipulated in section 44 and discussed in the textbook. These include that the assistance must be in terms of an employee share scheme or where a special resolution by the shareholders authorised such assistance to a specific person or persons that fall in a specific class or category. In the latter case the person to whom the assistance will be given must fall in that class and the resolution must have been taken within the two years preceding the board's decision to assist.

Section 44 further requires that the board must be satisfied that the solvency and liquidity requirements are met (see section 4 of the Companies Act of 2008) and that the assistance is given under terms that are fair and reasonable to the company.



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

Some of the cases dealing with the prohibition under the old Act are still relevant as far as section 44 is concerned. Their relevance is to the extent that they provide some guidelines concerning the circumstances in which the provisions of section 44 will be applicable.

The leading case in this regard is *Lipschitz v UDC Bank Ltd* 1979 (3) SA 781, where it was held that a transaction must be assessed in two phases:

- *First*, it must be ascertained whether there was financial assistance. In *Gradwell (Pty) Ltd v Rostra Printers Ltd* 1959 (4) SA 419 (A) the “impoverishment test” was formulated to assist in determining whether financial assistance was provided. In terms of the impoverishment test, one considers whether a transaction will have the effect of leaving the company poorer. If so, financial assistance was provided. In *Lipschitz* the court held that the ‘impoverishment test’ was not the only measure of financial assistance, but that providing security or otherwise exposing the company to risk will also qualify as financial assistance for purposes of the Act. For example, if the person obtained a loan to purchase shares in the company and the company stood surety for that loan, it will count as financial assistance. If the company buys an asset from the person in order to enable that person to purchase shares in the company, it will depend on the facts whether there was financial assistance. Factors that have emerged from case law to assist in this regard are whether the company needs the asset in its normal business and whether the company paid a fair price for it. The court in *Jacobson v Liquidator of M Bulkin & Co Ltd* 1976 (3) SA 781 also ruled that the decision as to whether or not financial assistance has been provided should not be based on the likelihood of a loan becoming irrecoverable or of a security being enforced due to the default of the principal debtor.
- *Second*, it must be determined whether that assistance was for the purpose of acquiring shares in the company. Suppose Company A is a major creditor of Company B. Company A acquires most of the shares in Company B. After the acquisition, Company A causes Company B to grant security over its movable assets to secure the loans. This will be financial assistance in terms of the first test, but it is not in connection with the purchase of shares. The assistance is to secure a loan. In *Fidelity Bank Ltd v Three Women (Pty) Ltd* [1996]4All SA 368, the fact that a particular transaction which facilitated the purchase of shares did not serve any legitimate commercial interest of the company led the court to conclude that the purpose of the transaction was indeed to give assistance for the purchase of shares.

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

### Activity 6.3

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

### Feedback

You will have to consider the approach of the court in the *Lipschitz* decision in your answer. Remember that we are not asking what the requirements of section 44 are. You must determine whether section 44 is applicable. After discussing the process as formulated in *Lipschitz*, you must come to a conclusion. For instance, you may say that if Free-4-All (Pty) Ltd needs the equipment, this will not be financial assistance and the company will not need to comply with section 44.

## Study Unit 7

### Groups of Companies

☺ **Study paragraphs 5.1-5.5 of your prescribed textbook!**

☺ **Study sections 2 and 3 of the Companies Act!**

#### Prescribed cases for this Study Unit:

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

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

### 7.1 Introduction

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.

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.

In this study unit we will explain what groups of companies are, how subsidiary companies are defined and which consequences flow from the existence of a group of companies.

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

- How is a group of companies defined in the Companies Act 61 of 1973?
- When is a company a subsidiary of another juristic person?
- How is a group of companies defined in the Companies Act 71 of 2008?
- What are the main consequences which flow from the existence of a group of companies?

### 7.2 Definitions

Paragraph 5.1 of the prescribed textbook.

The essential idea of a group is the existence of control through one company of one or more subsidiary companies. In Schedule 4 to the Companies Act 61 of 1973 a group of companies is defined as a holding company, not itself being a wholly owned subsidiary, together with all the companies being its subsidiaries. The Companies Act 71 of 2008 contains a new definition of a group of companies. This definition is discussed in paragraph 7.5 below.

### **7.3 Holding and subsidiary companies under the 1973 Companies Act**

Paragraph 5.2 of the prescribed textbook.

Section 1(3) of the Companies Act 61 of 1973 defines a “subsidiary company” in detail and section 1(4) assigns a converse meaning to the term “holding company” by providing that a company is deemed a holding company of another if the other company is a subsidiary. The holding-subsidiary relationship is defined in terms of:

- control over the majority of voting rights in the company, and
- control over the right to appoint or remove directors, having a majority of voting rights at board meetings.

The definition also provides that, if a company is a member of another company and has sole control of the majority of voting rights in that company, whether pursuant to an agreement of other members or otherwise, the company that has such control is classified as a holding company.

### **7.4 The 2008 Companies Act: subsidiary relationships**

Paragraph 5.3 of the prescribed textbook.

Section 3 of the Companies Act

Section 3 of the Companies Act 71 of 2008 changes the definition of a subsidiary company, but in general terms it retains the broad architecture of the definition in the Companies Act 61 of 1973, in that it is based on the majority of voting rights or the right to appoint directors holding the majority of votes in the board.

### **7.5 Group of companies**

Paragraph 5.4 of the prescribed textbook.

Sections 1 and 2 of the Companies Act

As mentioned earlier, the Companies Act 71 of 2008 contains a new definition of a group of companies. According to section 1, a group of companies means two or more companies that share a holding company or subsidiary relationship. Reference to the sharing of a subsidiary relationship in order to define a group of companies does not change the definition of a group of companies under the Companies Act 71 of 2008 much from the definition in Schedule 4 to the Companies Act 61 of 1973, since section 3 of the Companies Act 71 of 2008 retains the broad architecture of the definition of a subsidiary in the Companies Act 61 of 1973, as explained earlier. The fact that a group of companies can, in terms of section 1 of the Companies Act 71 of 2008 also mean two or more companies that share a holding company, also does not change the definition of a group of companies very much, since all the subsidiaries of a holding company are also included in a group under the definition in the Companies Act 61 of 1973, even though these subsidiaries might have no other common interest.

### **7.6 Legal consequences of a group of companies**

Paragraph 5.5 of the prescribed textbook.

Section 42 of the Companies Act

Several important consequences flow from the existence of a group, even though the law does not recognise a separate legal personality for the group.

*The main consequences, which are common both to the Companies Act 61 of 1973 and the Companies Act 71 of 2008, are the following:*

- The holding company must produce group annual financial statements before its annual general meeting;
- A subsidiary may not hold more than 10% of the shares of its holding company;
- Prescribed information must be disclosed where a subsidiary makes a loan to or provides security for its holding company or fellow subsidiary;
- Where a subsidiary has an independent board of directors, its holding company does not owe the subsidiary any fiduciary duties;
- A director of a subsidiary company does not owe a fiduciary duty to the holding company;
- In terms of section 4(1)(a) of the Companies Act 71 of 2008 a company satisfies the solvency test if the assets of the company or, if the company is a member of a group of companies, the aggregate assets of the company, as fairly valued, is equal to or exceed the liabilities of the company or, if the company is a member of a group of companies, the aggregate liabilities of the company, as fairly valued.

Also study the list in paragraph 5.5 of your textbook.

### Activity 7.1

Alpha Ltd holds 50% of the shares and voting rights in Omega (Pty) Ltd. In terms of the memorandum of incorporation of Omega (Pty) Ltd, a member has the right to nominate one director for every 25% of the total issued shares of the company that 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 Alpha Ltd and Mrs Morby, who holds 30% of the shares in Omega (Pty) Ltd, Alpha Ltd has an option to buy Mrs Morby's shares at any time. Consider whether Omega (Pty) Ltd will be deemed a subsidiary of Alpha Ltd.

### Feedback

Refer back to paragraph 5.2 in your textbook, as well as *Sage Holdings Ltd v The Unisec Group Ltd* 1982 (1) SA 337 (W) [246] and *The Unisec Group Ltd v Sage Holdings Ltd* 1986 (3) SA 259 (T) [247].

Alpha does not hold or control the majority of voting rights in Omega (Pty) Ltd. Furthermore, Alpha Ltd only has the right to appoint two of the five directors of Omega (Pty) Ltd. Should Alpha Ltd acquire Mrs Morby's shares, it will be able to appoint three of the five directors. Therefore, the question is whether the right to acquire Mrs Morby's shares can be interpreted as a right to appoint another director even before the shares are actually acquired. If the decision in the *Unisec* cases is followed, it would seem to be so, as the option can be exercised at any time.

Keep in mind that the *Unisec* cases were decided before an amendment to the definition of a subsidiary in section 1(3) of the Companies Act 61 of 1973 was enacted in 1992. However, according to *Hahlo* on page 426 the principles applicable to the interpretation of section 1(3)(a)(i)(bb) of the Companies Act 61 of 1973 in particular, remain the same. The same should also apply to section 3(1)(a)(ii) of the Companies Act 71 of 2008.

## Study Unit 8

### Takeovers, Offers and Fundamental Transactions

☺ **Study paragraphs 9.1-9.6 of your prescribed textbook!**

☺ **Study sections 112 - 127 of the Companies Act!**

#### 8.1 Introduction

Paragraphs 9.1 to 9.3 of the prescribed textbook.

Chapter 5 of the Companies Act 2008 is entitled “Fundamental Transactions, Takeovers and Offers” and it contains the new provision relating to the regulation of such transactions. Part C of Chapter 8 entitled “Regulatory Agencies and the Administration of the Act” contains the provisions dealing with the Takeover Regulation Panel.

Chapter 5 of the Companies Act 2008 is divided into three parts, namely:

- Part A which deals with the rules affecting Fundamental Transactions as they apply to all companies;
- Part B which deals with the authority of the Takeover Regulation Panel and the Takeover Regulations, and
- Part C which deals with the regulation of Affected Transactions and Offers. Parts B and C are applicable only to “regulated companies” (see s 118).

It is important for you to understand the difference between “affected transactions” and “fundamental transactions”. A transaction is referred to as an “affected transaction” if a regulated company is involved, in which case the Takeover Regulation Panel has jurisdiction over the transaction. A “fundamental transaction” may involve regulated or unregulated companies and is a term given to all transactions dealt with in Part A of Chapter 5 of the Companies Act 2008. A “fundamental transaction” will accordingly be an “affected transaction” if a regulated company is involved.

Included in “fundamental transactions” are: disposals of all or the greater part of the assets or undertaking of a company (s 112); amalgamations or mergers (s 113); and schemes of arrangement (s 114).

The definition of an “affected transaction” is to be found in s 117(1)(c). It includes a disposal of all or a greater part of the assets or undertaking of a regulated company (s 112), a merger or amalgamation involving at least one regulated company (s 113) and a scheme of arrangement between a regulated company and its shareholders (s 114) (see s 117(1)(c)(i), (ii) and (iii)). **(See**

**8.6 below for a full discussion of affected transactions and regulated companies).**

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

- What is a fundamental transaction?
- What is an affected transaction?
- How does the Companies Act 2008 define a regulated company?
- What is a mandatory offer and in what circumstances must it be made?
- What is a compulsory acquisition or squeeze out and in what circumstances would it apply?
- What requirements must be complied with before a company may sell or dispose of all or the greater part of its assets or undertaking?
- What is meant by the term “scheme of arrangement”?
- What is an amalgamation or merger?

**A. FUNDAMENTAL TRANSACTIONS****8.2 Disposal or sale of all or the greater part of the assets or undertaking of a company**

Paragraphs 9.3.1.2 and 9.4.1 of the prescribed textbook.

Section 112 of the Companies Act

The disposal or sale of all or the greater part of the assets of a company constitutes a fundamental transaction and if a regulated company is involved, then it also constitutes an affected transaction. Where a company decides to dispose of or sell more than 50% of its assets or undertaking, then this would constitute a disposal or sale of all (100%) or the greater part (more than 50% but less than 100%) of the assets or undertaking of the company. Section 112 of the Companies Act 2008 regulates the disposal or sale of all or the greater part of the assets of a company. In terms of this section, a company may only dispose or sell all or the greater part of its assets or undertaking if the following requirements are met:

- i. The specific proposed disposal is approved by a special resolution of the shareholders (either in advance or subsequently ratified);
- ii. the notice of the shareholders' meeting to consider the resolution is accompanied by a written summary of the terms of the transaction; and
- iii. the assets or undertaking to be disposed of are given a fair market value.

The above requirements do not apply to the disposal or sale of all or the greater part of the assets of a company where the transaction is:

- i. as a result of a business rescue plan (**see study unit 9**);
- ii. between a holding company and its wholly-owned subsidiary;
- iii. between two or more wholly-owned subsidiaries of the same holding company; and
- iv. between a wholly-owned subsidiary on the one hand, and its holding company and one or more wholly-owned subsidiaries of that holding company, on the other hand.

**See EXAMPLE C in par 9.3.1.2 of the prescribed textbook for an example of a disposal or sale of the greater part of a company's assets.**

### 8.3 Amalgamations or mergers

Paragraphs 9.3.1.1 and 9.4.2 of the prescribed textbook.

Section 113 of the Companies Act

Section 1 of the Companies Act 2008 provides that an amalgamation or merger refers to a transaction or series of transactions, involving two or more companies, resulting in the survival of one or more of the amalgamating or merging companies or the formation of one or more new companies, which together hold all of the assets and liabilities previously held by the several merging or amalgamating companies. Therefore, an amalgamation or merger occurs when:

- i. two or more companies combine their assets and liabilities;
- ii. these assets and liabilities are then held by one or more surviving companies OR by one or more newly formed companies; and
- iii. all the other amalgamating or merging companies then cease to exist upon completion of the amalgamation or merger.

Such a transaction (amalgamation or merger) is a fundamental transaction and is also an affected transaction if it involves one or more regulated companies.

Amalgamations or mergers are governed by section 113 of the Companies Act 2008. Section 113(1) provides that two or more profit companies, including holding and subsidiary companies, may amalgamate or merge if, upon completion of the transaction, each amalgamated or merged company will satisfy the solvency (the company's assets fairly valued, are equal to or exceed its liabilities) AND liquidity (the company is able to pay its debts as they fall due in the ordinary course of business) test. It is the duty of the board of each amalgamating or merging company to consider whether, upon completion of the transaction, each proposed amalgamated or merged company will satisfy the solvency and liquidity test. The transaction must also be approved by a special resolution of the shareholders.

Section 113(5) provides that the notice of the shareholders' meeting must include a copy or summary of the amalgamation or merger agreement and details of the proposed special resolution and appraisal rights. (**See the explanation of an appraisal right in par 9.4.2.2 of the prescribed textbook**).



In terms of section 113(2), companies which intend to amalgamate or merge, must enter into a written agreement setting out the terms of the amalgamation or merger. There are certain particulars which must be included in the agreement. **(See par 9.4.2.2 of the prescribed textbook.)**

### Activity 8.1

The directors of Ama (Pty) Ltd, Beta (Pty) Ltd and Cita (Pty) decide that it would be in the best interests of the respective companies to amalgamate or merge into one new company, Disa Ltd, in order to pursue a lucrative business adventure. Advise the directors of the respective companies whether such an amalgamation is permitted in terms of the Companies Act 2008, and if so, of the requirements for such amalgamation or merger.

### Feedback

This transaction would constitute an amalgamation or merger in terms of section 1 of the Companies Act of 2008 if it involves the amalgamation or merger of three profit companies and would result in the formation of a new company, Disa Ltd, holding all the assets and liabilities of Ama (Pty) Ltd, Beta (Pty) Ltd and Cita (Pty). Upon completion of the amalgamation or merger, Ama (Pty) Ltd, Beta (Pty) Ltd and Cita (Pty) would cease to exist. The amalgamation or merger of Ama (Pty) Ltd, Beta (Pty) Ltd and Cita (Pty) is permissible provided that the directors of each company reasonably believe that upon completion of the amalgamation or merger, Disa Ltd will satisfy the solvency and liquidity test. The three companies would then have to enter into a written agreement setting out the terms and means of effecting the amalgamation or merger, and in particular would have to set out the following particulars in the agreement:

- i. the proposed memorandum of incorporation of Disa Ltd;
- ii. the name and identity of each proposed director of Disa Ltd;
- iii. the manner in which the securities of Ama (Pty) Ltd, Beta (Pty) Ltd and Cita (Pty) are to be converted into securities of Disa Ltd, or exchanged for other property;
- iv. the consideration that the security holders of Ama (Pty) Ltd, Beta (Pty) Ltd and Cita (Pty) are to receive instead of or in addition to the securities of Disa Ltd should the securities of Ama (Pty) Ltd, Beta (Pty) Ltd and Cita (Pty) not be converted into securities of Disa Ltd and the manner of payment of such consideration;
- v. details of the proposed allocation of the assets and liabilities of Ama (Pty) Ltd, Beta (Pty) Ltd and Cita (Pty) to Disa Ltd;
- vi. details of any arrangement or strategy necessary to complete the amalgamation or merger; and
- vii. the estimated cost of the proposed amalgamation or merger.

The directors of Ama (Pty) Ltd, Beta (Pty) Ltd and Cita (Pty) would then have to submit the proposed amalgamation or merger agreement to the shareholders of Ama (Pty) Ltd, Beta (Pty) Ltd and Cita (Pty) respectively for approval by special resolution. The notice of the shareholders' meeting would have to be accompanied by a copy or summary of the amalgamation or merger agreement and must further furnish particulars of the proposed special resolution and appraisal rights.

## 8.4 Scheme of arrangement

Paragraphs 9.3.1.3 and 9.4.3 of the prescribed textbook.

Section 114 of the Companies Act

A scheme of arrangement is a fundamental transaction and if it involves a regulated company, then it is also an affected transaction. Schemes of arrangement are governed by section 114 of the Companies Act of 2008. Basically a scheme of arrangement is any arrangement or agreement between the company and any class of its security holders (which would include shareholders), including a reorganisation of the share capital of the company. In terms of section 114, a company may, on the initiative of the board and subject to approval by special resolution, implement any scheme of arrangement between the company and the holders of any class of its securities.

In terms of section 114(1)(a)-(f), the arrangement or agreement may involve:

- (a) a consolidation of securities of different classes;
- (b) a division of securities into different classes;
- (c) an expropriation of securities from the holders thereof;
- (d) an exchange of its securities for other securities;
- (e) a re-acquisition by the company of its securities in terms of s 48 (**see study unit 6**); or
- (f) a combination of the above.

**See EXAMPLE D in par 9.3.1.3 of the prescribed textbook for an example of a scheme of arrangement.**

Section 114 expressly provides that a company may not propose a scheme of arrangement if it is in liquidation or in the course of business rescue proceedings (**see study unit 9**).

Due to the complex nature of schemes of arrangement, section 114 of the Companies Act of 2008 requires that an independent expert be retained by the company proposing the arrangement, to compile a report concerning the proposed scheme of arrangement. The report must be furnished to the board and to the security holders involved in the proposed scheme. The minimum contents of this report as required by section 114(3)(a)-(h) are listed in par 9.4.3 of the textbook.

The Company Act requires that the expert be impartial and independent of the company. To this end, the expert must not have any relationship with the company or securities holders, must not have had any such relationship in the previous two years nor be related to any person who has or has had such a relationship (s 114).

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 subsidiary 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.

## 8.5 Court intervention in the implementation of fundamental transactions

Paragraph 9.4.4 of the prescribed textbook.

Section 115 of the Companies Act

The court may intervene with the implementation of any fundamental transaction (be it a proposed scheme of arrangement, a proposed disposal or sale of all or the greater part of the assets of a company or a proposed amalgamation or merger). Section 115 provides that notwithstanding any special resolution, a company may not proceed with the implementation of any proposed fundamental transaction (which would include an affected transaction if a regulated company is involved in the proposed transaction) if:

- (i) the special resolution approving the proposed transaction was opposed by at least 15% of the voting rights that were exercised on that resolution. In this situation any person who voted against the resolution may require that the company obtain court approval; in which case the proposed transaction may not proceed without the sanction of the court; OR
- (ii) the court finds that the resolution is manifestly unfair to any class of security holders or that the vote was materially tainted by conflict of interest, inadequate disclosure, failure to comply with the Companies Act of 2008, the memorandum of incorporation or any other applicable company rules or finds any other significant procedural irregularity and as a result orders that the resolution be set aside.

Section 115 further permits a security holder who voted against the proposed fundamental transaction to seek an appraisal remedy in terms of which the security holder can have his securities independently valued and re-purchased by the company at a fair price. The aggrieved security holder may only seek an appraisal remedy if he:

- (i) had notified the company in advance of his intention to oppose the special resolution; AND
- (ii) was present at the meeting and voted against the special resolution.

### Activity 8.2

Marico Ltd held 90% of the shares in Karoo (Pty) Ltd. Marico (Ltd) wished to make Karoo (Pty) Ltd a wholly-owned subsidiary. A scheme of arrangement was proposed in terms of s114 of the Companies Act 2008 between Marico Ltd and the 10% ordinary shareholders of Karoo (Pty) Ltd. The effect of the scheme was that the 10% ordinary shareholders would give up their shares in Karoo (Ltd) Pty in exchange for shares in Marico Ltd. The scheme was approved at a meeting of the ordinary shareholders of Karoo (Pty) Ltd. Keamo, Lisa and Hamid, who together hold 17% of the voting rights in Karoo (Ltd) Pty voted against the scheme.

Advise Keamo, Lisa and Mpho of their legal rights.

### Feedback

In order to answer this question fully you should start by briefly explaining that section 114 of the Companies Act of 2008 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. In terms of section 114(2), an independent expert must compile a report on the proposed scheme of arrangement. The report must be furnished to the board and to the shareholders of Marico Ltd and Karoo (Pty) Ltd.

You should further discuss the cases referred to above which deal with the requirement of a 'compensating advantage'.

You should further advise Keamo, Lisa and Hamid of their remedy under section 115. In terms of this section, Marico Ltd may not proceed with the scheme of arrangement without the approval of the court if the resolution was opposed by at least 15% of the voting rights that were exercised on that resolution, and any person who voted against the resolution requires the company to seek court approval.

Furthermore, Keamo, Lisa and Hamid are entitled under section 115(8) to seek an appraisal remedy if they had notified Marico Ltd of their intention to oppose the special resolution and were present at the meeting and voted against the special resolution. Keamo, Lisa and Hamid may demand that their shares be independently valued and bought back by Karoo (Pty) Ltd at a fair price.

## **B. AFFECTED TRANSACTIONS**

### **8.6 Affected transactions and regulated companies**

Paragraph 9.5.1 of the prescribed textbook.

As the Takeover Regulation Panel is required to regulate affected transactions it is important to know how an **affected transaction** is defined in the Companies Act 2008. In terms of section 117(1)(c)(i), (ii) and (iii), an affected transaction includes a disposal of all or a greater part of the assets or undertaking of a regulated company (s 112), a merger or amalgamation involving at least one regulated company (s 113) and a scheme of arrangement between a regulated company and its shareholders (s 114). (Note that all these types of fundamental transactions are subject to the approval requirements stipulated in section 115. However, if any of these transactions occur in the context of an approved business rescue plan in terms of Chapter 6, the provisions in the Companies Act 2008 regulating affected transactions, as well as the Takeover Regulations will not apply (s 118(3)).

Also included in the definition of an affected transaction is the acquisition of (or the announcement of the intention to acquire) a beneficial interest in voting securities of a regulated company to the extent contemplated in section 122 (see s 117(1)(c)(iv)). What is covered here is where a person acquires enough securities of a class with the result that he holds a beneficial interest in the securities amounting to 5, 10, 15 per cent or any further multiple of 5 of the issued securities of that class. (A disposal of securities with the result that a person no longer holds a beneficial interest in securities amounting to a particular multiple of 5 of the issued securities of that class is also covered by the definition.) Holding a "beneficial interest" in securities means that a person has a right or is entitled to receive or participate in dividends in respect of the company's securities, or to exercise (or cause to be exercised) any or all of the rights attaching to the securities (eg the right to vote) or to dispose (or direct the disposal) of the securities (s 1). Section 122 makes it clear that it covers persons acting alone or in concert and the section explains how to determine the number of issued securities of a class in order to work out the percentages.

The definition of an affected transaction also covers an announced intention to acquire a beneficial interest in the remaining voting securities of a regulated company that are not already held by a person or persons acting in concert (see s 117(1)(c)(v)).

## Regulated companies

It is important to note that the definition of an affected transaction refers to **regulated companies**. These are defined (by s 117(1)(i)) as a company to which Part B, Part C and the Takeover Regulations apply as determined in accordance with section 118(1). The company must be a public company (s 118(1)(a)), a state owned enterprise unless exempted in terms of section 9 (s 118(1)(b)) or a private company but only if the percentage of issued securities of that company that have been transferred (other than by transfer between related person) within a 24 month period before the affected transaction or offer exceeds the percentage prescribed by the Minister (s 118(1)(c)(i)). As far as this prescribed percentage is concerned, the Minister, after consultation with the Takeover Regulation Panel may prescribe a minimum percentage of not less than ten percent of the issued securities which would bring the company within the application of Part B, C of Chapter 5 and the Takeover Regulations (s 118(2)).

Also included in the definition of a regulated company is a private company, the Memorandum of Incorporation of which expressly provides that the company and its securities are subject to Parts B and C (of Chapter 5) and the Takeover Regulations, irrespective of whether the company falls within the criteria set out in section 118(1)(c)(i) above).

## 8.7 Takeover Regulation Panel

Paragraph 9.5.2 of the prescribed textbook.

Section 121 of the Companies Act

The Takeover Regulation Panel replaces the Securities Regulation Panel to regulate affected transactions. The Companies Act 2008 establishes the Takeover Regulation Panel as an organ of state within the public administration but outside the public service (s 196(1)). The Takeover Regulation Panel comprises of the Commissioner of the Companies and Intellectual Properties Commission, the Commissioner of the Competition Commission, three persons designated by the exchanges and a number of persons appointed by the Minister who have knowledge and experience in the regulation of securities and takeover (s 197(1)). Without regard to the commercial advantages or disadvantages of the transaction, the Takeover Regulation Panel is required to regulate affected transactions and offers to the extent provided for in Chapter 5 and the Takeover Regulations, investigate complaints relating to affected transactions and offers and consult with the Minister in respect of changes to the Takeover Regulations (see s 201 for the functions of the Panel and see also s 119). Section 119 requires the Takeover Panel to regulate affected transactions in order to promote the integrity and fairness in the marketplace, to ensure the provision of adequate information and time to allow informed decisions to be made by companies and holders of securities and to prevent actions that may frustrate or defeat takeover offers.

In terms of the Companies Act 2008 the Minister will now prescribe the rules to be known as the Takeover Regulations in consultation with the Takeover Regulation Panel (s 120 read with s 201(1)(d)). These Takeover Regulations are to give effect to the purposes of Part B and C of Chapter 5 of the Companies Act 2008 and must include regulations that provide for compliance with and enforcement of the provisions of Part B and C, the administration, operation and procedures of the Takeover Regulation Panel and any other matters relating to the powers and functions of the Takeover Panel (s 120).

Section 121 obliges any person proposing an affected transaction to comply with the reporting or approval requirements set out in the Takeover Regulations (unless exempted). Such person may not give effect to the transaction unless he has received a clearance notice or been granted an exemption. In carrying out its mandate to regulate affected transactions, the Takeover Regulation Panel may require the filing of various documents for approval and issue clearance notices if the transaction satisfies the applicable requirements of the Companies Act 2008 (s 119(4)(a) and (b)). The Takeover Panel may also initiate or receive complaints and conduct investigations and thereafter issue compliance notices in accordance with Chapter 7 (the Chapter dealing with remedies and enforcements) or the Takeover Regulations (s 119(4)(c)). This is specifically stated as one of the functions of the Takeover Panel (s 201(1)(b)). A person may file a complaint himself in relation to an affected transaction (s 168(1)(a)) or a complaint may be initiated directly by the Takeover Regulation Panel or at the request of another regulatory authority or the Minister (s 168(2)-(3)). The Takeover Regulation Panel may investigate the complaint under section 169 and act in terms of section 170. Objections to the compliance notice may be made to the Takeover Special Committee (a committee of the Panel established in terms of s 202(1)) or to a court so that the notice can be reviewed (s 172(1)). After considering representations the Takeover Special Committee or the court may confirm, modify or cancel all or part of the notice and then the applicant must comply with it (s 172(2)-(3)). A decision by the Takeover Special Committee is binding subject to any right of review or appeal by a court (s 172(4)).

## **8.8 Common types of affected transactions**

Two common types of affected transactions are:

- (i) Mandatory offers; and
- (ii) Compulsory acquisitions (or 'squeeze out').

### **8.8.1 Mandatory offers**

Paragraph 9.5.3.1 of the prescribed textbook.

Section 123 of the Companies Act

Mandatory offers as defined in section 123 also fall within the definition of an affected transaction (see s 117(1)(c)(vi)). A mandatory offer refers to a transaction where one or more persons who are related or interrelated or are acting in concert attain a prescribed percentage of all voting securities in the company. The prescribed percentage is that prescribed by the Minister on advice of the Panel but it must not be more than 35 per cent of the voting securities of a company (s 123(5)). Upon obtaining such prescribed percentage, such person or persons are required to make an offer for all outstanding securities in the company. The first situation in which a mandatory offer to acquire remaining securities must be made is where a regulated company re-acquires any of its voting securities in terms of section 48. (Section 48 regulates the circumstances under which a company may acquire its own shares.)

The second situation in which a mandatory offer must be made is where a person (alone or in concert) acquires a beneficial interest in any voting securities issued by a regulated company. However, before the obligation to make a mandatory offer arises the situation must be such that before the acquisition the person (or persons together) exercised less than the prescribed percentage of voting rights attaching to the securities and as a result of the acquisition (together with the other securities already held) they would be able to exercise at least the prescribed percentage of the voting rights attached to the securities (s 123(2)).

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 prior to the Companies Act of 2008, 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 Securities Regulation Code on Takeovers and Mergers ('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'".

### Activity 8.3

Michael wishes to acquire a controlling interest in Finchley 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.

Advise Michael 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 Finchley Ltd.

### Feedback

The minority shareholder is referring to the potential obligation to make a mandatory offer to the minority shareholders of the company. However, before you can advise Michael whether what he has been told is correct you would need to consider whether the situation is one to which the mandatory offer 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 Finchley Ltd) is a regulated company 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 s 117(1) (c) of the Companies Act 2008. It would seem that the proposed transaction would amount to an affected transaction. The question whether the company is a regulated company will be answered if you look at sections 117 and 118 of the Companies Act 2008. It would seem that Finchley Ltd is a regulated company in terms of the Companies Act 2008. If Michael buys the shares of the two shareholders, an affected transaction would have occurred in terms of s 123(2) of the Companies Act 2008. This would trigger an obligation to make mandatory offers to the minority shareholders in accordance with the Companies Act and the Takeover Regulations. In terms of s 123(3), Michael would be required within one day after the date of the completed transaction, to give notice in the prescribed manner to the holders of the remaining securities, offering to acquire any remaining such securities on terms determined by the Companies Act 2008 and the Takeover Regulations. S 123(4) requires that within one month after giving notice, Michael must deliver a written offer, in compliance with the Takeover regulations, to the holders of the remaining securities of Finchley Ltd, to acquire those securities.

### 8.8.2 Compulsory acquisitions and squeeze out

Paragraph 9.5.3.2 of the prescribed textbook.

Section 124 of the Companies Act

A compulsory acquisition as contemplated in section 124 is also defined as an affected transaction (see s 117(1)(c)(vii)). An offeror who has had his offer for the acquisition of a class of securities of a regulated company accepted by more than 90 per cent of the class (other than securities already held by him, related parties, concert parties, nominee and subsidiaries before the offer) may notify the outstanding holders of securities that he wishes to acquire the remaining securities and he is then entitled to acquire them on the same terms as the original offer (s 124(1)(a) and (b)).



This means that the offeror can effectively force the minority to part with their securities and he will become the holder of all the securities in the company. Provision is also made giving the outstanding minority the right to insist that his shares be acquired in certain circumstances (s 124(4)). In this context the 90 per cent majority takes into account securities already held by the offeror, nominees, subsidiaries and related parties. This allows the minority to escape being left as a small minority shareholder in a company whose controller has effectively changed.

### **Activity 8.4**

Penny Pinchers (Pty) Ltd is a private company with 12 shareholders who each hold 1 share in the company. Lunar Lane Ltd holds 1 share in Penny Pinchers (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 Lunar Lane Ltd has heard that all the shareholders except one are very keen to sell their shares. However, Lunar Lane Ltd does not wish to acquire anything less than 100% ownership of Penny Pinchers (Pty) Ltd. The board of Lunar Lane Ltd does not wish to structure the deal as a scheme of arrangement.

Advise Lunar Lane 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 Lunar Lane Ltd wishes to acquire total control of Penny Pinchers (Pty) Ltd. If the transaction falls under the definition of an affected transaction and if Penny Pinchers (Pty) Ltd (the offeree company) is a regulated company then the transaction would be regulated both by the Companies Act of 2008 and the Takeover Regulations. In order to decide whether the proposed offer falls under the definition of an affected transaction, you must consult the definition found in section 117(c) of the Companies Act of 2008. It would seem that the proposed transaction is covered by the definition and that Penny Pinchers (Pty) Ltd is a regulated company in terms of the definition in section 118. The affected transaction in this scenario is a 'squeeze out' or compulsory acquisition. This is transaction where a person or offeror, in this case Lunar Lane Ltd, attains 90% of any class of securities in a company, in this case Penny Pinchers (Pty) Ltd. If within four months after the date of an offer for the acquisition of any class of securities of a regulated company, that offer has been accepted by the holders of at least 90% of that class of securities, then the offeror may, in terms of section 124 of the Companies act 2008, notify the holders of the remaining securities of the class that the offer has been accepted by 90% of the security holders and that the offeror wishes to acquire all the remaining securities of that class. After giving notice, the offeror is entitled to acquire the securities concerned on the same terms that applied to the original security holders. Lunar Lane Ltd must follow this procedure should it wish to acquire all the shares in Penny Pincers (Pty) Ltd.

## Study Unit 9

### Business Rescue Proceedings

☺ **Study paragraphs 10.1 – 10.8 of your prescribed textbook!**

☺ **Study sections 128 - 154 of the Companies Act!**

#### 9.1 Introduction

Paragraph 10.1 of the textbook

Section 128 of the Companies Act

In the 2004 policy paper, *South African Company Law for the 21<sup>st</sup> Century: Guidelines for Corporate Law Reform*, setting out the objectives and scope of its review of corporate law in South Africa, the Department of Trade and Industry specifically included insolvency and the rescue of companies as one of the six areas of company law that would constitute the primary focus of the review process. It went on to state (in paragraph 4.6.2) that “judicial management is rarely used and even more rarely leads to a successful conclusion.” It was therefore intended to create a new system of corporate rescue that would be appropriate to the needs of a modern South African economy and in doing so, Chapter 11 of the US Bankruptcy Code would be considered in drafting the new corporate rescue provisions.

The business rescue proceedings contained in Chapter 6 of the Companies Act of 2008 are the result of that decision by the Department of Trade and Industry.

Carefully note the definitions contained in section 128, particularly those of “affected person”, “business rescue”, “financially distressed” and “independent creditor”.

#### 9.2 Resolution by board of directors to begin business rescue

Paragraph 10.2 of the textbook

Sections 129-130 of the Companies Act

One of the objections against judicial management has been that it may be commenced only by an order of court which makes the procedure expensive and complicated. It can therefore be regarded as one of the major improvements of the new rescue proceedings that it may be commenced by a resolution taken by the board. No approval by shareholders is required and the general meeting is also not authorised to take such a resolution.

Note the provision in section 129(7) (discussed in par 10.2.2), that if a company board has reasonable grounds to believe that the company is financially distressed but decides not to take a resolution to commence business rescue proceedings, a notice must be delivered to every affected person (as defined) explaining why they believe the company to be financially distressed and why they have not adopted a business rescue resolution. What effect do you think this notice will have on the business of the company and its creditors?

To protect affected persons against abuse of the procedure by company boards, section 130 provides that the court may, on application, set aside the resolution, appoint another business rescue practitioner or order the practitioner to provide security (see par 10.2.3). In terms of the definition in section 128(1)(a), any shareholder or creditor of the company, a registered trade union representing employees of the company, and any individual employee who is not so represented, qualify as affected persons and may thus bring such an application.

### **9.3 Court order to commence business rescue proceedings**

Paragraph 10.3 of the textbook  
Sections 31(3), 131-132 of the Companies Act

The possibility of commencing business rescue proceedings by an order of court is also included in the Act. Any affected person may apply for such an order, but the company or directors may not apply.

Note the two alternative grounds on which an applicant may rely, instead of proving financial distress (par 10.3.2). Also note the provisions of section 31(3) in terms of which a trade union may demand access to a company's financial statements for purposes of applying for an order commencing business rescue proceedings.

#### **Activity 9.1**

Delectable (Pty) Ltd is a small but successful catering company. It is now being sued for damages by a client whose guests contracted food poisoning after being served food provided by the company. If the client is successful, Delectable (Pty) Ltd will not be able to pay all its debts.

Advise the directors whether the circumstances of the company are of such a nature that it qualifies for business rescue proceedings and how business rescue proceedings may be commenced.

#### **Feedback**

You have to look at the requirements for a board resolution to start business rescue proceedings (in par 9.2 above) since directors may not apply to court for such an order.

### **9.4 Legal consequences of business rescue proceedings**

Paragraph 10.4 of the textbook  
Sections 133-137, and 144-149 of the Companies Act

Two very contentious provisions are mentioned in this part. Firstly, section 135 provides that any claims for remuneration or other payments that become due to employees during business rescue proceedings, will enjoy preference above all other claims, even those of creditors who provided post-commencement financing to the company. Only the business rescue practitioner's claims for remuneration and costs, and other claims for costs of the business rescue proceedings, rank higher than these claims of employees. (See par 10.4.3.) It remains to be seen whether a company will be able to obtain any financing during business rescue proceedings under these conditions.

The second, even more contentious provision is the one discussed in paragraph 10.4.5. This deals with section 136(2) which, if interpreted literally, means that a business rescue practitioner may cancel or suspend any clause in a contract to which the company is a party, for example by cancelling the clause that requires payment by the company in a contract of sale, but demanding delivery of the goods, or cancelling the clause requiring the provision of security by the company for a loan, but insisting on the loan being given. Hopefully, this is not the intended result of the provision but it may be necessary for a court to pronounce on this aspect before we can be sure.

### **Activity 9.2**

Delectable (Pty) Ltd rents very expensive kitchen equipment from Rento Ltd. They have since found out that they can rent the same equipment at a much lower rate from another company.

Will business rescue proceedings enable them to cancel the contract with Rento Ltd and will they be liable for breach of contract if they do?

### **Feedback**

See the discussion above and the provisions of section 136(2).

## **9.5 The business rescue practitioner**

Paragraph 10.5 of the textbook  
Section 138 of the Companies Act

The provisions requiring the appointment of a suitably qualified professional business rescue practitioner to manage and supervise the company during business rescue proceedings, are also a major improvement over judicial management where no qualifications were required for appointment as judicial manager. Unfortunately, the exact qualifications that will be required will only be known once the regulations under the Companies Act of 2008 are published.

### **Activity 9.3**

The directors of Delectable (Pty) Ltd are worried about another person taking over the management of their company if they start business rescue proceedings. They want to know if they may appoint their auditor as business rescue practitioner.

### **Feedback**

Study the qualifications listed in par 10.5.1 of the textbook and advise the directors.

## **9.6 The rights of creditors during business rescue proceedings**

Paragraph 10.6 of the textbook  
Sections 145 and 147 of the Companies Act

Note that, unlike the situation in insolvency law, secured creditors also have voting rights for the secured part of their claims and not just for the unsecured part (par 10.6.3).

## **9.7 The business rescue plan**

Paragraph 10.7 of the textbook  
Sections 150-153 of the Companies Act

The fact that judicial management does not provide for the drafting and execution of a rescue plan, has also been cited as one of the reasons for its failure to become an effective rescue procedure. The Act now prescribes highly detailed requirements for a business rescue plan and its approval by (mainly) the creditors.

## **9.8 Termination of business rescue proceedings**

Paragraph 10.8 of the textbook  
Section 132 of the Companies Act

Note that the practitioner is not compelled to apply for more time if the rescue proceedings have not ended within three months, but if he does not, then he must deliver a written progress report to the court or Commission every month. Do you think a period of three months is sufficient for the whole process to be completed?

## Study Unit 10

### Compromises

😊 **Study paragraphs 10.9-10.13.5 of your prescribed textbook!**

😊 **Study section 155 of the Companies Act!**

#### 10.1 Introduction

Paragraph 10.9 of the textbook

The compromise procedure in terms of section 311 of the Companies Act of 1973 has often been used to achieve a rescue of a company or business. The procedure entails an application to court by the company, a creditor, member, the provisional or final liquidator if the company is being wound up or the provisional or final judicial manager if the company is under judicial management, for an order directing that a meeting of the creditors (or class of creditors) of the company be summoned to consider a proposed compromise (s 311(1)). The notice summoning the meeting must be accompanied by a statement explaining the effect of the compromise (s 312). If the prescribed majority agrees to the compromise, the applicant must approach the court again to sanction the compromise. Thereafter the compromise will be binding on all creditors or on that class of creditors and also on the company (and the liquidator or judicial manager) (s 311(2)).

The court has discretion whether to sanction the compromise, even if the required majority has voted in its favour. In exercising this discretion, the court must take into account the number of creditors present who voted in favour of the proposals (s 311(5)).

A section 311 scheme is often used to transfer control of an insolvent company to an outsider who is then deemed to have taken cession of creditors' claims in return for payment to them of part of their claims against the company.

Chapter 6 of the Companies Act of 2008 contains the new business rescue proceedings as well as a new procedure for a compromise between a company and its creditors (s 155). The last-mentioned procedure is discussed in detail below.

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

- Who may propose a compromise?
- What is the structure of a proposal for purposes of a compromise?
- What information must be provided in a compromise proposal?
- What are the requirements for adoption and approval of a compromise?
- What are the effects of a sanctioned compromise?

## 10.2 Compromise between a company and its creditors

Paragraphs 10.10-10.11 of the textbook

The Companies Act 2008 provides for a new procedure for effecting compromises in section 155. In terms of the new Act a company may effect a compromise with its creditors irrespective of whether it is in financial distress (as defined in section 128(1)(f)), unless it is engaged in other business rescue proceedings in terms of Chapter 6 of the Act.

In terms of section 155(2) the board of a company or its liquidator (if the company is being wound up) may propose an arrangement or a compromise of its financial obligations to all its creditors or to all the members of any class of its creditors. Note that, unlike a compromise in terms of section 311 of the Companies Act of 1973, this compromise procedure is limited to creditors, and does not provide for a compromise with shareholders (see Study Unit 8 for the provisions on an arrangement between the company and its shareholders, which is one of the fundamental transactions).

A proposal for a compromise must be made by delivering a copy of the proposal and notice of a meeting to consider the proposal, to the Commission and to every creditor of the company or every member of the relevant class of creditors, whose name and address is known to or can reasonably be obtained by the company (s 155(2)).

## 10.3 Prescribed contents of a proposal

Paragraph 10.12-10.13.2 of the textbook

Note the similarities between the prescribed contents of a compromise proposal and business rescue plan.

## 10.4 Adoption and sanctioning of the proposal

Paragraphs 10.13.3-10.13.4

Note that the proposal must first be adopted by the required majority of creditors, and then an application must be made to court for an order sanctioning the compromise.

Unlike the section 311 compromise, the new compromise procedure requires only one application to court, namely to approve the compromise once the proposal has been adopted by the required majority of creditors. It will therefore no longer be necessary to ask the court's permission to arrange the meeting where the proposed compromise will be discussed and voted on.

## 10.5 Effects of approval

Paragraph 10.13.5 of the textbook

If the compromise is approved by the court, a copy of the order must be filed with the Commission by the company within five business days (s 155(8)(a)). A copy of the order must also be attached to each copy of the company's Memorandum of Incorporation that is kept at the company's registered office or elsewhere as contemplated in section 25 (s 155(8)(b)). Most importantly, the order of court sanctioning a compromise is final and binding on all the company's creditors or all members of the relevant class of creditors, as the case may be, from the date on which the copy of the order is filed (s 155(8)(c)). However, a compromise sanctioned in terms of section 155 does not affect the liability of any person who is a surety of the company (s 155(9)).

A liquidator may also enter into a compromise with creditors in terms of the new section 155 discussed above. Section 311 that presently regulates a compromise between a company and its creditors specifically refers to the possibility that a compromise could provide for the discharge of the winding-up order (s 311(4)). Section 155 does not contain a similar provision but it is clear from other provisions that this is envisaged, especially since there would not be any other reason for a company being wound up to enter into a compromise with creditors.

### **Activity 10.1**

Consider the differences in the procedures proposed in the common law, s 311 of the Companies Act and s155 of the Companies Act 2008 relating to compromises between a company and its creditors. Critically evaluate whether the respective sections provide sufficient protection for company creditors.

### **→Feedback**

At common law, a compromise can only be reached with creditors who agreed to be bound by the compromise. Despite the fact that the majority of creditors agreed to the compromise, dissenting creditors (who do not agree) could institute proceedings against the company.

#### Section 311 and 312 of the Companies Act 1973:

Under the Companies Act 61 of 1973, compromises with creditors are dealt with under sections 311 and 312. Sections 311 and 312 of the Companies Act 1973 govern both schemes of arrangement between the company and its members and between a company and its creditors.

Schemes of compromise can take many forms. Creditors may be required to write off a portion of their claims. They may be asked to waive interest on their claims. Creditors may also simply be asked to postpone the due date for payment of their claims. Schemes of compromise can relate to all three classes of creditors (preferent, secured and concurrent) or only one class, leaving the other classes of creditors unaffected by the scheme. A comparison is usually made between what the effected class of creditors would be paid in terms of the scheme of compromise and the amount they would be paid if the company is liquidated.

A compromise can be forced on dissenting creditors by means of a scheme of compromise in terms of s 311 of the Companies Act 61 of 1973. A company may in terms of such a scheme, request creditors to accept a compromise of their claims against the company. This is done based on the fact that the amounts they would receive under the scheme would exceed the amount that the creditors would receive should the company be liquidated. Very often these schemes entail a third party, the proposer, acquiring the compromised claims of creditors, as well as the shares in the company. With regard to the contents of the proposal section 312 (1) (a) (i) refers in general to the statement but the drafter of a scheme of compromise must look to what is required under our case law to be set out in the scheme of compromise. At the common law a section 312 (1) (a) (i) statement usually requires the scheme of compromise to compare the fees of the liquidator if the scheme would be rejected and the winding up continued, against the fees of the receiver appointed to administer the scheme.

A scheme of compromise under s 311 is commenced by a company (or a liquidator of the company) applying to the High Court for leave to call meetings of creditors for purpose of explaining the scheme to the creditors and to put the scheme to their vote. The Court can at this stage examine the terms of the proposed scheme of compromise. The Court may refuse to order the meetings of creditors if there is any concern that the terms of the scheme are onerous or against public policy. Schemes of compromise can also be brought if the company is already in liquidation.



Such schemes of compromises usually provide that third party will acquire all the shares in the company once all the creditors are bound by the scheme of compromise. The Court may then as part of the order sanctioning the scheme of compromise, discharge the liquidation of the company.

Meetings of the creditors in each affected class are chaired by an independent chairman. The creditors are required to vote for or against the scheme. Section 311 (2) (a) of the Companies Act 1973 requires 75% in value of the creditors must vote in favour of the proposal in order for it to be held to have been adopted by the creditors. This would however be very negative as this would mean that a few creditors who hold higher values in claims could bind smaller creditors to their detriment. Our case law however indicates an interpretation that stifles this. Our courts have developed to hold that in schemes of compromise 75% of the creditors in each class in value and in number must approve of the scheme.

After the 75% approval is obtained from the affected classes of creditors the High Court as to yet again sanction the scheme of compromise by means of a court order. It is possible that even where 75% of the creditors in number and value have agreed to the scheme of compromise, the High Court will refuse to sanction the scheme of compromise on the basis that it is inequitable or oppressive of creditors' rights.

In summary: Although a section 311 scheme of compromise under the Companies Act 1973 can force dissenting creditors to be bound by a scheme of compromise which may reduce their claims, there is ample protection. The court may intervene at the inception of the procedure by not allowing leave to propose the scheme or again in sanctioning the scheme, if it would be unfairly detrimental to any or all creditors

#### Section 155 of the Companies Act 2008:

Part E of chapter 6 of the Companies Act 71 of 2008 which will come into effect in mid or late 2010, governs compromises between a company and its creditors. The Companies Act 2008 separates schemes of arrangement between the company and members and schemes of compromise with creditors. Schemes of arrangement in relation to a company and its members are dealt with in section 114 and schemes of compromise can be found in section 155.

The compromise chapter in the Companies Act 2008 is similar to sections 311 and 312 of the Companies Act 2008 in that it permits a company (or the liquidator of the company) to propose an arrangement of compromise of the financial obligations of a company to all creditors or to the members of any class of creditors.

It is however not required that an application be brought to the High Court before the compromise is proposed to the creditors. Section 155 (2) of the Companies Act 2008 simply requires that the board or the liquidator of the company to propose the arrangement. This is done by delivering a copy of the proposal, together with notice of the meeting to consider the proposal, to the company and to all creditors (or every member of the affected class of creditors) whose name or address is known to or could simply be obtained by the company.

Unlike in the Companies Act 1973, section 155 (3) codifies and sets out in some detail what the proposal must be contained. It contains an itemised list of the information which must be contained in the proposal. One of these items is a statement as to whether or not the proposal of the compromise includes any proposals made "informally" by a company creditor. What the word "informally" means is unclear. It could mean that the drafter of the proposal needs to include every single compromise of a claim by a single creditor in relation to their debt however insignificant or irrelevant in relation to all the creditors.

The list of information that must be contained in a proposal further includes details of all the assets and creditors of the company, the nature and extent of any proposed moratorium on claims, the treatment of ongoing contracts to which the company is a party, the order of preference in which the proceeds of the property of the company will be applied to pay creditors, any conditions precedent must be satisfied for the proposal to come into operation and be implemented, the number of employees of the company and their terms and conditions of employment, and a projected balance sheet and statement of income and expenses for the ensuing three years. A proposal must be concluded with a certificate by an authorised director or officer of the company stating that the factual information appearing therein is accurate, complete and up to date and that the projections provided are estimates made in good faith.

Section 155 (6) provides that

"A proposal .... will have been adopted by the creditors of the company .... if it is supported by a majority in number representing at least 75% in value of the creditors or class, as a case may be, present and voting in person or by proxy at the meeting called for that purpose". Section 155 (6) therefore codifies the common law requirement that a scheme of compromise must be approved by 75% of the creditors in number and in value in each affected class.

The wording "a proposal ... will have been adopted by the creditors" is however ambiguous. This could be interpreted to mean that as soon as the requisite percentage of creditor votes is obtained the proposal is binding on the dissenting creditors. Section 155 (7) (a) provides that a company "may" apply to court for an order approving the proposal. This suggests that it is not necessary for the company to obtain the sanction of the High Court before a compromise becomes binding on the dissenting creditors.

In summary: Once the Companies Act 2008 comes into operation companies will no longer be required to apply for leave to the High Court before making a proposal of a compromise to creditors. As long as a majority in number of the creditors, representing at least 75% in value of the claims of the creditors, approve of the proposed compromise, the compromise will become binding on the dissenting minority of creditors. The High Court will therefore have no discretion to scrutinize the fairness of the proposal.

## Study Unit 11

### Insider Trading

☺ **Read paragraph 15.5 in Chapter 15 of your prescribed textbook!**

☺ **Note that the prescribed information that you have to study for the examination is contained in this part of the study guide!**

### 11.1 Introduction

Insider trading became a statutory offence with the introduction of section 233 of the Companies Act of 1973. After a singular lack of success in the prosecution of offenders, the legislation underwent a major transformation in 1989. Section 440F was to have been the new anti-insider trading provision. However, even before this provision became effective it was substituted by another provision in 1990. The Securities Regulation Panel, which was established at much the same time, was given the function of supervising dealings in securities and this included the supervision of the insider trading provisions.

Despite the fact that the provisions were potentially very broad in their application, no successful prosecutions followed. In January 1999, section 440F of the Companies Act was repealed and new provisions regulating insider trading became law with the passing of the Insider Trading Act 135 of 1998. However, on 1 February 2004, the Securities Services Act 36 of 2004 came into operation and repealed the Stock Exchanges Control Act 1 of 1985, the Financial Markets Control Act 55 of 1989, the Custody and Administration of Securities Act 85 of 1992, as well as the Insider Trading Act.

The Securities Services Act begins with a statement of aims which include the increasing of confidence in the South African financial markets, the promotion of the protection of regulated persons and clients, the reduction of systemic risk and the promotion of the international competitiveness of securities services in the Republic (s 2). Systemic risk is the danger of a failure or the disruption of the financial system of Republic as a whole (s 1).

A regulated person is a self-regulatory organisation (in other words, an exchange or central securities depository) or any other person who provides or who previously provided securities services (s 1). Securities services include the buying and selling of securities, the custody and administration of securities, the management of securities, the clearing of transactions in listed securities and the settlement of transactions in listed securities (s 1).

Although the Act extends far wider, you are only required to study the insider trading provisions. Chapter VIII of Securities Service Act entitled 'Market Abuse' now regulates insider trading and prohibits certain manipulative practices - the two main types of market abuse.

The Chapter begins with definitions which are specifically relevant (s 72) and then it defines the offence of insider trading (ss 73-74). A general prohibition of manipulative, improper, false or deceptive trading practices which create or might create a false or deceptive appearance of trading activity or an artificial price for a security listed on a regulated market is then included (s 75). Certain practices are deemed to be prohibited trading practices and the publication of false, misleading or deceptive statements, promises and forecasts in respect of listed securities or in respect of the past or future performance of a public company is prohibited (ss 75-76). Provisions imposing civil liability for insider trading are included (s 77).

The provisions regulating insider trading will be considered in more detail below. (The provisions regulating prohibited trading practices will not be elaborated upon.)

## 11.2 Relevant definitions

Securities Services Act sections 72 and 74

A knowledge of the definitions of certain words is central to an understanding of the insider trading provisions.

Central to all the insider trading offences is that the person must know that he/she has “**inside information**” (s 72). Before information would qualify as inside information it must satisfy a number of criteria. The first is that the information must be specific or precise. This would exclude speculation and rumour. The second is that the information must not have been made public. In an attempt to clarify whether information is public information, the Legislature inserted section 74 which includes a non-exhaustive list of circumstances in which information **is regarded** as having been made public (s 74(1)) and another list in which inside information which would otherwise be regarded as having been made public **must still be so regarded** despite the existence of these circumstances (s 74(2)).

As far as the second requirement is concerned, section 74 of the Act contains a non-exhaustive list of circumstances in which information is **regarded** as having been made public and another list of circumstances in which inside information which would otherwise be regarded as having been made public, must still be so regarded.

Information is regarded to have been made public when

- (a) it is published in accordance with the rules of the relevant regulated market for the purpose of informing investors and their professional advisers, or
- (b) it is contained in records which by virtue of an enactment are open to inspection by the public, or
- (c) it can be readily acquired by those likely to deal in any listed securities to which the information relates, or
- (d) it can be readily acquired by those likely to deal in any securities of an issuer to which the information relates, or
- (e) it is derived from information which has been made public.

Furthermore, information **must still be regarded** as having been made public even though it -

- (f) can be acquired only by persons exercising diligence or observation or having expertise, or
- (g) is communicated only on payment of a fee, or
- (h) is only published outside the Republic.

The third criterion for information to qualify as inside information is that the information must be such that if it were made public it would be likely to have a material effect on the price or value of any security listed on a regulated market. The courts would have to decide whether the information was price or value sensitive.

The fourth criterion which must be satisfied is that the information must have been obtained or learned as an insider. A primary insider includes a person who has inside information through being a director, employee or shareholder (irrespective of size) of an issuer of securities listed on a regulated market to which the inside information relates. A person who has inside information by having access to such information by virtue of her employment, office or profession is also classified as an insider.

In this case there need be no direct connection between the person's employment, office or profession and the issuer of the securities to which the inside information relates. This category covers a large number of persons, for example legal advisers, accountants, bankers and others. Further, a person who knows that the direct or indirect source of the information he has was one of the persons mentioned above will also be an insider. These persons are sometimes referred to as tippees.

Previously the definition of an "insider" referred to "an individual". Now the definition refers to "a person". This would clearly cover natural and juristic persons which was not the case under the Insider Trading Act. Note also that the Securities Services Act defines the word "**person**" to include a partnership and any trust (s 72).

Although the word "**deal**" is still not specifically defined the Securities Services Act states that it includes conveying or giving an instruction to deal (s 72). It is assumed that it would also cover buying and selling.

The prohibition against insider trading applies in respect of securities listed on a regulated market. The term "**securities**" is very widely defined in section 1 of the Securities Services Act. It includes shares, stocks and depository receipts in public companies and other equivalent entities, (but not shares in a share block company), notes, bonds, debentures and various other financial instruments.

Note however that except for the purposes of Chapter IV of the Securities Services Act (which chapter deals with the custody and administration of securities) the definition of "securities" excludes money market instruments and the definition also excludes any security mentioned in the list that the registrar by notice in the *Gazette* specifies as excluded.

The insider trading prohibition relate to securities listed on a regulated market. The concept of a "**regulated market**" is a market (domestic or foreign) which is regulated in terms of the laws of the country in which that market conducts business as a market for dealing in securities listed on that market (s 72). Thus unlisted securities will not be covered by the insider trading provisions but insider trading in securities listed on domestic and foreign markets is covered.

### 11.3 Offences and defences

Securities Services Act sections 72-73

The Securities Services Act prohibits the same three types of conduct that were prohibited in the Insider Trading Act. The first prohibition relates to dealing, the second prohibition covers improper disclosure of inside information and third covers encouraging or discouraging dealing.

The Securities Services Act has two provisions relating to **dealing**. The first is section 73(1)(a) which prohibits dealing for one's own account and the second is section 73(2)(a) which prohibits dealing for any other person.

It is an offence for an insider who **knows** that he or she has inside information to **deal** directly or indirectly, or through an agent for his or her **own account** in the securities listed on a regulated market to which the information relates or which are likely to be affected by it (s 73(1)(a)). The insider could escape liability if it was proved on a balance of probabilities (see s 73(1)(b)) that he/she was acting in pursuit of the completion of an affected transaction (see s 440A of the Companies Act for the definition of an "affected transaction") or he/she only became an insider after giving the instruction to deal to an authorised user and the instruction was not changed in any manner after he/she became an insider.

It is also an offence for an insider who **knows** that he or she has inside information to **deal** directly or indirectly for **any other person** in the securities listed on a regulated market to which the information relates or which are likely to be affected by it (s 73(2)(a)). The insider could escape liability if it was proved on a balance of probabilities (see s 73(2)(b)) that he/she is an authorised user and was acting on specific instructions from a client, except where the inside information was disclosed to him/her by that client or he/she was acting on behalf of a public sector body in pursuit of monetary policy, policies in respect of exchange rates, the management of public debt or external exchange reserves, or he/she was acting in pursuit of the completion of an affected transaction, or he/she only became an insider after giving the instruction to deal to an authorised user and the instruction was not changed in any manner after he/she became an insider. (See s 72 for the definition of a “public sector body” and note that the Public Investment Commissioners is excluded from this definition.)

The Securities Services Act makes it an offence for an insider who knows that he/she has inside information to **disclose** that information to another person (s 73(3)(a)). It would be a defence if the accused could prove on a balance of probabilities that the information was disclosed in the proper performance of the functions of his/her employment, office or profession in circumstances unrelated to dealing in any security listed on a regulated market and that it was also disclosed at the same time that the information was inside information (s 73(3)(b)).

It is also an offence for an insider 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 the securities listed on a regulated market to which the inside information relates or which are likely to be affected by it (s 73(4)). 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 or for the person to act or refrain from acting.

## 11.4 Sanctions available

Securities Services Act sections 77; 80; 82; 105

Any person who contravenes the insider trading provisions contained in section 73 commits an **offence**. Penalties which could be imposed are a fine not exceeding R50 million or up to 10 years in prison or both (s 115). When deciding on a penalty, the court is required to take into account any civil award previously made under section 77 which arises out of the same cause (s 80(1)). Note that if the Director of Public Prosecutions declines to prosecute for an alleged offence, the FSB may institute a prosecution in respect of that offence in a competent court (s 82(9)).

Section 77 of the Securities Services Act deals with the question of **civil liability** resulting from insider trading.

The Securities Services Act retains what has been called the derivative **civil action**. This action can be instituted by the Financial Services Board (the FSB) against insiders involved in a contravention of the insider trading provisions (s 77). It relieves a person who has suffered damages as a result of insider trading from having to throw good money after bad in pursuing the culprit. The FSB is responsible for investigating matters related to insider trading and bringing civil actions and distributing the awards to claimants.

Separate subsections impose civil liability on an insider who knows that she has inside information for dealing for her own account (s 77(1)), dealing for another person (s 77(2)), improper disclosure of information (s 77(3)) and encouraging another person (s 77(4)).

In terms of section 77(1), the FSB can institute civil proceedings against an insider who knows that he/she has inside information, who **deals** directly or indirectly or through an agent for his **own account** in the securities listed on a regulated market to which the inside information relates or which are likely to be affected by the information, and who profits or would have made a profit if he/she had sold the securities at any stage, or avoids a loss through the dealing. The phrase “or would have made a profit if he or she had sold the securities at any stage” has been included to deal with the situation where the insider buys securities when he has inside information and then holds onto the securities and does not actually realise the profit. Obviously, the FSB will not be successful if the person concerned raises one of the specific defences which is proved on a balance of probabilities.

The FSB can sue this **insider who deals for his own account** for payment of the equivalent of the profit or loss referred to, a penalty (for compensatory or punitive purposes), interests and costs. The court has a discretion regarding the determination of the penalty but it must not exceed three times the profit or the loss referred to. 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 80(2)).

In terms of section 77(2), the FSB can institute civil proceedings against an insider who knows that he/she has inside information, who **deals** directly or indirectly **for any other person** in the securities listed on a regulated market to which the inside information relates or which are likely to be affected by the information, and who makes a profit for that other person or would have made a profit if the securities had been sold at any stage, or avoids a loss through the dealing. Obviously, the FSB will not be successful if the insider raises one of the specific defences which is proved on a balance of probabilities.

The FSB can sue this **insider** (let us call her Babs) **who deals for another person** (let us call him Zack) for payment of the equivalent of the profit or loss mentioned above, a penalty (for compensatory or punitive purposes) not exceeding three times the profit or the loss mentioned, the commission or consideration received for such dealing, interest and costs. The amount of the profit or the profit that would have been made or he loss avoided is determined in the discretion of the court which must have regard to the consideration for the dealing, the time between the relevant dealing and the publication of the inside information and any other relevant factors (s 77(6)).

If the other person on whose behalf the dealing occurred (Zack) is liable as an insider in terms of section 77(1), the first insider (Babs) is jointly and severally liable with Zack to pay the equivalent of the profit or loss, interest and the costs of the suit (s 77(5)). Each party would be individually liable for the penalty which the court may impose. For Zack to be liable as an insider under subsection (1), he must have known that he had inside information, he must have dealt directly or indirectly or through an agent, for his own account and made a profit or would have made a profit if he had sold the securities at any stage or avoided a loss. (See section 77(1) discussed above.)

In terms of section 77(3), the FSB can bring civil proceedings against an insider who knows that he/she has inside information, and who **discloses** it any other person. The FSB will not succeed if this insider successfully proves one of the specific defences.

An **insider who discloses inside information** (let us call her Carly) will be liable to pay the FSB, if the person to whom the information was disclosed (let us call her Trix) dealt in the securities listed on a regulated market to which the information relates or which are likely to be affected by it, the equivalent of the profit made or profit which would have been made if the securities had been sold at any stage or the loss avoided as a result of the dealing, a penalty (for compensatory or punitive purposes), interest, costs and the commission or consideration received for the disclosure.

Although it would be a criminal offence for Carly who knows that she has inside information to simply disclose the information (without a defence), this would not be enough to impose civil liability. Trix must have dealt in the relevant securities and (as a result of the dealing) made a profit or have been able to make a profit if the securities had been sold at any stage or she must have avoided a loss, for example by selling securities she already held before the inside information became public. As the penalty imposed by the court cannot exceed three times the profit or loss mentioned above, it would seem that if Trix did not deal in the relevant securities and thereby make a profit or avoid a loss, no penalty can be imposed. However, even if no amount can be claimed in respect of profit or loss or a penalty, it would seem that the amount received for making the disclosure (if any) could still be claimed. This is because the requirement that Trix must have dealt in the securities does not seem to relate to this.

If Trix (the person who received the disclosure) is liable as an insider in terms of section 77(1), then Carly is jointly and severally liable with Trix to pay the equivalent of the profit or loss, interest and the costs of the suit (s 77(5)). For liability as an insider in terms of section 77(1), see above.

In terms of section 77(4), the FSB can bring civil proceedings against an insider who knows that he/she has inside information, and who **encourages or causes any other person to deal** in the securities listed on a regulated market to which the inside information relates or which are likely to be affected by the information.

An insider who **encourages** (let us call her Simone) **another person** (let us call this other person Jean-Paul) to deal will be liable to pay the FSB, if Jean-Paul dealt in the relevant securities, the equivalent of the profit made or profit which would have been made if the securities had been sold at any stage or the loss avoided as a result of the dealing, a penalty (for compensatory or punitive purposes), interest and costs and the commission or consideration received for the encouragement.

Although it would be an offence for Simone who has inside information to simply encourage Jean-Paul to deal, it is not enough to incur civil liability. Jean-Paul must have dealt and made a profit or avoided loss as a result of the dealing. Since the penalty mentioned cannot exceed three times the profit or avoided loss mentioned above it would seem that if Jean-Paul did not deal in the relevant securities and did not make a profit or avoid a loss, no penalty can be imposed.

If Jean-Paul is liable as an insider in terms of section 77(1), then Simone is jointly and severally liable with Jean-Paul to pay the equivalent of the profit or loss, interest and the costs of the suit (s 77(5)). For Jean-Paul to be an insider he must (inter alia) have known that he had inside information. This might be the case if Simone had not only encouraged him to deal but had also disclosed the inside information to him. For liability as an insider in terms of section 77(1) and the definition of an insider, see above.

Although it is a criminal offence to discourage a person from dealing (see s 73(4)), no civil liability is imposed.

## 11.5 The FSB and the Directorate of Market Abuse

Securities Services Act sections 78; 82-83

The powers and duties of the **FSB** are contained in section 82 of the Securities Services Act. The FSB is responsible for the supervision of compliance with the market abuse chapter of the Securities Services Act which includes the insider trading regulations and the provisions dealing with prohibited trading practices (s 82(1)).



Besides being able to institute the proceedings discussed above (see ss 77 and 82(1)(b)), the FSB has the power to investigate matters relating to insider trading and to administer proof of claims and distribution of awards. Further, the FSB may summon persons to furnish information, lodge documents or to appear for interrogation by them. Failure to appear, give evidence or produce any document is an offence (s 82(3)(d)). The FSB may enter and search premises and examine, seize and make extracts of documents. This must be done with a warrant although in certain circumstances no warrant is required. The FSB has the power to delegate an investigation to such person as it deems fit (s 82(4)).

The Insider Trading Directorate established as a committee of the FSB in terms of section 12 of the Insider Trading Act continues to exist despite the repeal of that Act (s 83(1)(a)). However, it now has the grander title of **Directorate of Market Abuse** (s 83(1)(b)). The power to institute civil proceedings as contemplated in Chapter VIII of the Securities Services Act and to investigate any matter relating to an offence of insider trading, prohibited trading practices and false, misleading or deceptive statements, promises and forecasts is exercised by the Directorate on behalf of the FSB (see s 83(1)(c)).

The Directorate has the authority to withdraw, abandon or compromise any civil proceedings instituted under section 77, but any agreement of compromise must be made an order of court and any amount to be paid under it must be made public (s 78(1)). Further, any agreement of settlement made where no civil proceedings have been instituted may be made an order of court on application of the FSB (s 78(2)).

By all accounts in the newspapers, it seems that the Directorate is making good use of its powers to reach agreements of settlements with persons against whom it could potentially have brought a civil action.

### **Activity 11.1**

Pule is the personal assistant of the managing director of Pro-Toys 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. Pule realises that if the company releases the new product it will have a positive effect on the company's profitability. She tells her husband, Severis, about the meeting and the new product. Severis immediately instructs his broker to buy shares in Pro-Toys Ltd. When Pule hears what her husband has done, she advises her friend, Thembi, to buy shares in Pro-Toys Ltd. When Thembi asks her why she should do this, Pule simply replies "Because I say so". Thembi however, does not act on this advice. After the new product is released, the price of Pro-Toys Ltd's shares rises considerably. Severis sells the shares he bought in Pro-Toys Ltd at a considerable profit.

Consider whether any criminal proceedings could be brought against Pule and Severis under the insider trading provisions in the Securities Services Act of 2004.

## ➔ Feedback

You should explain that the Securities Services Act of 2004 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 Pule and Severis.

Pule has **disclosed information** to Severis and she also **encouraged** Thembi to deal in the shares of Pro-Toys Ltd. Give a summary of the law and the definitions relevant to these two offences.

This would show what the prosecution would need to prove to successfully prosecute her for these two offences. Apply the law and come to a conclusion.

Severis **dealt** in the shares of Pro-Toys Ltd and subsequently sold his shares at a profit. Give a summary of the law and the definitions relevant to this offence. Apply the law and come to a conclusion.

Note that if you encounter a similar question in an examination, you will be awarded marks if you set out the legal principles correctly and show how you apply them to the facts, even if the conclusion you drew from the facts is not completely correct.