

DISCUSSION NOTES

Please note that these notes do not replace your study guide, textbook and prescribed articles. It is merely there to assist you in your revision. It highlights some of the important parts of the work.

Study unit 1: Legal personality and lifting of the veil

Once a company is incorporated and a **certificate of incorporation is issued**, it is a separate legal entity distinct from its members. It can enter into contracts in its own name and sue and be sued. Its members are not liable for its debts and enjoy limited liability.

Separate legal personality:

Salomon v Salomon & Co Ltd:

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 Only those who are appointed as representatives of the company in accordance with the articles (which has been replaced by the Memorandum of Incorporation) can bind the company.

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

QUESTIONS FOR DISCUSSION:

- When does a company acquire legal personality?

- With reference to case law explain the meaning and effects of separate legal personality.
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Piercing the corporate veil/ disregarding separate juristic personality:

- In certain cases the courts have disregarded the separate legal personality of a company in order to recognize the substance or practical realities of a situation rather than the form.

Innes CJ in *Dadoo Ltd and others v Krugersdorp Municipal Council* at 550/1 held the following: “...This conception of the existence of a company as a separate entity distinct from its shareholders is no merely artificial and technical thing. It is a matter of substance; ... cases may arise concerning the existence or attributes which in the nature of things cannot be associated with a purely legal persona. And then it may be necessary to look behind the company and pay regard to the personality of the shareholders, who compose it.”

Before the codification of the principle of disregard of a company's separate existence by the Companies Act of 2008, this matter was regulated by the common law and referred to as “**lifting**” or “**piercing**” the corporate veil. The courts used it to place limitations on the principle of separate legal personality in order to avoid abuse

- ‘**Piercing the corporate veil**’ refers to those **exceptional circumstances** where the court **ignores the separate legal existence of the company** and treats the shareholders as if they were the owners of the assets and had conducted the business of the company in their personal capacities OR attributes certain rights or obligations of the shareholders to the company.
- There are no hard and fast rules regarding the lifting of the corporate veil.

Botha v Van Niekerk:

- The seller must have suffered an “unconscionable injustice” before the court could lift the veil.

Cape Pacific:

- The court confirmed that it has no general discretion simply to disregard a company's separate legal personality.
- The separate legal personality of a company should not be easily ignored.
- However, circumstances do exist for example fraud, dishonesty or other improper conduct where it would be justifiable to pierce the corporate veil.
- *Botha v Van Niekerk* was too rigid.
- The court indicated that it would adopt a more flexible approach namely of taking all the facts of each case into consideration when determining if the veil should be pierced.
- A balance should also be struck between the need to persevere the separate legal identity of the company against policy considerations in favour of piercing the corporate veil. The veil could also be pierced in relation to a specific transaction.

Hülse-Reutter:

- Agreed that court has no general discretion simply to disregard a company's separate legal personality.
- The corporate veil would only be lifted if there was evidence of misuse or abuse of the distinction between the company and those who control it and this has enabled those who control the company to gain an unfair advantage
- Therefore a dual test was introduced: by adding the element of unfair advantage.
- The court further confirmed that much depended on a close analysis of the facts of each case and considerations of policy.

Die Dros (Pty) Ltd and another v Telefon Beverages CC and others:

- Where fraud, dishonesty and other improper conduct is present, the need to preserve the separate legal personality of a company must be balanced against policy considerations favouring piercing the corporate veil.

Le'Bergo Fashions CC v Lee and another:

- The Court will pierce the corporate veil where a natural person, who is subject to a restraint of trade uses a close corporation or a company to front to engage in the activity that is prohibited by the agreement

The Companies Act 2008: Disregarding the separate legal personality of a company

Section 20(9) of the Companies Act 71 of 2008:

- The Companies Act 71 of 2008 follows the example of the Close Corporations Act by codifying the general principle of piercing the corporate veil.
- Section 20(9) of the Companies Act 71 of 2008 provides that if a court finds that the incorporation of a company or any act by or use of a company constitutes an **unconscionable abuse** of its juristic personality, the court may declare that the company will be deemed not to be a juristic person in respect of rights, liabilities and obligations relating to the abuse.
- The wording of the section is a combination of section 65 of the Close Corporations Act and the judgment in *Botha v Van Niekerk*.
- It ignores the view expressed in *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* that described the test in *Botha v van Niekerk* as too rigid.

We do now know what test will be used and it remains to be seen how the courts will decide what would constitute an unconscionable abuse and to what extent they will use the existing case law dealing with the common-law rule of piercing the corporate veil.

It therefore seems that there are still no hard and fast rules; no general discretion of the courts and that the fact of each case will still have to be taken into consideration when deciding whether to pierce the corporate veil.

QUESTION:

Under which circumstances will the separate legal existence of a company be disregarded? Refer to relevant authority in your answer.

Activity:

John operated a fast food establishment in Durban under a franchise agreement with McTucky's Ltd. In terms of the franchise agreement, John is not allowed to operate a similar business in the Durban area within three years after the end of the franchise agreement. John does not renew the franchise agreement when its term ends, but continues to operate a fast food restaurant from the same premises that he previously occupied.

McTucky's Ltd wants to institute an action against John for breach of the restraint of trade in the original franchise agreement. John's defence is that the new business is owned by a newly incorporated company, Macfries (Pty) Ltd, which was not a party to the original agreement. John is the sole shareholder and director of Macfries (Pty) Ltd.

Discuss the possibility that the courts may lift the corporate veil in these circumstances.

Study unit 2: Types of companies

The types of companies that are provided for in the Companies Act 71 of 2008 are:

1. Non-profit companies (NPC's) and
2. Profit companies

1. Profit Companies:

Profit companies can be divided into:

- Public companies (Ltd)
- Private companies (Pty) Ltd
- Personal liability companies (Inc) and
- State-owned companies (SOC)

Exercise:

- **Candy Ltd is a company.**
- **Rand Water SOC Ltd is a company.**
- **Front End (Pty) Ltd is a company.**
- **Dandala and Associates Inc is a company.**
- **Estcourt View Home Owners' Association NPC is a company.**

Characteristics of companies recognised in terms of the Companies Act 2008:

71 of

A public company ('Ltd')

- Shares may be offered to the public and are freely transferable;
- This company can be listed on the JSE Limited;
- Can be formed by 1 person
- Must have at least 3 directors
- Obligated to hold annual general meetings
- Obligated to appoint an auditor
- Obligated to appoint a company secretary
- Obligated to appoint an audit committee

A state-owned company ('SOC Ltd')

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

A personal liability company ('Inc'/'Incorporated')

- Must meet the criteria for a private company, mainly used by professional associations (such as attorneys);
- Memorandum of Incorporation must state that it is a personal liability company
- Directors are jointly and severally liable along with the company for debts and liabilities contracted during their term of office. Section 19(3) uses the word “contracted” and not “incurred”, which was held by the court in *Fundtrust (Pty) Ltd (In Liquidation) v Van Deventer* to limit directors’ liability to contractual debts, and to exclude delictual and statutory liabilities.

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

- Can be formed by 1 person
- Must have at least 1 director
- The doctrine of constructive notice applies in terms of section 19(5) of the Companies Act.

A private company (‘(Pty) Ltd’)

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

In terms of section 8(2)(b) of the Companies Act 71 of 2008, a private company’s Memorandum of Incorporation must contain a prohibition against offering of its securities to the public and restrict the transferability of its securities.

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

2. Non-profit companies (‘NPC’)

A non-profit company is a company that is not formed with the aim of making a profit for its members (note that a non-profit company has members and not shareholders like profit companies). Its objects must relate to social activities, public benefits, cultural activities or group interests. A non-profit company must be formed by at least 3 persons who will be the company's first directors. It must have at least 3 directors, but they are not allowed to obtain any financial gain from the company other than remuneration for the work they performed. A non-profit company does not have to have members. If these companies have members, some members may enjoy voting rights while others may not. The income and property of non-profit companies are not distributable to its incorporators, members, directors, officers or persons related to any of them. Upon liquidation, income and assets must be paid over to another non-profit company, voluntary association or trust with a similar purpose.

QUESTIONS:

- Name and briefly indicate distinguishing characteristics of the profit companies recognised in terms of the Companies Act 71 of 2008.
 - What are the requirements that must be adhered to by a non-profit company?
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Study unit 3: Company formation

Important documents relevant for company formation:

- Notice of incorporation
- Memorandum of incorporation
- Registration certificate

Documents that organise the running of a company:

- Memorandum of incorporation and the Rules

The Memorandum of incorporation:

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

- Details of Incorporators
- Number of directors and alternate directors
- Share capital (maximum issued)
- Content of Memorandum of Incorporation

Alterable and unalterable provisions of the Memorandum of Incorporation

The Companies Act imposes certain specific requirements on the content of a Memorandum of Incorporation, as necessary to protect the interests of shareholders in the company. A number of default company rules or alterable provisions are provided for. Companies may accept or alter the following alterable provisions as long as the alteration remains consistent with the Companies Act.

- The Memorandum of Incorporation is the sole formal constitutive document
- The Memorandum of Incorporation must be lodged, at the Commission, before registration of the company together with the **Notice of Incorporation**
- In case of an inconsistency between the Memorandum of Incorporation and the Companies Act, the Memorandum of Incorporation will be invalid to the extent of its inconsistency.

'Ring-fenced companies' (section 15(2)(b) and (c)):-

Section 15(2)(b) provides that the Memorandum of Incorporation of a company may contain special conditions applicable to the company and requirements in addition to those stipulated in the Act, for the amendment of such conditions. Section 15(2)(c) also allows the Memorandum of Incorporation to prohibit the amendment of any particular provision in the Memorandum of Incorporation. If the Memorandum of Incorporation of a company contains the provisions allowed by section 15 (2)(b) or (c), the name of the company must be followed by the expression "(RF)". This is an abbreviation for the words "ring fencing" and is intended to warn outsiders dealing with the company that there are special conditions contained in the Memorandum which they should check. The Notice of Incorporation filed by the company must also contain a prominent statement drawing attention to each such provision and where it is located in the Memorandum of Incorporation (section 13(3)).

THUS:

RF follows the name of these companies. It is an important principle for representation of companies. An RF-company is one of the circumstances where a third party would be deemed to know the restrictions in the Memorandum of Incorporation. The other exception to the rule that a company is no longer subject to the doctrine of constructive notice is in case of **personal liability companies**.

Procedure for the Amendment of the Memorandum of Incorporation:

The amendment may be proposed by:

- Board of directors
- Shareholders with at least 10% of the exercisable voting rights
- As required by Memorandum of Incorporation
- Amendment must be adopted by special resolution (no need to convene a shareholders' meeting).

The rules:

- Adopted by the board of directors
- Must be ratified by an ordinary resolution of the shareholders' meeting
- Subordinate to Memorandum of Incorporation

Companies Act, Memorandum of Incorporation and company rules:

Unless the Memorandum of incorporation provides otherwise, the board of directors may make, amend or repeal any necessary or incidental rules relating to the governance of the company in respect of matters not addressed in the Companies Act or the Memorandum of incorporation.

A rule must be consistent with the Companies Act and the Memorandum of Incorporation, failing which it will be void to the extent of the inconsistency.

If there are contradictions between the Companies Act 71 of 2008 and the Memorandum of Incorporation, the provisions contained in the Companies Act will enjoy preference.

In other words, the order of preference is as follows:

- (1) Companies Act 71 of 2008
- (2) Memorandum of Incorporation
- (3) Rules

The Memorandum of Incorporation and rules are binding/ creates a contractual relationship:

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

- Which documents must be lodged with the Companies and Intellectual Property Commission to register a company?
 - What is the sole constitutive document in companies called?
 - Explain the meaning and effect if 'RF' follows a company's name.
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Activity:

Mandla is a member of a close corporation that intends to enter into a contract with Monri (Pty) Ltd. He has just found out that the company's rules are contained in the Memorandum of Incorporation as well as in the Rules of the Board of Directors. This worries him. Upon hearing that you are an LLB student he approaches you and asks you to advise him about the following:

- a) The legal status of the Memorandum of incorporation and the Rules of the Board of Directors.
- b) What happens if a provision in the Rules of the Board of Directors is inconsistent with the Memorandum of Incorporation?

Advise Mandla accordingly.

Pre-incorporation contracts:

- Contract concluded obo of company that is not yet registered
- Intention of person concluding the contract is to hold company liable once company comes into existence
- Common law agency impossible – non-existent principle

Formal requirements that must be adhered to in order to conclude a valid pre-incorporation contract in terms of the Companies Act 71 of 2008**Section 21: Pre-incorporation Contracts**

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

Liability under pre-incorporation contract concluded in terms of section 21 of the Companies Act 71 of 2008:

- If nothing is done (company neither rejects the contract nor adopts it) deemed to be adopted after 3 months
 - If partly rejected, person who contracted will be liable for rejected part
 - If totally rejected, person who contracted will be liable for the entire contract
 - If ratified by the company, company liable
- If the person who concludes the contract is held liable, he or she only has a claim for counter performance in terms of the agreement.

Activity:

Jack enters into a lease agreement with Mpfari on behalf of a yet to be incorporated company.

- What is required in terms of section 21 of the Companies Act for the contract to be binding against the company when it is incorporated?
- Who will be liable if the company is not incorporated?
- Who will be liable if the company only ratifies the agreement partially?

Registration of company names:

In order to reserve a name a form CoR 9.1 must be completed and a filing fee is payable.

There has been a reform in the criteria for acceptance of names to give maximum effect to the constitutional right to freedom of expression.

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

- Protect the public from misleading names which falsely imply an associate that does not exist;
- Protect the interest of the owners of names and other forms of intellectual property (such as trade marks) from other persons passing themselves off, or coat-tailing, on the owner's reputation and good standing; and
- Protect the public from names that would fall within the ambit of expression that does not enjoy constitutional protection because of its harmful or other negative nature.

To avoid deception of the public, the name of a company may not:

- be the same as the name of another company, external company, close corporation or cooperative; or the name of a business which has already been registered in terms of the Business Names Act 27 of 1960; or a trademark which has been filed for registration in terms of the Trade Marks Act 194 of 1993; or a mark, word or expression protected in terms of the Merchandise Marks Act of 1941;;
- be confusingly similar to a name, trade mark, mark, word or expression as described above (subject to a few specific exceptions);
- give the false impression that the company is associated with the government, or with a particular person or government office etcetera; and

- may not include any word, expression or symbol that may constitute propaganda for war, incitement of imminent violence or advocacy of hatred based on race, ethnicity, gender or religion, or incitement to cause harm.
- The Companies Act does not make provision for the registration of a shortened or translated name.
- A name reservation in a foreign language must be accompanied by a certified translation and certificate of translation.
- In terms of the **Consumer Protection Act 68 of 2008** members of the public are required to register their business / trading name / sole proprietorship / partnership names with the Commission.
- Where, according to the Commission, there is a possibility that the name is similar to the name of another company or another business undertaking or trade mark or that the name gives an impression that there is a connection between the company that is applying and another entity or state organ, the Commission may compel the applicant to inform parties that may be interested by serving them with a copy of the application and name reservation. If the company's name is to be associated with another existing business, the Commission will require proof from the applicant company that the associated company was thus made aware before registration of a similar name is to be allowed.
- The Companies Act also allows any person who has an interest in the name of a company to apply to the Companies Tribunal for it to determine whether or not the name is in accordance with the requirements of the Companies Act.

- In *Peregrine Group (Pty) Ltd & others v Peregrine Holdings Ltd & others* the seven applicant companies and eleven respondent companies were all registered under names with the word 'Peregrine' as the first and dominant word. The applicants sought an order directing the first to eighth respondents to change their names by excluding the word 'Peregrine' and restraining them from passing off their businesses as that of or associated in the course of trade with that of the applicant.
- The Registrar of Companies (who was also a respondent) stated that he did not, as a matter of principle, 'allow the monopoly of an ordinary generic word'. He had thus permitted the registration of no fewer than 29 entities bearing some designation of the name 'Peregrine'.
- The court looked at the activities the companies engaged in to decide whether the similarity in the names would cause confusion. In addition the client bases of the two companies were considered to see whether there is an overlap.

- A court may direct a company to change its name if the name is undesirable and calculated to cause damage to the applicant.
- It was held that the court enjoyed wide discretion to hold that a company's name is undesirable. Where the names of companies are the same or substantially similar and where there is a likelihood that members of the public would be confused in their dealings with the competing parties, these would be important factors to be taken into account in deciding whether or not a name was undesirable. However, the mere fact that the names of companies are the same or similar is not a conclusive factor in determining whether or not a name is objectionable.
- The court also considered whether or not 'Peregrine' could be described as generic or descriptive of the services they offered. If so, the name could be subject to a monopoly. The court however held that 'Peregrine' is an ordinary English word with no secondary meaning that could be associated with the companies' functions.
- In determining whether or not there was a likelihood of confusion which would have the effect of deceiving or misleading the public, the type (degree of sophistication) of customer catered for by the businesses of the respective parties and the extent and ambit of the competing activities of the two groups had to be considered. In this latter regard the absence of a common field of endeavour was not conclusive.
- The date of registration of the companies would also play a role. The company who registered the name first would enjoy preference over companies who later changed their names.
- In order to prove passing off, it has to be proven that the applicant had acquired a reputation in the services which it offered with the name and that the respondent had made a representation which would lead members of the public to associate the respondent's business with the applicant's.

Questions asked in order to ascertain whether or not a name is offensive/objectionable:

- Do objector and company have similar businesses?
- How sophisticated are their clients?

Activity:

Suppose John, who previously was a franchisee of McTucky's Ltd, wants to incorporate a company with the name MacTuckies Ltd. The new company will run substantially the same business as McTucky's Ltd. Consider whether McTucky's Ltd has grounds to object to the registration of the name.

Study unit 4: Capacity and representation

Legal Capacity and Power of Companies:

- **Section 19(1)(b)** of the Companies Act of 2008 states that a company has all the legal capacity and the powers of an individual except to the extent that a juristic person is incapable of exercising any such power, for instance the capacity to enter into a marriage. The company's Memorandum may impose additional restrictions on the company's capacity. The capacity of a company is therefore no longer limited by its main or ancillary objects or business and these need not even be stated in the Memorandum of Incorporation.
- **Section 20** of the Companies Act 71 of 2008 determines that no transaction is invalid solely because it exceeds the company's capacity.
- Shareholders may ratify transaction that breaches a limitation, restriction or qualification by special resolution (s 20(2))
- Shareholders, directors or prescribed officers may restrain a company from doing anything inconsistent with limitations, restrictions or qualifications, but
 - May not prejudice the rights of third parties who contracted in good faith; and
 - Without actual knowledge of the limitation, restriction or qualification.
- Shareholders have a claim for damages against anyone who intentionally, fraudulently or due to gross negligence causes the company to act inconsistent with the Act or a limitation, restriction or qualification of capacity (see s 20(6)), unless ratified by the general meeting (see s 20(2)).

Activity:

The Memorandum of incorporation of ToyZ Ltd state that the main business of the company is to sell toys. Suppose that the board of directors of ToyZ Ltd decides to buy a luxury yacht on behalf of the company.

- Is this a valid transaction?

- Would your answer differ if the Memorandum of incorporation of ToyZ Ltd stated that the company only has the capacity to sell toys?
- How will it affect your answer if the seller of the yacht was aware of the limitation in capacity of the company?

Representation:

Authority may be actual, implied or ostensible

Sources of actual authority:

- Memorandum of Incorporation
- Rules
- Express or implied mandate

Ostensible authority:

In terms of ostensible authority a company may be liable to a *bona fide* third party if it is represented by someone who does not have actual authority, but the company allows such a person to represent the company as if that person did have authority.

Doctrine of constructive notice –

A person dealing with company is deemed to know the content of the company's registered documents.

Section 19(4) of the Companies Act 2008 abolishes doctrine of constructive notice, except:

- Person is deemed to have knowledge of special conditions in RF company
- For purposes of personal liability companies

The *Turquand* rule –

Common law Turquand rule:

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

The *Turquand* rule was formulated to keep an outsider's duty to inquire into the affairs of the company within reasonable bounds.

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

In Wolpert v Uitzigt Properties (Pty) Ltd the articles of the company provided that the board of directors could authorise a person to sign promissory notes on its behalf. Therefore, the board could authorise anyone to sign promissory notes on its behalf. One of the company's ordinary directors signed promissory notes 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 to sign the notes, but not that a specific person was authorised.

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* the court held 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 grounds that the person had no authority.

- **Section 20(7) of the Companies Act 71 of 2008:**

Section 20(7) of the Companies Act 71 of 2008 now contains a provision that in some respects resembles the *Turquand* rule by providing that a person dealing with a

company in good faith is entitled to presume that the company, in making any decision in the exercise of its powers, has complied with all the **formal and procedural requirements** in terms of the Act, the company's Memorandum of Incorporation and any rules of the company, unless the person knew or reasonably ought to have known of any failure by the company to comply with any such requirement. However, this provision does not replace the *Turquand* rule because section 20(8) provides that subsection (7) must be interpreted concurrently with, and not in substitution for any relevant common-law principle relating to the presumed validity of the actions of a company.

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

- E.g. Company A's Memorandum of Incorporation determines that the board of directors has authority to conclude all contracts on behalf of the company. If the amount of the transaction exceeds R50 000, consent must be obtained from the shareholders in general meeting.

- The underlined part in the block above contains an internal requirement. Even though the Memorandum of Incorporation is registered and available to the public, a third party contracting with the company would have to do further investigation to ascertain whether or not consent was obtained from the shareholders.
- The *Turquand* rule makes this unnecessary as in terms of this rule, third parties who act in good faith may assume that such internal requirement has been complied with.

- *Practical effect of Turquand rule:*

A company cannot escape liability under an otherwise valid contract on the ground that some internal formality or procedure was not complied with.

- The *Turquand* Rule does not protect:
 - Directors, prescribed officers or shareholders
 - A third party who has relied on a forged document

Activity

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

Mr Buckley, one of the directors, is authorised by the board of directors to act on behalf of the company. Mr Buckley concludes a 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. He however assumes that the approval of the general meeting has been obtained since it had always been obtained for previous transactions.

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

The Doctrine of Estoppel -

Company will be bound to a contract entered into by a person *without actual authority* if:

- There was a **misrepresentation** made by **the company** that the person had authority;
- The misrepresentation was intentional or negligent (fault required);
- The third party was induced by the misrepresentation to deal with the purported agent;
- The third party suffered prejudice due to the misrepresentation.

In *Freeman and Lockyer v Buckhurst Part Properties (Mangal) Ltd* the court decided that estoppel could not only arise from the articles, but also because the company with the full knowledge and approval allowed an ordinary director to act as the managing director and in this manner culpably represented that he was entitled to act.

Activity:

The rules of Concord Ceramics (Pty) Ltd (RF) provide that the board of directors have authority to deal on behalf of the company. The rules further provide that for any transaction of which the value exceeds R1 million the approval of the general meeting by way of a special resolution is required.

- Are third parties deemed to be aware that the consent of the general meeting is required for transactions in excess of R 1 million?
- To what extent is the doctrine of constructive notice still applicable to this company?
- Suppose that one of the directors enters into a contract in excess of R1 million without the approval of the general meeting. Will the company be bound to the contract?
- Suppose that Mike, a site manager on one of the company's plants, regularly contracts on behalf of the company without having a mandate to do so. The board of directors take note of this behaviour, but never take any steps to caution Mike against contracting on behalf of the company. Mike enters into a contract with Timothy for the purchase of raw materials. The company now argues that Mike did not have authority to enter into the contract and that it is not bound to the contract. Advise Timothy on whether the company can be held bound to the contract.

Study unit 5: Corporate finance, shares, debentures and distributions

Section 1 of 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." Shares are movable, transferable property without a nominal or par-value.

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 number of shares must be authorised in the Memorandum of Incorporation. 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 of directors may increase or decrease the authorised share capital. They may further reclassify any shares authorised but not issued.

In *Standard Bank of SA Ltd v Ocean Commodities Inc* the court held that a share usually entitles its holder to vote at a shareholders' meeting, to share in dividends if declared by the board and to share in any assets of the company after it has been wound up. It is therefore clear that there are personal rights attached to shares. The extent of these rights depends on the class of shares held.

Distinctions between shareholders and debenture holders:

- The shareholder of a company has the right to a share in the profits of a company (provided that a dividend is declared by the company) and a right to a share in the net assets of the company if it is wound up. However, a shareholder is also under a duty to abide by the company's Memorandum of Incorporation.
- As a debenture is a debt instrument, the holder of a debenture has effectively loaned a sum of money to the company on certain terms. Accordingly, the debenture holder is entitled to repayment of the sum of money loaned to the company and is therefore a creditor of the company.
- A debenture is a **document issued by a company acknowledging that it is indebted to the debenture holder in the amount stated therein** (*Coetzee v Rand Sporting Club* 1918 WLD 74)
- A debenture may be **secured** or **unsecured**.
- Debenture holders **may have a right to attend and vote at general meetings and to appoint directors**, and have **special privileges regarding the allotment of securities**, **unless** the Memorandum of incorporation provides otherwise

The procedure for the issue of shares prescribed by the Companies Act 2008:

- The power to issue shares is exercisable by the company's board of directors, not the shareholders of the company in general meeting.

- The directors may only issue new shares within the classes and to the extent that the company's MOI has authorised the shares.
- The board of directors may at any time resolve to issue new shares.
- If the issue of shares exceeds the authorised share capital of the company, the issue of the shares may be retrospectively authorised by amendment of the company's MOI by special resolution or, in appropriate cases, by the board itself.
- The issue of shares must be approved by the shareholders of the company by special resolution where the shares are issued to:
 - directors, including future directors, or to certain prescribed officers of the company;
 - a person related or interrelated to the company, or to a director or prescribed officer of the company; or
 - a nominee of any of the above persons.
- No special resolution is required where the issue is:
 - under an underwriting agreement;
 - in the exercise of pre-emptive rights;
 - in proportion to existing shareholdings and on the same terms and conditions as have been offered to all shareholders;
 - in pursuance of an employee share scheme;
 - in pursuance of an offer of shares to the public.
- Where further shares are issued in a transaction or series of integrated transactions, and the voting power of the new shares equals or exceeds 30 per cent of the voting power of all the shares of that class held before the new issue of shares, the issue must be approved by a special resolution.
- A company may not issue shares to itself.

“Right of pre-emption” in private companies.

- A right of pre-emption is a right conferred on shareholders in private companies to subscribe for new shares to be issued by the company in proportion to their voting power.

- Rights of pre-emption prevent the dilution of shareholding interests held by existing shareholders of the company and are therefore aimed at protecting such shareholders.

The solvency and liquidity test:

- The solvency and liquidity test set out in section 4 of the 2008 Act replaces the capital maintenance concept, which underpinned the 1973 Act.
- The solvency and liquidity test will play a crucial role in company distributions, share repurchases, financial assistance by a company for the purchase of its own shares, and financial assistance given by a company to its directors. The test will also play a role in mergers and acquisitions.

In terms of **section 4**, a company will satisfy the solvency and liquidity test if, considering all the reasonably foreseeable financial circumstances of the company at that time, both of the following conditions apply:

- The assets of the company, fairly valued, equal or exceed the liabilities of the company as fairly valued
- 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 date on which the test is considered, or, in the case of a distribution, 12 months following that distribution.

- Accordingly, the test aims to assess whether a company is in the financial position to pay out funds to shareholders, prospective purchasers of company shares and company directors.
- The test seeks to ascertain whether a company is solvent (it has more assets than debts), and whether it is reasonably foreseeable that it will have the ability to pay its debts as they become due over the next 12 months. Thus, the liquidity test is really an enquiry into the cash flow position of the company. Solvency does not necessarily imply liquidity, and vice versa.

Classes of shares:

Shares

Main features

<u>Ordinary shares</u>	<p>Constitute the equity share capital of the company</p> <p>The amount of the dividend paid fluctuates in accordance with the profits of the company</p>
<u>Preference shares</u>	<p> Holders enjoy preference over other classes of shares with regard to the payment of their dividends and sometimes to the return of capital on a winding up. The preferential dividend is usually fixed as a percentage of the nominal value of the shares</p>
<u>Cumulative preference shares</u>	<p> Holders enjoy a right of priority in respect of both arrear dividends and current dividends</p>
<u>Participating preference shares</u>	<p> Holders have a right to share on a <i>pro rata</i> basis together with ordinary shareholders in the distribution of surplus profits after the payment of their preferential dividend.</p>
<u>Preferential rights to refund of capital on winding-up</u>	<p> Holders enjoy a right to repayment of their capital in a winding-up with priority to ordinary shareholders</p>
<u>Convertible preference shares</u>	<p> Holders have the right to convert, usually after a given date, all or part of their preference shares into shares of another class</p>
<u>Deferred shares (founder's shares)</u>	<p> Issued to remunerate promoters of companies for their services in the formation and incorporation of companies</p> <p> Qualify for a dividend after a prescribed minimum dividend has been paid to ordinary shareholders</p>

Distributions (Payment of dividend, repurchase of shares by company/ debt/ waiver of debt)

Section 46 of the Companies Act regulates distributions. A distribution is any direct or

indirect transfer by a company of money or other property of the company (except its shares) to one or more of its shareholders or beneficial holders of shares, whether as the payment of dividends, payment for the purchase by a company of its previously issued shares, the incurrence of a debt for the benefit of one or more of the shareholders of the company, or the forgiveness of a debt owed to the company by one or more of the shareholders of the company.

A distribution may be made in the **following circumstances:**

- The board of directors must authorise the distribution.
- It must reasonably appear that the company will be able to satisfy the solvency and liquidity test immediately after the distribution has been made
- The board must acknowledge by way of a resolution that it has applied the solvency and liquidity test and reasonably concluded that the company will satisfy the test immediately after completion of the proposed distribution.

Activity:

Prosperity Ltd wants to decrease its share capital by a repurchase of shares.

- Advise the board of directors of Prosperity Ltd of the requirements before they may proceed with this transaction.

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

Financial assistance:

- One must determine whether a transaction is financial assistance. If it is not, section 44 is not applicable - Take careful note of the *Lipschitz* decision (Impoverishment test (*Gradwell*), exposure to risk, purpose of acquiring shares in the company)

Section 44 of the Companies Act 71 of 2008:

Requirements for financial assistance:

In terms of section 44 of the Companies Act a company may give financial assistance by way of a loan, guarantee, provision of security or otherwise to a person for the purpose of or in connection with the acquisition of shares and other securities in the company, provided that such assistance is not prohibited by the Memorandum of Incorporation and that certain requirements are met.

- Assistance may be given to two categories of persons:
 - In terms of an **employee share scheme**; OR
 - If the shareholders **by way of a special resolution** have agreed that specific persons or persons falling in a specific class of persons may be assisted to acquire shares in the company
- Persons must then fall in the class of persons
- Board must authorise provision of financial assistance
- Resolution of the board to provide financial assistance must be within two years of the shareholders' resolution

Before financial assistance is given, the board must be satisfied that:

- The solvency and liquidity criteria have been met
- That the assistance is provided in terms that are fair and reasonable to the company.
- It is possible to include restrictions on financial assistance in the Memorandum of Incorporation, or to include extra qualifications of persons that may be assisted
- The board must ensure that such restrictions or limitations have been complied with before extending financial assistance.

Activity:

Vusi, a shareholder and director of Securities (Pty) Ltd agrees to sell his shares in the company to Jonathan for R20 000. To enable Jonathan to acquire the shares, Securities (Pty) Ltd agrees to lend Jonathan the sum of R20 000.

Explain whether this transaction amounts to financial assistance and if so, what requirements have to be satisfied in order for it to be a valid transaction.

Study Unit 6: Shareholders and company meetings

Corporate decision making:

- The majority makes the decisions in companies.
- General rule: corporate decisions are to be taken at properly constituted meetings of the company and not by separately obtaining the individual assent of members.
- The courts however, recognise that a company can perform certain acts validly without any meeting being held, provided that all members were **fully aware** of what was being done and **unanimously assented** thereto (*Gohlke and Schneider v Westies Minerals (Pty) Ltd* and *In re Duomatic*)
- **Section 60** of the Companies Act 2008: unanimous assent unnecessary. A decision may be taken by the required majority of shareholders in writing. This does not apply in matters which must be decided upon at an AGM.
- 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 a special resolution.

Matters to be decided upon at the annual general meeting:

Section 61(8) of the Companies Act 71 of 2008 stipulates that at least the following matters must be transacted at the Annual General Meeting:

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

Activity:

Bongi and Zandile each hold 50% of the shares in Monateness (Pty) Ltd. They are also the only two directors of the company. Monateness (Pty) Ltd's Memorandum of Incorporation provides that the company in general meeting may declare final dividends and that no dividend may exceed the amount recommended by the directors. At a meeting of the board of directors, Bongi and Zandile agree that the company must declare a dividend of 25 cents per share. The dividend is paid out to them without a general meeting being held to formally declare the dividend. Was the declaration of the dividend valid? Refer to relevant case law in your answer.

Section 62: Notice requirements:

- In writing
- Must indicate date, time and place
- Must indicate purpose of the meeting
- Indicate that shareholder is entitled to appoint a proxy
- Must include a copy of any proposed resolution

- Must be given at least **10 days prior to the meeting (15 days for public companies and non-profit companies with members)**

If there has been a material defect in the giving of notice, the meeting may proceed only if every person who is entitled to vote in respect of any item on the agenda are present at the meeting, and votes to approve the ratification of ratify the defective notice.

Quorum:

Presence at meeting of holders of at least 25% of the shares entitled to be voted in respect of at least one matter

If quorum is not achieved within 1 hour, meeting must be postponed for a week.

Resolutions:

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

Proxies:

- Shareholder may appoint proxy to act on his/ her behalf.
- Appointment must be in writing, dated and signed by shareholder.
- A proxy can remain valid for a maximum of one year from date of signature.

Postponement/ Adjournment of meetings:

- A meeting may be postponed or adjourned for one week if, within one hour after the appointed time for a meeting to begin, a quorum is not present
- Where a quorum is not present at the postponed or adjourned meeting, those present in person or by proxy will be deemed to constitute a quorum

- A meeting may be adjourned from time to time without further notice on a motion supported by a majority of the voting rights held by all those present at the meeting.

Activity:

The board of directors of Zithulele (Pty) Ltd convened a meeting to be held on 26 February 2011. Mr Ngcobo a shareholder of Zithulele (Pty) Ltd was given a notice dated 19 February 2011, 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.

Study Unit 7: Directors and directors committees:

- **Section 66(1)** of the Companies Act 71 of 2008 provides that '[t]he 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.'

Companies are obliged to have directors:

- Public and non-profit companies – at least 3
- Private and personal liability companies – at least 1
- Memorandum of Incorporation may provide for a higher number.
- The prescribed minimum number of directors stated above is **in addition** to the minimum number of directors that a company must have to satisfy any requirement in the Act or its Memorandum to appoint an audit committee or a social and ethics committee

Where a company does not have the prescribed number of directors any act done by the board or the company will nevertheless remain valid

Vacancies on the board of directors:

A vacancy will arise on the board of a company if a director's term of appointment expires, the director resigns, dies, he or she ceases to hold the position which entitles him or her to be an *ex officio* director or is unable to perform his or her duties as director, is declared delinquent or placed under probation, becomes ineligible or disqualified or is removed from office.

In *Rosebank Television & Appliance Co (Pty) Ltd v Orbit Sales Corporation (Pty) Ltd* the court confirmed that a resignation becomes effective once it has been communicated to a company irrespective of whether it was only later accepted.

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 Companies Act 71 of 2008.

Types of Directors:**Types of directors recognised by King Code:**

- Executive directors
- Non-executive directors
- Independent directors

(NB! Note what the court held in *Howard v Herrigel* regarding the distinction between executive and non-executive directors.)

Types of directors recognised by Companies Act, 2008:

- *Ex officio* director
- MOI-appointed director
- Alternate director
- Elected director
- Temporary director

Shareholders must elect **at least 50%** of the directors of a profit company. The rest of the directors can hold office either because they have also been elected by the shareholders, or for one of the following four reasons:

- A director can hold the office of director because he holds another office. E.g. the MOI can provide that any person who is appointed as legal adviser of the company will also be a director of the company. In such case a person appointed as legal adviser will automatically be a director – an ex officio director.
- A director can hold the office of director because he was appointed by name in the MOI or because he was appointed by someone who was given the authority in the MOI to appoint a director - MOI-appointed director.
- A director can hold the office of director because he is an alternate director. Depending on the MOI, these directors may either be appointed by the board or elected by the shareholders, but at least 50% of the alternate directors must be elected by the shareholders.
- A director can hold the office of director because he is a temporary director. Depending on the MOI, the board may appoint these directors.

Activity:

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

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

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

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

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

Disqualification to act as Directors:

Ineligible: ☹ (may never be) A person who is ineligible to be a director is absolutely prohibited from becoming a director

- There are no exceptions to the prohibition.

- Juristic person
- Unemancipated minor/ under legal disability
- Ineligible in terms of provisions of MOI

Disqualified: A disqualification from being a director is not absolute

- A court has discretion to permit a disqualified person to accept appointment as a director.

- Declared delinquent (the court's discretion is excluded here)
- Unrehabilitated insolvent
- Prohibited from being director i.t.o. public regulation
- Removed from office of trust for misconduct/ dishonesty
- Convicted of fraud, dishonesty, theft or a related offence
- Disqualified in terms of provisions of MOI

Ex Parte Barron:

- Court can 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

QUESTION:

Explain the difference between persons who are ineligible to be directors of a company and those who are disqualified from being directors of a company.

Section 162: Delinquency and probation:

A director may be declared delinquent or under probation in terms of s 162 of the Companies Act 2008

The Companies and Intellectual Property Commission must keep a public registry of persons who are subject to an order of the court in terms of this section

Delinquency:

Any one of the following may apply for a delinquency order:

- Company
- Shareholder
- Director
- Company secretary or prescribed officer
- Registered trade union or other employee representative

The **Commission or Take-over Regulation Panel or a state organ** may also under certain circumstances apply to declare a director delinquent.

Grounds:

- Served as a director or prescribed officer while ineligible or disqualified
- Acted as director while under probation in a manner that contravened order of probation

- Grossly abused position of director
- Took personal advantage of information or an opportunity
- Intentionally or by gross negligence inflicted harm to company or its subsidiary.
- Acted in a manner that amounts to gross negligence, willful misconduct or breach of trust
- Acted on behalf of the company while knowing he lacked authority to do so
- Allowed the carrying on of the company's business in a reckless or fraudulent manner despite knowing it was in contravention of section 22(1) or
- Was a party to an act or omission of the company despite knowing that it was intended to defraud a creditor, employee or shareholder of the company or had another fraudulent purpose
- Has repeatedly been subject to a compliance order (for example by the Commission or Takeover Regulation Panel) for substantially similar conduct
- Has at least twice been personally convicted of an offence or subjected to an administrative penalty in terms of any legislation
- Was a director of a company or managing member of a close corporation that was convicted of an offence or subject to an administrative penalty and the court is satisfied that the order is justified in the light of the offence and the person's role in the management of the company or corporation at the time.

Order:

If the delinquency order is based on the first two grounds listed above, the court **must** issue an unconditional delinquency order that will last for the lifetime of the person declared delinquent.

If based on one of the other grounds, the order must subsist for at least seven years, but may be for a longer period as determined by the court. The application of the order may also be limited to one or more particular types of companies. The order may furthermore include any other conditions that the court considers appropriate, including that the person must:

- Undergo remedial education
- Carry out a designated program of community service
- Pay compensation to any person who was negatively affected by this conduct and has no other legal basis on which to claim compensation

Probation:

Applicants:

- Company

- Shareholder
- Director
- Company secretary or prescribed officer
- Registered trade union or other employee representative

The **Commission or Take-over Regulation Panel** may also under certain circumstances bring an application.

Grounds for order:

A person may be placed under probation on one of the following grounds:

While serving as a director, the person

- was present at a meeting and failed to vote against a resolution despite the inability of the company to satisfy the solvency and liquidity test as required by the Act; or
- acted in a manner materially inconsistent with the duties of a director; or
- acted or supported a decision of the company to act in a way that had a result that was oppressive or unfairly prejudicial to a shareholder or another director, or that unfairly disregarded the interests of a shareholder or another director as described in section 163(1) if the court regards the order as justified in the circumstances; or
- Within any period of 10 years after the effective date the person has been a director of more than one company, or a managing member of more than one close corporation, irrespective whether concurrently, sequentially or at unrelated times; and during this time two or more of those companies or close corporations each failed to fully pay all of its creditors or meet all of its obligations, except in terms of a business rescue plan resulting from a resolution of the board placing the company in business rescue in terms of section 129 or a compromise in terms of section 155. Here also the court must be satisfied that the way in which the company or corporation was managed contributed to its failure to pay its debts and the declaration is justified having regard to the person's conduct.

Order:

A probation order may not subsist for a period of more than five years and may be limited in its application to one or more particular categories of companies. It may also be made subject to any other conditions the court considers appropriate such as that the person must:

- Undergo remedial education
- Carry out a designated program of community service

- Pay compensation to any person who was negatively affected by this conduct and has no other legal basis on which to claim compensation
- Be supervised by a mentor in any future participation as a director while the probation order is in force or may only serve as a director of a private company or a company of which he or she is the only shareholder.

QUESTION:

On what grounds can a person be declared a delinquent for the purposes of the Companies Act 71 of 2008?

Activity:

Cynthia is a director of Healthline (Pty) Ltd. Healthline has developed a new treatment for AIDS. Cynthia sold the formula to a scientist at AIDSCO (Pty) Ltd for R1 M. Healthline is very upset about this. Explain whether or not the company may take action against Cynthia in terms of section 162. In your answer refer to:

- The applicants
 - The grounds
 - The possible order
 - The effect of the order
-

Duties of Directors:

Fiduciary Duties:

- Directors stand in a fiduciary relationship to the company of which they are directors, even if they are non-executive directors. In *Cyberscene Ltd and others v i- Kiosk internet and information (Pty) Ltd*, it was confirmed that a director stands in a fiduciary relationship towards a company of which he is a director, even if he or she is a non-executive director.

- A director has a fiduciary duty towards the company to act *bona fide* and for the best interest of the company.
- He or she should therefore always avoid a conflict between his own interests and those of the company.
- This duty entails in principle that he or she may not for personal gain make use of any information which he acquired in his capacity as a director.
- If the company suffers a loss as a result of the director's breach of his fiduciary duty or if the director has benefited, the amount of that loss/ benefit can be recovered by the company and the transaction can be set aside.

Robinson v Randfontein Estates Gold Mining Co – Directors must avoid conflicts of interest.

Facts: *the company wanted to buy a farm, but couldn't come to an agreement with its owner. Robinson, the chairman of the board bought the farm in his own name for R120 000 and sold it to the company for a profit of R550 000*

AD held: *Robinson was not justified in making a profit from his office or placing himself in a position where his personal interests conflicted with his duties. He was ordered to repay the company the profit of R430 000 which he had made.*

The fiduciary relationship arises from the purpose for which a director is entrusted with his office.

Howard v Herrigel -

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.

Regal Hastings v Gulliver- Directors must avoid a conflict of interest. Previous director who has since resigned can be held liable for profits made in the course of his performance of duties in company.

It makes no difference if the profit is made in good faith with full disclosure and whether or not the company suffered any loss as a result of the director's actions.

Magnus Diamond Mining Syndicate v Macdonald & Hawthorne - Directors may not use information acquired in capacity as director for own personal benefit.

Industrial Development Consultants v Cooley - Directors may not use information acquired in their capacities as directors for their own personal benefit. Even where a person did not wish to contract with a specific company and then a contract is concluded with a director, such director could be held liable for profits as he/ she used information that he/ she gained in his/ her capacity as director for his/ her own benefit.

Facts: *the managing director, Cooley, tried to get a building contract for his company. The other party did not wish to do business with the company, but indicated they would do business with Cooley himself. Cooley resigned as MD and accepted work from the other party.*

Held: *Even though the other party was not prepared to contract with the company Cooley was held liable to pay the company all the profit he made in terms of the contract, because they were made as a result of information Cooley got in his capacity as a director.*

The court confirmed that a managing director might be in breach of the fiduciary duty owed to the company despite termination of his or her office and may be held liable to account to it for any profits he made as a result of information which he obtained in his capacity as its director

A director may not use the information that he acquired in his capacity as director for his own personal benefit (*Magnus Diamond Mining Syndicate v Macdonald & Hawthorne* (1909 ORC 65) and *Sibex Construction (SA) (Pty) Ltd v Injectaseal Ltd* (1988 2) SA 54 (T); *Atlas Organic Fertilizers v Pikkewyn Ghwano (Pty) Ltd* (1981 (2) SA 173 (T) 197))

Fiduciary Duties in terms of the Companies Act 71 of 2008: (ss 75 and 76)

Remember: The duties of directors contained in the Companies Act 71 of 2008 are subject to and **does not substitute their common law duties.**

- To disclose to the board any personal financial interest in matters of the company (s 75).
- 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 (s 76(2)(a)).
- To disclose to the board of directors any material information that comes to a director's attention (s 76(2)(b))
- To act in good faith and for a proper purpose (s 76 (3)(a)).
- To act in the best interests of the company (s 76 (3)(b)).
- To act with a reasonable degree of care, skill and diligence (s 76 (3)(c)).

Activity:

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

Advise Samson whether or not he acted in breach of his fiduciary duties to Tectronics (Pty) Ltd. Refer to relevant case law in your answer.

Duty to act with reasonable care and skill:

- Section **76(3)(c) (i) & (ii)** requires a director to exercise a degree of care, skill and diligence that may reasonably be expected of a person carrying out the same functions in relation to the company as those carried out by that director and having the general knowledge, skill and diligence of that director.

- The test to determine whether or not a director acted with the required degree of care and skill is objective with subjective elements.
- The extent of a 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.
- There is a difference between the full time director or executive director who participates in the day to day management of the company's affairs and the non-executive director who has not undertaken any special obligation.
- A director is not required to have special business acumen or expertise, or singular ability or intelligence or even experience in the business of the company.
- He or she is expected to exercise the care which can reasonably be expected of a person with his knowledge and experience.
- In respect of all duties that may properly be left to some other official, a director is, in the absence of specific grounds for suspicion, justified in trusting that official to perform such duties honestly. He or she is entitled to accept and rely on the judgement, information and advice of the management, unless there are proper reasons for questioning such. A director is therefore entitled to rely on the following persons:
 - One or more employees of the company whom the director reasonably believes to be reliable and competent in the functions performed
 - The information, opinions, reports or statements provided by legal counsel, accountants, or other professional persons retained by the company
 - The board or committee as to matters involving skills and expertise that the director reasonably believes are matters within the particular persons professional or competence or as to which the particular person merits confidence or a committee of the board of which the director is not a member, unless the director has a reason to believe that the actions of the committee do not merit confidence.

- Remedies against a breach of the duty of care and skill may be based on contract if a contract was concluded between the company and the director. Alternatively, a delictual claim for damages exists. In order to claim for delict, obviously all the requirements must be proven.
- **Section 77 (2) (a) and (b)** provides that a company may recover loss, damages or costs sustained by it from the directors in terms of the common law principles relating to breach of fiduciary duties or a breach of the duty to act with care and skill.
- **Section 77(3)(b)** further provides that a director may be held liable for any loss, damages or costs sustained by the company as a result consequence of the director having acquiesced in the carrying on of the company's business despite knowing that it was being conducted in a manner prohibited by section 22 (1).

Case Law:

In *Fisheries Development Corporation v Jorgensen*, it was held that:

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

The Business Judgment Rule (Section 76(4))

In any proceedings against a director, other than for wilful misconduct or wilful breach of trust, a court may relieve the director from liability if it appears to the court that the director has acted honestly and reasonably or it would be fair to excuse the director.

The Companies Act 71 of 2008 introduces the business judgment rule. 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.

NB! The Business Judgment Rule will only apply if the decision was taken in the presence of the director.

Activity:

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

- On what basis can the liquidator possibly hold the directors liable for the loss that the company had suffered?
- How will the court determine whether or not the directors are liable for the loss? Refer to relevant case law in your answer.
- Explain the defence that could possibly be raised by Tinyiko in terms of the Companies Act 71 of 2008 to avoid liability.

Study Unit 8: Auditors and Company secretaries

- The annual financial statements of public companies must be audited.

- Other companies must audit statements if required by regulation/ voluntarily.

Company Secretaries:

- The company secretary is the principal administrative officer of his or her company.
- Every **public company** or **state-owned company** must appoint a company secretary who is knowledgeable or experienced in the relevant laws.
- A private company, personal liability company or a non-profit company may voluntarily appoint a company secretary.

Disqualification to serve as company secretary

A person, who is disqualified in terms of section 69(8) to serve as a director of a company, may not be appointed as a company secretary. Briefly stated, a person is therefore disqualified from being appointed as a company secretary if such a person –

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

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

Duties:

- Provide directors with guidance about their duties, responsibilities and powers.
- Make directors aware of any law affecting the company.
- Report to the Board any failure on the part of the company or a director to comply with the Act.
- Keep minutes of shareholders' meetings, board meetings and committee meetings
- Certify the annual financial statements
- Ensure that a copy of the company's financial statements is sent to every person entitled to receive it.
- Carry out functions in respect of annual transparency and accountability report.

Auditors:

Auditor must be:

- A permanent resident of the RSA
- A registered auditor
- Independent

Appointment:

- Public companies and SOC must appoint an auditor upon incorporation and each year at the AGM.
- If no auditor is appointed upon registration the directors must appoint an auditor within 40 business days after the date of incorporation.
- The same individual may not serve as an auditor for more than 5 consecutive years. (Rotation requirement).
- If a person has served as an auditor for two or more years and then ceases to be the auditor, he or she may not be appointed again until the expiry of least 2 further financial years.

Rights of auditors:

- Access to accounting records, books and documents;
- Access to information regarding subsidiaries if the company is a holding company.
- To attend any general meeting of the company;
- To receive all notices and communications relating to a general meeting that members are entitled to receive;
- To be heard at any general meeting on any part of the business pertaining to his/ her duties or functions.

Resignation of auditor and casual vacancy:

- Resignation effective when notice is filed.
- Declares that no irregularities.
- Board must appoint a new auditor within 40 business days.
- The board must nominate a new auditor within 15 days to the audit committee.
- If the audit committee does not reject the proposal in writing within 5 business days, the board may appoint the nominated auditor.

Audit committee:

- **Section 94 of the Companies Act 71 of 2008** requires that at each annual general meeting, a **public company**, a **state-owned company** and any other company which has voluntarily decided to have an audit committee, must appoint an audit committee for every financial year.
- The audit committee must have at least **three members** and consist only of **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.

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

- Nominate and appoint a registered, independent auditor;
- Determine the fees to be paid to the auditor and the auditor's terms of engagement;
- Ensure that the appointment of the auditor complies with the Companies Act and other legislation;

- Determine the nature and extent of non-audit services that the auditor may provide or must not provide;
- Pre-approve any proposed agreement with the auditor for the provision of non-audit services;
- Prepare a report to be included in the annual financial statements describing how the audit committee carried out its functions, stating whether the committee is satisfied that the auditor was independent from the company and commenting in any way considered appropriate.
- Deal with complaints.
- Make submissions to the board on accounting policies, financial control, records and reporting;
- Perform other functions as determined by the board including development of policy to improve governance.
 - Consider whether the auditor's independence may have been prejudiced.
- Consider compliance with other criteria relating to independence or conflict of interest as prescribed by the Independent Regulatory Board for Auditors.

Liability of auditors:

- Auditors may incur civil liability to company (client) and third party.
- In respect of the company, an auditor may be held liable in terms of breach of contract or delict
- In respect of third parties, auditors may be held liable in terms of delict or incur statutory liability in terms of section 58 (2) of the Auditing Professions Act.

Study Unit 9: Remedies, Regulating Agencies and ADR.

- The Companies Act of 2008 provides for specific remedies for holders of securities.
- The MOI and rules form a contractual relationship. Therefore the contractual rights of parties will apply if there is a contravention of the MOI to the extent that the Companies Act does not expressly provide otherwise.
- Alternatives to formal dispute resolutions (ADR) include "voluntary" mediation, conciliation or arbitration.

Statutory remedies:**Against directors:**

Section 162 – declaring directors delinquent or placing directors under probation

Against the company:**(a) Section 20(2):****The applicant:**

- One or more shareholders
- Directors
- Prescribed officers

Grounds:

- If company does something in contravention with the Companies Act of 2008; or
- A person causes the company to do something inconsistent with the Act.

Effect:

- Any person who causes the contravention is liable to any other person (including shareholders) for the loss or damage suffered as a result of the contravention.
- Each shareholder has a claim for damages if a person causes the contravention against such a person

(b) Security Holders' declaratory order: (s 161)

- A securities holder may apply to a court for a declaratory order determining his or her rights or;
- Any order to protect his or her rights/ rectify harm done by the company or directors.

These remedies are not available to members of non-profit companies.

(c) Oppressive or prejudicial conduct or abuse of the separate juristic personality of the company: (Section 20(9))

Applicant:

- Shareholder or
- Director

Grounds:

- Any act/ omission of the company or a related person that is oppressive or unfairly prejudicial or unfairly disregards the interests of the applicant;
- The company's business is being carried on in a manner that is oppressive or unfairly prejudicial, or
- The powers of the directors of the company or related person are being or have been exercised in a manner which is oppressive or unfairly prejudicial to or unfairly disregards the interests of the applicant.

The order:

- The Court may restrain the conduct complained of;
- Appoint a liquidator if the company appears to be insolvent;
- Place the company under supervision and commencing business rescue proceedings;
- Regulating the company affairs by amending the MOI or amending a shareholders' agreement;
- Directing an issue or exchange of shares;
- Appointing directors in place of or in addition to all directors in office, or declaring any person delinquent or under probation;
- Directing the company or any other person to repay the consideration that the securities holder paid for shares with or without conditions;

- Varying or setting aside a transaction/ contract.
- Requiring the company to produce financial statements to the court or an interested person;
- To pay compensation to an aggrieved person;
- Directing rectification of the registers or records of the company or
- For the trial of any as determined by the court.
- If court finds that there has been an unconscionable abuse of the juristic personality of the company as a separate entity, the court may order that the company is to be deemed not to be a juristic person in respect of the rights, obligations or liabilities of the company, or of another person specified in the declaration. The court may give any order it deems fit.

(d) Dissenting securities holders' appraisal rights:

Section 164 of the Companies Act of 2008:

- Section 164 provides a remedy for dissenting shareholders who are aggrieved by the variation of class rights. This remedy only becomes available when the resolution which detracts the shareholders is taken and cannot be used before the adverse decision has been taken

Dissenting shareholder can make use of the appraisal remedy provided for in the Companies Act 2008:

- Where the company has adopted a special resolution to amend its MOI by altering the preferences, rights or other terms of any class of its shares in a manner that is materially adverse to the rights or interests of the holders of that class of shares.
- Where a company is considering adopting a resolution concerning the disposal of the greater part of the assets of the company.
- In circumstances where the company is considering merging or amalgamating with another corporate entity.
- Where a company is considering entering into a scheme of arrangement.

Procedure:

- Dissenting shareholders may send a written objection to the resolution of the company prior to the meeting.
- Within 10 business days after adoption of the resolution, the company must send a notice that the resolution has been adopted to each security holder who filed an objection and has not withdrawn the objection, or voted in favour of the resolution.
- The shareholder may then demand payment of a fair value for the shares held by him or her.
- The demand must be sent within 20 business days after receiving notice from the company that the resolution has been adopted or within 20 business days after learning that the resolution has been adopted if no notice is received.
- The company must then make a written offer to pay an amount considered by the company's directors to be a fair value, accompanied by a statement showing how the value was determined within 5 business days.
- The offer made by the company to dissenting shareholders must all be on the same terms.
- The offer must be accepted within 30 business days after it was made.
- The company must pay the agreed amount within 10 business days after the shareholder accepted the offer and tendered the share certificates or transferred the shares to the company or the company's transfer agent.
- If the company fails to make an offer or the offer is considered to be inadequate the shareholder may apply to court to determine a fair value and for an order requiring the company to pay the shareholder that fair value.
- If compliance with a court order would result in a company being unable to pay its debts as they fall due and payable for the next 12 months, the company may apply to court for an order varying its obligations.

On behalf of the company:**Derivative actions:**

Although a company is a separate legal entity and should therefore itself act if it has been wronged, this will not always be possible, particularly when the wrongful action has been committed or is supported by persons holding the majority of the votes in the company. Our company law has thus always accepted that in some circumstances the minority should be able to act on behalf of the company (i.e. deriving the right of action from the company's right to act) to redress wrongs done to the company if the company cannot or will not do so itself.

The derivative action in terms of section 165 of the Companies Act of 2008 replaces the statutory derivative action found in section 266 of the 1973 Act. Note that whereas the statutory derivative action in terms of the Companies Act of 1973 co-existed with the common-law action and offered an alternative remedy to the common law, section 165 of the Companies Act of 2008 has now abolished the common-law action. Section 165 is thus the only derivative action available to a person who wishes to act on behalf of the company.

Section 165:

Section 165 abolishes any right at common law of a person other than a company to bring or prosecute any legal proceedings on behalf of that company.

Demand (notice) to company:

A person can deliver a notice to a company demanding it to institute legal proceedings or take other steps to protect the company's legal interests.

Who can deliver demand?

- a shareholder/ person entitled to be registered as a shareholder;
- a director
- a prescribed officer;

- a registered trade union that represents employees, or another representative of the employees;
- or any person who is granted leave by the court to do so.
- The company may apply to court within 15 days to have the demand set aside if it is frivolous, vexatious or without merit.
- If demand is not set aside, the company must appoint an independent person or committee to investigate the demand.
- This person or committee must report to the board.
- Within 60 days (or as long a court permits) action must be instituted or a refusal notice must be served on the person who made the demand.

The person who made the demand may apply to the court for leave to continue with proceedings in the name of or on behalf of the company if:

- The company failed to take steps as required;
- The company appointed a person or committee who is not independent;
- The company accepted an inadequate report
- The company acted in a way inconsistent with the reasonable report of an independent, impartial investigator or
- The company has served a refusal notice.

QUESTIONS:

Give an example of a remedy provided by the Companies Act 2008:

- a. Against directors who have abused their position.
- b. To enable shareholders to protect their rights.
- c. To prevent the abuse of the separate juristic personality of the company.

Alternative Dispute resolution:

- Alternative dispute resolution is dealt with in Part C of Chapter 7 of the Companies Act 71 of 2008.
- If a dispute was resolved through ADR, the parties can submit the order to a court to be confirmed as a court order.

Alternative remedies to criminal actions:

The Companies Act 71 of 2008 seeks, where appropriate, to replace criminal offences with civil penalties. Examples of ways in which the Companies Act 71 of 2008 imposes civil penalties on persons have contravened its provisions are:

- The Companies and Intellectual Property Commission can issue compliance notices to companies and individuals.
- The Companies and Intellectual Property Commission can levy an administrative fine in certain circumstances.
- Application can be made for a court order to ensure compliance in certain instances.
- Application can be made to declare a director delinquent or under probation.
- Defaulting directors and certain other persons may be personally liable in certain circumstances.
- A number of provisions give rights to shareholders and other stakeholders.

The Companies and Intellectual Property Commission:

The body that is normally responsible for the enforcement of the Companies Act is the Companies and Intellectual Property Commission.

The Commission must monitor proper compliance with the Companies Act, investigate complaints concerning contraventions of the Act, promote the use of ADR by companies for resolving internal disputes, keep a Companies Register and advise the Minister on changes to the law.

The Commission plays a central role in the enforcement of the Companies Act 71 of 2008. Any person may file a complaint with the Commission. The Commission may also initiate complaints on its own motion or at the request of another regulatory authority. The commission may respond to complaints in different ways.

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

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

The role of the Companies and Intellectual Property Commission and the Tribunal:

The Companies and Intellectual Property Commission has a broad range of objectives and functions. One of its most important functions is receiving complaints regarding alleged contraventions of the Companies Act 71 of 2008, a particular company's Memorandum of Incorporation or the rules of a company. Once it has received a complaint regarding an alleged contravention of the Companies Act 71 of 2008, the Commission must decide whether or not to issue a **compliance notice** in respect of that complaint. It will decide whether or not to issue such a notice after conducting an **investigation** into the complaint. However, the Commission has other objects and functions, including **promoting the use of alternative dispute resolution ("ADR")** procedures by companies in resolving internal disputes, **promoting the reliability of financial statements, establishing a register of companies, advising the Minister Finance** on company law matters, **issuing guidance** to the public regarding the 2008 Act, and **carrying out research** relevant to the Companies Act 71 of 2008.

The **Tribunal** is tasked with resolving disputes that may arise in connection with the Companies Act 71 of 2008. In terms of section 156(b), a person seeking to **address an alleged contravention** of the Companies Act 71 of 2008 or to **enforce rights under the Act**, or under a company's Memorandum of Incorporation or rules, has the

option of applying to the Tribunal for **adjudication**. The Tribunal also has a role in resolving disputes referred to it in terms of the ADR provisions of the Companies Act 71 of 2008. The Tribunal also has other functions assigned to it such as resolving **disputes concerning company names** (sections 160 and 17(2)).

Complaints to the Companies and Intellectual Property Commission or the Take-over Regulation Panel:

Any person may lodge a complaint if a person has acted in a manner inconsistent with the Companies Act or has acted in a way that infringes the rights of the complainant.

If the Companies and Intellectual Property Commission or Take-over regulation panel receives a complaint it can:

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

Powers of the Companies and Intellectual Properties Commission and the Take-over Regulation Panel:

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

- Excuse any person as a respondent;
- Refer the complaint to the Companies Tribunal, or CIPC or TPR (as the case may be)
- Issue a notice of non-referral, with a statement advising the complainant of any rights he or she may have to seek a remedy in court;
- The CIPC can propose that the person meets with the Companies Tribunal or CIPC to resolve the matter by consent order
- Commence proceedings in court in the name of the complainant, if the complainant:
- Has a right in terms of the Companies Act to apply to the court and
- Has consented to the CIPC or TRP doing so; or
- Report the matter to the National Prosecuting Authority if the person committed an offence under other legislation or

- The CIPC may issue a compliance notice or
- The TRP may refer the matter to the Executive Director who may issue a compliance notice.

A compliance notice may require the person to:

- Cease, correct or reverse any action in contravention of the Companies Act of 2008;
- Take any action required by the Companies Act of 2008;
- Restore assets or their value to a company or any other person;
- Provide a community service (for CIPC notices) or
- Take any other reasonable necessary steps to rectify the effect of the contravention.
- The person who received the compliance notice may object thereto within 15 business days of receipt.

QUESTIONS:

- Which body is normally responsible for the enforcement of the Companies Act?
- Name four alternatives that the Act envisages for addressing complaints regarding alleged contraventions of the Act.
- What are the functions of the Companies and Intellectual Property Commission?
- Who may file a complaint with the Companies and Intellectual Property Commission?
- How may the Companies and Intellectual Property Commission respond to a complaint?
- Discuss the procedure that an investigation of a complaint by the Companies and Intellectual Property Commission will follow.
- What are the functions of the Companies Tribunal?
- What is ADR and to which alternatives does it refer?

NB! Study Unit 10: Partnerships
can be ignored for purposes of the examination

Study Unit 11 – Close Corporations

Please note that this Study Unit will count towards more than 20 percent of your examination mark.

Distinguishing features of close corporations:

- Close corporations acquire legal personality upon incorporation.
- Legal personality is acquired upon registration of the founding statement.
- Close corporations enjoy perpetual succession, which means that the entity exists separately from its members and changes in membership will not influence its future existence.
- Sometimes the court may be called upon to “pierce the corporate veil” or disregard the separate legal personality of the close corporation.
- As close corporations were intended mainly for small businesses, the number of members is limited to 10.
- Only natural persons are permitted to be members of a close corporation.
- A company or another close corporation may not be a member of a close corporation.
- A minor, insolvent or person under legal disability may become or remain a member of a close corporation with the necessary assistance from a guardian, trustee or the court.
- A trustee in his or her capacity as trustee of a testamentary or *inter vivos* trust may become a member of a close corporation. However, the restriction in membership to the maximum of 10 members still applies.
- Should the membership of a close corporation change, an amended founding statement must be lodged for registration.
- The Close Corporations Act 69 of 1984 regulates close corporations. Upon incorporation of the Companies Act 71 of 2008 certain section of the Close Corporations Act 69 of 1984 will be amended. However close corporation will continue to mainly be regulated by the Close Corporations Act 69 of 1984.

QUESTION:

What are the advantages connected to close corporations as a business form?

The Future of Close Corporations:

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

- Provision is however made for close corporations to convert into companies.

Membership:

Characteristics of member's interest:

- Members' interest is expressed as a percentage (out of a total of 100%) in the founding statement.
- Members' interest may not be jointly held
- The aggregate members' interest must at all times add up to 100%
- A members' interest in a close corporation is similar to a share in a company
- Members' interest is an incorporeal, moveable thing
- Members' interest is a personal right to share in the profits of the close corporation after its creditors has been paid.

Member's interest can be acquired by:

- becoming a member upon registration of the founding statement (no longer possible)
- acquiring member's interest from existing members
- making a contribution to the close corporation.

Disposal of a member's interest

The disposal of a member's interest is largely controlled by the members.

Requirements for disposal of a member's interest

- must be made in accordance with the association agreement; or
- with the consent of all members.

Death of a member

- A member may bequeath his or her member's interest to his or her heir or legatee in a will.
- Transfer of the member's interest to the heir/ legatee may however only occur with the consent of the other members.

Should the members not permit such transfer, the executor of the estate may:

- sell the member's interest to the close corporation
- sell the member's interest to other members
- sell the member's interest to a third party subject to the other members' pre-emptive right to purchase the member's interest.

The monetary value will thereafter be paid over to the heir or legatee.

Insolvency of member

- Section 34(1) of the Close Corporations Act 69 of 1984 prescribes a mandatory procedure for disposal of an insolvent member's interest.
- The purpose is to balance the rights of the other members against the rights of creditors of the insolvent member's estate.

If a member becomes insolvent, the trustee may realise the member's interest and do one of the following:

- sell the member's interest to the close corporation
- sell the member's interest to the other members
- sell the member's interest to a third party subject to the other members' pre-emptive right to purchase the member's interest.

The monetary value will then be paid over to the creditors.

Attachment and sale in execution

Section 34A of the Close Corporations Act 69 of 1984 applies in instances where a member's interest has been attached after judgment is taken against the member. The member's interest may then be sold to the close corporation, other members or an outsider subject to the right of pre-emption in favour of the close corporation and other members.

Internal relations in Close Corporations:

Association Agreements:

Regulate internal relations.

- An association agreement is not a prerequisite for the formation and running of a close corporation.
- The members of the corporation may change provisions to suit their specific needs in an association agreement on condition that such changes are not inconsistent with the Act.
- Association agreements must be signed by all members.
- Certain matters are unalterable:
 - Disposal of insolvent member's interest
 - Who is disqualified from participating in management and
 - The right to call a meeting
- Alterable provisions include:
 - The rights of the members to carry on business and manage the close corporation
 - The requirements are for making a decision and voting
 - The procedure and proportions for payments to members.
 - The manner in which members will settle disputes.
 - The procedure to be followed at meetings.
- An association agreement is not lodged with the Registrar and is not a public document. However, should such an agreement be concluded, it must be held at the registered offices of the business.
- No stipulation in contravention of the Close Corporations Act 69 of 1984 which is included in the association agreement will be valid.

Loans and payments to members: Section 51

- Loans can only be made to members if written consent is given by all the other members and the solvency and liquidity requirements are complied with.
- In terms of section 51(2), a member is liable to the CC for any payment received contrary to any of the solvency and liquidity requirements.
- In circumstances where the CC is wound up because it cannot pay its debts, the onus is on the members who received payment from the CC to prove that the solvency and liquidity requirements were met, provided that the payment took place not more than two years prior to the commencement of the winding-up.
- If the members cannot show that the CC satisfied the solvency and liquidity requirements after the payment was made, the members will be liable to the CC for the payments made by the CC to them. The members will therefore be required to repay the amounts paid to them by the CC.
- Note that section 51 applies only to instances where payments are made to members in their capacity as members and not if the payment is made to a member in his or her capacity as a creditor.

Activity:

Jane and Jill each hold a 50% member's interest in Flight of Fancy CC ("FOF"), a catering business. In June 2010, FOF makes an equal cash distribution to both Jane and Jill utilising profits from the previous financial year. In July 2011, FOF is wound up on the basis that it cannot pay its debts. Will Jane and Jill be liable to FOF for the payment each received from FOF?

Duties of members:

- fiduciary duty (duty of good faith) in terms of s 42 of the Close Corporations Act 69 of 1984 and
- duty of care and skill.

Fiduciary Duty

A member's fiduciary duties towards the close corporation are similar to the fiduciary duties that a director owes to a company.

Section 42 of the Close Corporations Act 69 of 1984 provides that a member should:

- act honestly and in good faith and in particular
 - exercise powers to manage or represent the corporation in the interest of the corporation;
 - not act without or exceed such powers;
- avoid a conflict of interest between his or her own interests and those of the close corporation and in particular
 - not derive any personal financial gain to which he or she is not entitled by virtue of being members of the close corporation;
 - disclose any material interest in a transaction to the other members of a close corporation as soon as possible
 - not compete with the close corporation's business activities in any way

Contracts concluded between member and close corporation:

Should a member have a material interest in a contract of the close corporation, it must be disclosed to the other members and all material facts regarding the interest must be divulged as soon as possible.

Should a member fail to disclose his or her interest, the contract would be voidable at the option of the close corporation. Application can, however, be made to the court to declare the contract binding upon the parties despite failure to disclose.

If fiduciary duties are breached a member may be held personally liable for any loss suffered by the corporation or debts incurred as a result of such a transaction (s 42(3)). The member would then have to repay any profit made by him or her.

Duty of Care and Skill (Section 43 of the Close Corporations Act 69 of 1984)

A member will be liable only if the close corporation suffers a loss as a result of the breach of this duty (s 43(1)).

The member's conduct is measured against the conduct which could reasonably have been expected from a person with the same level of skill and knowledge as the member (to establish negligence).

If there has been a breach, of the duty of care and skill another member may institute action against the close corporation or its members in his or her personal capacity.

Question:

Discuss the nature and scope of the fiduciary duties of members of a close corporation and the consequences of breach.

Remedies:

Remedies available to members of close corporations:

Termination of another members' interest:

Section 36 of the Close Corporations Act 69 of 1984:

In terms of **section 36 of the Close Corporations Act**, a member(s) may apply for the termination of another member's membership by order of court. In order to do so the member(s) will have to prove:

- That the member is unable to perform his/ her part in carrying out the business.

- That the member's conduct is likely to have a prejudicial effect on the carrying on of the business of the close corporation.
- That the member's conduct has made it reasonably impossible for the other member(s) to associate with him/ her in the carrying on of the business of the close corporation.
- That In the circumstances it is just and equitable that such a person should cease to be a member of the close corporation.

Relevant information relating to how the members' interests in the close corporation should be adjusted once the person's membership of the close corporation ceases should be presented.

The court may then order cessation of a member's membership and make any order it deems necessary regarding the disposal of the member's interest.

Protection against unfair and prejudicial conduct

Section 49 of the Close Corporations Act 69 of 1984: Personal action

- A member may institute an action where there was a single act or omission in the conduct or affairs of the business by the corporation or other member or members which was unfairly prejudicial to such member.
- The court will only intervene if it is just and equitable to do so.

Section 49 of the Close Corporations Act is available to a member whose rights are unfairly prejudicially affected, or aware of other members so affected by the close corporation's conduct or the conduct of one or more of the other members. The court may make any order that it deems fit to remedy the situation, including:

- The aggrieved act or omission be stopped;
- The corporation must amend the founding statement or association agreement;
- The corporation be wound up.

In *Gatenby v Gatenby* it was held that the court enjoys a wide discretion in the order it may make to provide relief to the victim of oppressive conduct. In this case the court ordered the sale of the corporation's sole asset to place the close corporation in a financial position to buy back an aggrieved member's interest.

In *De Franca v Exhaust Pro CC* the court held that it enjoyed discretion to order the purchase of any member's interest by other members or by the corporation if the court finds it just and equitable to do so. The court however requires proof of the value of the member's interest in order to establish a fair price for the member's interest.

Section 50 of the Close Corporations Act: Derivative action

- A member may institute action against another member who **does not comply with his or her duties**.
- This action is instituted on behalf of the close corporation, it is therefore a derivative action and not a personal action.
- The close corporation is liable for the legal costs.

External Relations:

Representation in Close Corporations: Section 54 of the Close Corporations Act

- Members of close corporations act as agents for the close corporation.
 - The doctrine of constructive notice does not apply to close corporations. Therefore, third parties or outsiders are not deemed to have knowledge regarding the content of close corporations' registered documents.
 - Close corporations are in general bound to any contract concluded with an outsider by a member, regardless of whether or not the transaction falls within the scope of the enterprise's main business.
 - A close corporation could however escape liability if the third party or an outsider knew or reasonably ought to have been aware of the fact that the member who concluded the contract on behalf of the close corporation lacked the necessary authority to do so.
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- *J&K Timbers (Pty) Ltd v GL&S Furniture Enterprises CC*: a member is an agent, even though no authority, express or implied, has been conferred upon him by the close corporation and the corporation is bound by the related act, unless the third party knew or reasonably ought to have known of the absence of such power.

Activity:

John, Mike and Dave are members of a CC, with each of them holding an equal member's interest in the CC. Mike and Dave are aggrieved at the manner in which John has been performing his management duties in respect of the CC. They are of the view that John has breached his fiduciary duties to the CC on several occasions over the past year. What is Mike and Dave's remedy in terms of the CC Act, and how should they go about invoking this remedy?

Activity:

Johannes, Phineas and Beauty are the members of Mnandi CC. Beauty discovers that Phineas concluded a contract of purchase and sale on behalf of Mnandi CC for the purchase of a yacht without the consent of the other members. She believes that Mnandi CC should not be held bound to the terms of the contract because the corporation's main business is catering. She also points out that the association agreement stipulates that only Johannes has authority to conclude contracts on behalf of Mnandi CC. Advise Beauty whether or not Mnandi CC will be bound to the contract concluded by Phineas. Refer to relevant case law in your answer.

Auditors in close corporations:

Close corporations are not exempted from financial reporting. An annual financial statement must be drawn up. The annual financial statement must be approved by or on behalf of members holding at least 51% of the member's interest in the close corporation. A report must be drawn up by the appointed accounting officer.

In terms of section 58(2A), section 30(2)(b), and (3) to (6) of the Companies Act 71 of 2008, read with the changes required by the context, apply to a corporation that is required by the regulations made in terms of section 30(7) of the Companies Act, to have its annual financial statements audited. A close corporation will thus be compelled to have its financial statements audited in the same circumstances as a private company.

NB! Study Unit 12: Trusts can be ignored for purposes of the examination.
